1950

How to Improve Accounting &Tax Service to American Business, Complete Text of Papers Presented a the 63rd Annual Meeting

American Institute of Accountants

HOW TO IMPROVE

accounting & tax service

TO AMERICAN BUSINESS

ACCOUNTING PROBLEMS OF MOBILIZATION • FINANCIAL REPORTING

TODAY'S TAX PROBLEMS • ACCOUNTING SERVICE TO SMALL BUSINESS

CLIENT-PUBLIC ACCOUNTANT RELATIONSHIP • INSTITUTIONAL ACCOUNTING

STOCK BROKERAGE ACCOUNTING • OPERATION OF AN ACCOUNTANT'S OFFICE

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HOW TO IMPROVE

accounting

&

tax service

TO AMERICAN BUSINESS

Acceptance address of the new president

by T. COLEMAN ANDREWS, CPA

FIRST, I WANT to thank you for the great honor you have today bestowed upon me. I thank you not only for myself but also for my state and for the entire southeastern part of the country. This is the first time, I believe, that the accounting profession of Virginia and the southeast has been honored by the elevation of one of its members to the presidency of the American Institute of Accountants. Needless to say, you have made this the proudest moment of my life.

I should like to speak briefly about some of the matters that will command our attention as a profession during the coming year. Since you already have received, or will receive, reports on every phase of the Institute activities during the course of this meeting, it is not necessary, and it would not be appropriate, for me to undertake a broad review and discussion of these activities. I merely wish to emphasize some of the matters that seem to me to be of paramount importance.

It must be apparent to everyone that the public accounting profession has outlived its growing pains and now has reached that stage of maturity where it has shed the problems of youth for the responsibilities of manhood. It is no mere boast to say that public accounting has become one of the country's leading professions—not merely because of its numbers, but, rather, because of the magnitude and effectiveness of its contributions to the rapidly expanding economy of the nation.

I think it was natural that the rapid growth and development of our profession should lead to some apparent, if not real, conflict of interests along the way. The measure of seriousness of such conflicts is determined not so much by the heat that they generate as by the wisdom with which they are faced by the parties involved.

One of the principal conflicts that has arisen has grown out of the feeling of our friends of the legal profession that we have encroached upon their prerogatives. Personally, I always have thought that this conflict has been more apparent than real. Nevertheless, the legal profession has openly challenged some of our activities.

I have been proud of the manner in which the American Institute of Accountants has dealt with this matter. We have approached it in a spirit of give and take, through a special task force, and through the National Conference of Lawyers and Certified Public Accountants.

While this conference is not ready to report complete agreement, I believe that agreement is possible. I further believe that it will be achieved, because I am convinced that there is plenty of work to keep both professions busy and that neither profession wants to invade the territory of the other. Joint areas of activity are unavoidable and even desirable. I am satisfied that negotiations will be continued and that mutually satisfactory agreement will be reached.

We have also had basic differences with the uncertified public accountants. It seems to me that we certified public accountants must avoid developing the attitude that the CPA certificate is obtained as a matter of right. This is not the case at all. The certificate is a privilege—one that carries with it heavy responsibilities, not the least of which is the obligation to be alert to the public interest that we serve.

The most rigid tests of fitness to practice public accounting are imposed upon those who seek to call themselves certified public accountants. It is clear that we can take no other position than that those who hold CPA certificates are best qualified for public practice and that this certificate should not be granted to any but those who demonstrate their fitness to enjoy the privilege of public practice by taking and passing appropriate examinations.

Those who demand the privilege of practicing without certification will say that this is a self-serving declaration. This reaction is only natural; so we must expect it. But we must take comfort and courage from our record, and from experience, which clearly shows that the public interest demands that this restriction be imposed.

We have no obligation to those who seek a free ride at the public's expense. We *do* have an obligation to those who aspire to certification to see that the examinations are fair and open to all. We have discharged this obligation with faithfulness in the past, and we will continue to do so in the future.

As public accountants, our principal characteristic is independence. We are, by law, designated "certified public accountants." Thus, the people, in their sovereign capacity, publish to the world that we are possessed of the knowledge and skill required for the examination and formulation of opinions concerning the accuracy and integrity of accounts. More than that, they publish to the world that our characters have been subjected to searching inquiry and not found wanting.

Thus, in effect, the people acting in their sovereign capacity, have satisfied themselves and published that we have demonstrated not only expertness in the examination of accounts but also the strength of character that gives the public the right to rely upon our opinions as to the fairness of the representations of those who have the obligation of giving an account of their stewardships.

These pronouncements impose upon us great and inescapable obligations. From them our independence arises. Deprived of our independence we would be reduced to the status of artisans, and the public would be deprived of a service that has contributed mightily to the unequalled industrial, commercial, and financial eminence that our country has achieved.

There are only two ways by which we can lose this independence. One would be by failure to live up to the standards of skill and integrity that the public has the right to expect of us. I do not fear that this will happen. Our record is too good to warrant anyone's regarding such an eventuality as being even conceivable. Indeed, I think it is little short of remarkable that the instances of lack of skill and integrity are infinitesimal in relation to the vast number of engagements that we handle.

The other way in which we can lose our independence is by bureaucratic usurpation and virtual abolition of our function. This I do fear. The trend of political thinking and action leaves me no alternative. We must, therefore, be alert to the danger that lies in this direction and firmly resolve to resist with all the vigor that we possess any and all proposals that threaten to take away or diminish the mainstay of our usefulness.

This is not just a question of selfish interest. It is much broader than that. It is the age-old question whether as a people we are going to support and control the government or let the government support and control us. There is no middle ground; it is always one way or the other. Man is either completely free or he is not free at all.

Man has no more mortal enemy than autocracy. Hence, in resisting any effort that the government makes to take over our function as a profession, we not only defend our professional independence but also add our strength to the defense of freedom and against the tendency of all government to become absolute, autocratic and tyrannical.

Nor does our duty end there. The public has a high regard for our opinions about management and finance, not only as to private enterprise, but also as to public affairs. The public has a right to look to us for guidance and counsel in the administration of public funds. Today we of the United States stand committed to the expenditure of billions of dollars every year at home and abroad for the sole purpose of protecting ourselves and our friends from the onslaught of communism. Never before in all history has a people taken on such a burden. The people have a right to expect us, as certified public accountants, to cry out when we see these public funds wasted in duplication and thrown away on nonessentials. Time and time again in recent months I have been asked: "Why don't you public accountants speak up?" Now it is our professional duty to speak up. It is our professional duty to help find ways to insure the people of our country that they are getting what they are paying for.

We devoutly hope that the Korean emergency is nearly over. But we are already in a deeper and even more serious emergency which may last for years. We might as well recognize now that "emergency" has become "normal." For the first time in our national history, we are going to have to maintain a large-scale military establishment on a permanent basis. We have not even begun to realize the effects this will have on our national economy and on our daily lives.

When an emergency becomes permanent, it cannot be handled with improvisations and half-measures as the government has been doing for most of the last twenty years.

Unsound fiscal policy will bring about the very collapse the Russians are counting on to win the cold war.

Because we are a very rich country, we have been able to stagger along under a burden of waste and inefficiency which would have wrecked any other country in the world—which has wrecked some other countries. We cannot afford it any longer.

As an accountant who has devoted a great deal of time to the study of federal government finances, I think I know what I am saying when I tell you that the accounting system of our national government would not be tolerated in any successful business in the United States. There has been a little improvement recently, but not nearly enough. The government does not yet have a budget which tells us what our money will be spent for and how much the various items will cost. We do not have an accounting system which tells us where the money has gone after it has been spent. And it is not merely the people who don't know. Government officials themselves don't know—and can't know, with the system we have now. We need not only improvement in techniques, but a strengthening of the system by separation of auditing and accounting. Unless we get sound accounting for the federal government, and get it soon, we just will not be able to stand the strain of our arms program over the next few years.

This program calls for sacrifice, not only on the battle front, but also on the home front; and I suggest that cold war or hot war, recurring "police actions," or continuing global conflict, we are in for a long period of sacrifice. Let us, therefore, individually and collectively recognize the situation for what it is and *meet* it—not with mere sighs of distress, nor with the whimpering of irresolute weaklings, but with the defiance of courageous and provident men, aware of the priceless benefits of freedom, instantly and bristlingly responsive to every threat to our enjoyment of it.

We are told that we must take in our belts. All right, let's tighten them a notch or two; and let's be prepared to keep on tightening them until our bellies are so thin that fluoroscopes will become useless. But let's demand the same thing of the government.

We also are told that, for a time at least, we may not expect "business as usual." All right, let's cut back in that department of our lives; and let's be prepared to keep on cutting back until every moment of our time and every ounce of our energy is devoted to defense, if that becomes necessary. But let's demand that those who call upon us to make this sacrifice give up "government as usual" and reconcile themselves to giving up more and more of it until the security of our way of life is assured.

Higher taxes? All right, so be it. But let's demand that public funds be spent for things we really need, without waste or duplication. We cannot carry the burden of defending ourselves and a large part of the rest of the world and carry also the burden of inexcusable waste and extravagance in the organization and management of our nondefense internal affairs without eventually breaking our backs.

Senators and Congressmen of the greatest knowledge and soundest understanding of the nation's fiscal affairs—of untainted devotion to our form of government—and of the highest competence and integrity—assure the people that the budget can be balanced without injury to any essential activity of the government. Many of us of the public accounting profession long have been of this opinion.

With the financial stability of the government now hanging in the balance, and with the survival of modern civilization at stake, it is high time that we and others throughout the land demand that the government cut out the frills, get down to essentials, and devote itself seriously and honestly to the job immediately at hand.

It also is high time for the government to recognize—and we should demand that it recognize—that it cannot continue to make a whipping boy of business in time of peace and expect business to continue to perform the miracles of production that saved our necks in World War I, again in World War II, and yet again in Korea. We should not allow an instrument of defense which, in a matter of days, converted mere blueprints into the rockets and tanks that turned the tide of battle in Korea to be so shabbily and ungratefully treated.

This is not to say that the government alone is sinful and that a brilliant halo encircles the head of business, for business has indeed behaved badly since the Communists struck in Korea on June 25th. Overnight the prices of many commodities were raised to unconscionable and unjustifiable levels. This wasn't just normal operation of the law of supply and demand. It was the old grab game of demanding what the traffic would bear in a seller's market.

Immediately labor began to demand a cut in the take, the spiral of inflation started all over again, and the consumer, who has been taking it on the chin all too long, was again forgotten. Freedom isn't preserved by destroying it. Hence I say that the government should get off of the back of business. But while we are demanding our due from the government, we also should remind business that it is pretty hard to help a fellow who doesn't try to help himself.

If we are faced with a long period of strengthening our defenses, as most certainly we are, let's cut out all the frills and furbelows, tighten up our belts, and get down to the business of defense. Unless matters get a lot worse than they are now, we won't need controls if everyone—the government, business, labor, and you and I—play the game according to the rules of good sportsmanship.

Particularly must we purge ourselves of the sins that we have committed in the name of "social justice," get down to bare essentials, and devote all our resources and energy to defense. There never was a greater miscarriage of justice than our resort to force people to do "good" by law: personal goodness simply cannot be achieved by legislation, and, as Admiral Ben Morrell recently put it, people who advocate this course "lack faith in God and in their fellowmen."

Therefore, let us get down to the basis of "billions for defense, but not one cent for deficits."

T. COLEMAN ANDREWS, CPA, the newly elected president of the American Institute of Accountants, has served as vice president of the Institute and as a member of its council, executive committee, and many other committees, including those on cooperation with the bar, budget and finance, cooperation with the SEC, and National Defense. He also headed the Institute committee on federal government accounting in 1948–49, and, as a member of one of the Hoover Commission's task forces, had a major role in the preparation of its report on government accounting.

Once the Auditor of Public Accounts of Virginia, Mr. Andrews later became the Comptroller and Director of Finance of his home city of Richmond, Va. During the last war he served with the Fiscal Director in the office of the Under Secretary of War, in the Contract Renegotiation Division of the Navy Department as Chief Accountant and Transportation Director of the North African Economic Board, and as an officer on the General Staff of the fourth Marine Aircraft Wing in the Pacific. He was called back to Washington after thirty months overseas to organize and head the Corporation Audits Division of the General Accounting Office. It was his work in this post that brought him the 1947 annual award of the American Institute of Accountants for outstanding service to the profession through service to the public. Mr. Andrews heads his own CPA firm.

The keystone of national security—

a sound global plan

by H. STRUVE HENSEL

ONE PRICE OF VICTORY in Korea is the danger that the lesson of that war will be entirely missed. As we glory in our amphibious conquest of Seoul and the collapse of the Reds our memory seems proportionately too dim with respect to the grave mistakes which lost us many men and much material. The shamefaced worries of last July and August are forgotten. The dead are gone. The wounded are tucked away in hospitals. The widows and orphans have been promised "due care." The battle-exhausted men have been rested. We either remember nothing or we believe completely in the trite maxim: "All's well that ends well." Yet that is the refuge of those who never learn. Are we really that stupid? Our margins between victory and defeat have at times been extremely slim. Korea was no exception. If, by an unhappy spin of the wheel, a war should end adversely, the disaster would be too complete. Are we going on forever blithely risking our security?

It is time that we, the people, examined our future. It is also more than appropriate that frank security discussions should originate with us. Collectively, we have far more to lose than our politicians. Collectively, we possess far more intelligence than our few governmental officials. It will be our sons and brothers who will be called upon to risk their lives. The burdens of taxes, controls, and shortages will fall most heavily on us. Furthermore, politicians are never so inspired as when they are stimulated by an informed and vocal electorate.

The first big flaw in our armor, as disclosed by Korea, was faulty intelligence. From the first day, no one could understand how the Red Koreans ever concealed on the 38th Parallel a concentration of 150,000 men with their guns, tanks, and trucks. We can forget for a moment the years of preparation. Now, after the report of the United Nations Commission on the subject, we know that the concentration was perfectly obvious for months to all except those who would not believe what they saw. Unfortunately, we had such mentally blind men in just the wrong spots. As a result, the top men in our Central Intelligence Agency have been changed. Whether the failure was one of evaluation methods and system as well as of men remains to be seen. In any event, that defect has been recognized and improvement is being sought.

The other and far more serious fault was a complete lack of over-all integrated strategic planning. This basic defect is so fundamental that it is escaping attention. Instead we are shuffling personalities around—criticizing our military preparedness and production—appropriating billions—and slapping on controls and taxes. We are preparing to mobilize manpower and industrial production. But, lest elections be unduly influenced by events, full-scale mobilization will be delayed until sometime in November.

But just what sort of strength are we going to mobilize? Will we concentrate on the Army, Air Force, or Navy? How much of our industrial capacity will we convert? How, when, and where is this great strength to be used? Does anyone know just where we are going or how we intend to get there? The answer is clearly negative. We have no plan. We are trying to prepare for the

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vague indefinite. There lies our greatest danger.

Before Korea, it is clear that we had no over-all plan. Instead, we had a melange of half-conceived plans, uncoordinated and not thought through. No program could be more wasteful, more confusing, and less effective. As a result, many men died.

Last year about this time, our announced policy was to leave the South Koreans to their fate. We encouraged—if we did not inspire—the United Nations suggestion that we leave Korea to its own salvation. Some of our optimists were testifying—a few weeks before the explosion—that South Korea, abandoned to its own resources, could safely defend itself. In any event, none of our officials would publicly admit any danger of our becoming involved. Militarily, we were told, Korea was not an essential post to hold. That seemed definite even if somewhat strange. The Russians could almost sue us for misrepresentation.

Then came a surprising day last June. The Reds crossed the 38th Parallel to begin their campaign of aggression. In a flash, our people were aware of the over-all strategic importance of resisting the Communist invasion at its start. Purely military considerations were clearly subordinate. We had to fight. Our leaders were not so quick. It took them many sleepless hours to reverse our prior policy and to accept the Korean challenge. Had our strategists ever had a real over-all plan, we would have realized last year that Korea, irrespective of its military significance, could not be abandoned to Russia. If we had planned intelligently, our military leaders would not have been caught flatfootedly unprepared.

Last October, in 1949, General Bradley told the House Armed Services Committee that the military planning of the Joint Chiefs of Staff had to be based on "assumptions" as to our international objectives. Think for a moment of the enormity of that admission of the complete lack of comprehensive planning! It was like planning the equipment for a vacation without being sure of where one was going. The lack of planning thus admitted by General Bradley was confirmed by the Report of the Armed Services Committee. By an overwhelming bipartisan majority, such Committee found that the confusion and disagreement among our military men—generally called the First Battle of the Pentagon—stemmed from the lack of top-level strategic direction. For all the attention it received, that Report of Chairman Vinson's Committee might as well never have been written.

Last year we were opposed to rearming Germany. We seemed to recognize the Russian threat in Iran, China, and some part of Asia but, in spite of the Siege of Berlin, we dealt with Germany as if Hitler were still alive and dangerous. Today—but only after Korea—we are talking of arming the Germans. Although we once thought it unnecessary, we have now guaranteed the territorial integrity of Western Germany. We seem at last to understand—what was obvious years ago—that, if Russia can be excluded from the industrial production of the Ruhr, the Russian war machine has a latent, if not an immediate, weakness. Since we are just beginning to see the light, it is obvious we had no plan, except the general idea that we must spend money. Yet it was clear years ago that a powerful Western Europe would be the greatest barrier to Russia's aggression.

China has been lost to us. Whether that unfortunate result could ever have been prevented by our action is debatable. Nevertheless, our policy in China was so wavering and so weak that we never had a real chance. We fiddled with theories of agrarian reform and tried to force coalitions of friend and foe. We gained neither the affection nor respect of either faction. We still do not know what to do.

The strategic importance of Formosa is now obvious. Yet not so long ago we thought otherwise. Even today that patent importance cannot be mentioned by any officials answerable to the President.

It is not that we always make the wrong decisions. On balance, if one waits long enough, our record is good. But that qualification—"If one waits long enough"—is important. We never plan ahead and we waste an irreplaceable wealth of men and substance. Some day we may be too late. Wars are not sporting events. Sometimes there is no return game next week.

This Administration has not invented our characteristic lack of over-all strategic planning. That has been a national habit for centuries. Yet this Administration, which should have learned so much in the last World War, is starting its mistakes just where we began the last time. But distances in this more modern world have become shorter. Time has been almost obliterated. Lack of over-all planning is a far more serious sin than ever before.

One organizational lesson learned in World War II is the absolute necessity of focusing our diplomatic moves, our military strength, and our economic resources on predetermined objectives, in other words, coordinating our actions and our resources in accordance with a global strategic plan. To accomplish that result, Congress established the National Security Council, consisting of the President or Vice President as Chairman, the Secretaries of State and Defense, and the Chairman of the National Security Resources Board. The Security Council was to have an aggressive and imaginative staff of experts. The concept of the late Secretary Forrestal was admirable. Our sinews of policy were to be woven together on a global basis. Never again would we fail to know where we were heading or how we expected to get there.

Furnished with the organizational machinery to prepare a global and unified plan, we still missed the ball. The Security Council has never functioned as was intended. The President and the Vice President have been absorbed with domestic political questions. Until recently, they asserted that peace was never nearer. The Secretaries of State and Defense have neglected the Security Council and opposed each other. The Department of State has organized its own competitive Strategic Committee on an Assistant Secretary level. The expected staff of brilliant experts consisted before Korea of less than twenty-five people, including stenographers and messengers. Such a council could not formulate a global strategic plan even if it had desired. That is a job for a dynamic, imaginative, experienced, and self-starting body. No wonder Bernard Baruch suggested the creation of another body of outstanding men to sit in continuous session and to plan our security! Although the crisis is now upon us, the Security Council has not been put on a going-concern basis and Baruch's suggestion has been ignored.

None of us would try to build a house without a blueprint. International affairs are even more complicated. None of us would sail with a sea captain who had not mastered navigation and charted his course. No responsible lawyer would try a case without a trial plan, outlining the tactics to be pursued in every possible eventuality, and the cases which might be cited at every turn would be listed and digested in the margin. Why is it that our international statesmen—dealing daily with our future and freedom—proceed entirely by ear without an over-all plan? Why has no one raised his voice to cry, "Just where are we going and just how do we expect to get there?"

This global plan of strategy, which is so neglected and yet so vital, is far broader and far more fundamental than a military war plan. It is the foundation concept of diplomacy from which war plans stem and not the other way around. It is something for statesmen and not generals or admirals. It is the basic program of our national conduct for peace if possible, and for war only when the other planned moves have failed to achieve our essential objectives without conflict. It is the master blueprint of those objectives combined with an appraisal of their relative importance. It is a current estimate of the world situation in the light of the strengths and weaknesses of our enemy and our possible allies. It is a catalog of our available resources and of those which may be denied to us. It is a plan for coordinating our power—industrial as well as financial, military, and diplomatic—to strengthen ourselves and our friends. It is also an advance analysis of the possibilities and probabilities which may come to pass and a determination of the steps to be taken in each event. It must be global in scope and endless in time. That is a large order for any plan but the needed over-all plan is the strategy of our relations with the rest of the world now and tomorrow, in peace and in war.

A sound plan of global objectives will answer many questions, for the diplomats and the military men. What should we try to accomplish in the world? How can we best achieve those ends? Where are the danger zones? In what order will they probably be faced? How can our position be improved? What moves of the enemy must be resisted at all costs, what moves can be met successfully without war, when should we yield? At what point is war avoidable, at what point our only recourse? What objectives must be preserved in spite of war? Those are not military questions. They involve over-all strategy which may win without war and yet will indicate the probable outlines of the war if it must come.

There are also many internal facets to an over-all strategic plan. Military strength depends on our manpower and industrial capacity. Military leaders are, therefore, relatively helpless unless the mobilization of the countless factories and numerous skills is unified and soundly programmed. Material resources must be conserved and allocated. Substitutes must be developed for materials which may come under enemy control and which cannot be satisfactorily stockpiled. Transportation and communications facilities must be shaped and augmented in accordance with a central theme. The present efforts to scatter those activities among the many governmental departments with a single coordinator at the top will fail just as it did in the last war. Is there no one in government who remembers the frustrating confusion which hamstrung our industrial efforts until the master agency—the War Production Board—was created? Our present approach has no central ignition system and no unified transmission. If the many wheels move in the same direction, it will be coincidence and not plan.

Externally, unity and comprehensiveness in planning are more vital than ever. We may well have split into two worlds instead of the one world conceived by the late Wendell Willkie. But there is still only one globe and Willkie was right at least in his belief that all international problems are interrelated and that none can be dealt with singly. This is even more true as Russian aggression and intrigue have spread. We can no longer have one German policy, another Chinese policy, and a third Russian policy. We cannot even have separate European, Asian, South American, or African policies. We must have a single global policy and a single global plan. We must know in advance the relative importance of Korea, Iran, Germany, and Indo-China. What we do in respect of Formosa and Japan must be consistent not only with our basic objectives but also with our policies in Western Europe, India, and Iraq. Our relations with South America must be fitted into that over-all plan. The Marshall Plan, the Truman Doctrine, the North Atlantic Pact, the Accord of American Republics, and our Pacific program must move in unison according to a master design. The day of separating our dealings with other nations into separate and unrelated compartments is over. In a planning sense, the two worlds are still one.

Given a sound over-all plan, there is real hope that we may attain our goals of freedom and peace without war. Otherwise, combat seems inescapable. Much will depend on the allies won to our cause and the extent to which opportunistic prospective belligerents may be induced or forced to remain neutral. Intelligent propaganda and the spread of mutually beneficial trade, the interchange of ideas on a basis of mutual respect, the engendering of confidence in the other nations, including our enemy, that we know where we are going and intend to get there—all those means of influence must be hitched to the central machine. We can, if we plan, make the anti-Russian world so strong that Russia must behave. Present economic and military strength must be designed to persuade and convince as well as to crush. The world has learned that the United States can, given time, become most powerful. The world must also be made aware that we are currently strong enough to stop aggression wherever it shows itself. Our strategy must also be designed to check Russia's infiltration of the rest of the world at every step. Wars can be won before the first shots are fired.

Guided by a master strategic plan, our military preparations can be given a sounder base and a relevant arsenal. Our generals and admirals, knowing our basic objectives and the foreseeable areas of conflict, will be able to plan for the more likely probabilities rather than force to guess about military tactics in a vacuum. If in October last year General Bradley had not thought that Korea was unimportant, he would never have asserted that amphibious landings were a relic of the past. That was a military blunder predicated on a strategic mistake, but military men should not decide over-all strategy. If our leaders had any real understanding of the globe, there would never be any loose thinking, much less public talking, of the Marines as a mere police force. Carriers would not have been relegated to the boneyard. The Air Force would not have concentrated its preparedness on long-range, high-level bombing of strategic centers, to the neglect—in comparison at least—of tactical air support of troops in the field. Heavy and effective tanks would have been in the field as well as in the arsenals and in the factories. You probably have heard how the Navy, to combat the Russian tanks in Korea, developed in 24 days a revolutionary shaped-charge 6.5 antitank rocket. That was a miracle of design, production, and logistics, but also a dramatic exposé of faulty planning.

Sound military plans are impossible unless the military men are given guidance by an outline of our world plans. And if we try to evolve over-all global plans from purely military plans, we will be reasoning backward. Secretary Johnson tried that approach and it is hoped that his successor will avoid that mistake. For the sake of our security and the avoidance of waste, let us take some of the guess out of military planning. Let us tell our military men whether Iran and Indonesia may be vital, how far we will go to protect Western Europe, whether we must be prepared to preserve the tin and rubber supplies in the Far East, whether Formosa, the Balkans, and North Africa are to be defended at the risk of world war. The answers to those questions, much more than any theoretical discussions of air power, sea power, and land power, will determine whether we will be concerned with carriers, amphibious landings, or large-scale land operations, guerrilla infiltrations, or area bombing.

A master over-all plan will do more to end the confusion in Pentagonia than all the big sticks in the District of Columbia. We will never be militarily prepared to fight everywhere and every conceivable type of action at once. There must be priorities of programs; determinations of the relative importance in early and later stages of weapons and tactics; carriers, landing craft, tanks, and long-range bombers; area bombing, amphibious landings; and strategic retreats. If we try to mobilize for every type of warfare everywhere at the same time, our industrial system will fall apart at the seams and our financial resources be exhausted in very few years. The struggle to check aggression will be defeated by its own ineptitude. For once let us plan intelligently before we waste our substance unnecessarily and dangerously. We have a lot, but there is a bottom to our barrel.

A sound over-all plan must not only be comprehensive. It must be most flexible. A too-rigid plan can be almost as bad as none. That was the mistake made by England in 1914. Everthing was planned to the last detail for the war which did not come. England's 1914 plan had to be thrown away. That is just as bad as our lack of plan for Korea. An effective plan must provide for changes in short-range and even long-range objectives, for shifts in policy as a result of varying degrees of success and failure, for changes in the relative strengths and alignments of our enemy and our allies, and for the counterplay of the programs of our enemy and our friends. Probably no strategic plan in all its aspects survives more than a short time. Major objectives will undoubtedly remain constant but ways and means must be varied with the events of each day. No wonder Bernard Baruch suggested that our master planners sit in continuous session with no other duties.

The necessity of a strategic plan, far above military levels, does not end with the outbreak of hostilities. War is never an end in itself. War is rather a last resort step to achieve national objectives deemed so vital as to make us willing to accept the loss and destruction of combat. If the war is so fought that our objectives are destroyed along with the enemy forces, victory will be empty and the war will have been inexcusably stupid.

We have frequently been dismayed by the paradox of winning a war but losing the peace, as we have come to call it. The truth is that we have more often destroyed the desired fruits of victory by the way we have fought the war. The "unconditional surrender" decision, which enforced the destruction of Germany, is the real cause of the existing power vacuum in Europe. The decision to invade France instead of the Balkans made the Russian domination of Eastern Europe easier. Perhaps such strategic decisions were sufficiently justified by the tempers of the time. It may, however, be that we saved lives and material in 1945 only ultimately to lose more in Korea and elsewhere. In any event, the significant influence of such decisions on the continuing history of the world is now clear. Necessity of over-all long-range planning, above the military level, both in war and in peace, is also proved.

Furthermore, it is not enough for our leaders in star chamber fashion to formulate a master strategic plan, which is never made known. Our major national objectives and the general outlines of our strategy must be disclosed and sold to our people. This need not involve the disclosure of any secrets to the enemy. The more publicly it is known that Russian aggression will not be tolerated and that we are planning intelligently to stop it at clearly defined points, the better for us and all peoples who desire to be free. Not only have the people much to contribute to national planning if they know what is being sought, but the full possibilities of our national strengths are never realized unless the people are unified in concept and program. The present public inertia is much too noticeable. It is not merely that taxes, controls, and sacrifices will be accepted more willingly if we understand and agree. A free people which knows and believes is twice strengthened and twice armed. The forward leap in our security drive after 1941, when we knew, understood, and agreed, startled the world. Frank disclosure of our basic plans will produce the result. For once, we ought to be able to find a sound substitute for another Pearl Harbor.

Whenever there is widespread national confusion and uncertainty, there is usually some fundamental error. Being more emotional as a people than analytical, we tend to concentrate on visible unsatisfactory results rather than basic causes. Some of us attack the Chinese policy, others the German policy. Some of us are concerned primarily with the Middle East, others solely with Europe, and still others solely with Asia. There are many who regard air power as the panacea, others who believe preventive war is the only way to cut the Gordian knot. The very confusion should provide the clue to the basic flaw. There is no master plan. We cannot wait to meet each Korea as it arises.

Once our lack of over-all planning is recognized by the people, we will be on the upward road. Our politicians are our servants and their ears are tuned for our wave length. Once they know that we know, they too will know. We are entitled to intelligent service, and, if we insist upon sound planning, we will get it. Our government never is any better than we want it to be.

Accounting problems in mobilization

by LIEUTENANT GENERAL E. W. RAWLINGS

WE HAVE EMBARKED on a program of preparedness which we all sincerely hope will lead us away from and not toward war. The horrors of the last war are still too vivid in the minds of this generation for it willingly to engage in what cannot but be the risk of catastrophy to our civilization as well as our economy. However, our country has been forced to recognize that it is impossible to live in a world divided as sharply as this world has become, with the opposite side an armed camp, and our country and our allies relatively unarmed and unprotected. As a result, we have been compelled to enter upon a program of restoring our arms and armour. The extent and import of this may not be known to all of you, and I will try to bring you up to date.

Congress has appropriated in the fiscal year 1951 original and supplemental acts $13.2 and $11.7 billion, making approximately $25 billion to cover the cost of the national military establishment, your military departments. In addition to that, it has appropriated $5.2 billion for assistance to our allies and $800 million for atomic energy. That gives us a total authorized to be spent in this fiscal year for defense and related activities of over $31 billion. That is almost twice what we spent on our Army and Navy in 1917, '18, and '19, the period of the first World War. It is slightly more than the total expended by the Army and Navy in fiscal years 1940, '41, and '42, when we were preparing for and beginning to fight the last war.

However, we must not lose sight of the fact that the dollar we are spending this year does not buy as much preparedness as it formerly did, any more than it buys as many eggs or automobiles. Reducing the $31 billion to 1939 dollar terms it may not look as large, but we must not forget that it still represents a very substantial part of our national income.

Of this $31 billion, approximately $5.6 billion goes to pay your soldiers, sailors, airmen, and marines. The rest of it goes for operating costs, for research, and other expenses, and chiefly to buy equipment and supplies used and consumed by the military organizations, most of which are purchased from civilian industry. It is in connection with these enormous expenditures that accounting becomes important and that your profession can contribute substantially to our—your and my—defense effort.

Comptroller organizations, in some ways broader in scope and more active than those of many industrial corporations, have been established in all three of the military departments. Admittedly, they are not yet functioning perfectly, nor have they yet produced all the tools needed by our management, that is, our commanders, to derive the maximum return for the funds expended. Nevertheless, we have made and are making long strides in our effort to establish operating controls comparable to the best used in the business world. We have called upon and will continue to call upon members of your profession for assistance, and I would like to add, we appreciate your eagerness to help. Many of you served in the armed forces during the war, and there is the possibility that again you may be called back into the service to provide us with needed technical skill.

In addition to the enormously complex problems of our internal accounting and auditing, with the solution of which members of your group may be able to help us

LT. GEN. E. W. RAWLINGS, Comptroller of the United States Air Force, is the first comptroller appointed in any of the departments of defense, and in that respect blazed the trail for organization of similar offices in other government departments.

considerably, we have also a more direct need of assistance in an area which relates to your regular public accounting operations. It pertains to our procurement costs. Accounting plays a very large part in procurement of military material, most of which, in dollar volume, has relatively little connection with the ordinary products of civilian industry.

Some industries, including most aircraft and ship builders, as well as producers of certain technical items, depend to a large extent upon military business for their daily operation. Yet, to other companies, military business is only a small part of their normal peacetime production. The special tooling and other production equipment required limits decidedly the possible number of interested producers, and reduces the possible competition upon which supply and demand prices depend. Hence, unlike the conditions in the business world, competition cannot always be depended upon to produce the right and fair price. More than ever when, as at present, there is a great increase in the demand for military material, what effective competition there has been greatly decreases, and in time of war it almost disappears entirely. As a result, during periods of active preparedness and war, some means other than competition has been required to establish prices fair to the government. Such prices must also be fair to industry, because a great part of our military strength depends upon the soundness of the free enterprise which supplies our fighting forces with the implements of war.

The cost-plus-a-percentage-of-cost contract was that commonly used before the last war. This put a premium on inefficiency by increasing the profit to the contractor when his costs increased, and therefore was replaced entirely by the cost-plus-a-fixed-fee principle in which the government negotiated in advance a fixed fee to be paid to a contractor regardless of the cost. While far more satisfactory than the old cost-plus-a-percentage contract, this form of contract offered little incentive other than patriotism to a manufacturer to reduce his costs, and the result was that during the latter stages of the war there were introduced so-called incentive and price redetermination contracts in which the contractor was given an opportunity to share in some way in the savings which he might effect. The great part of military procurement is and will continue to be done by some form of contract in which the price is keyed to the cost of production, either directly or indirectly. It is in this field that accounting plays so large a part.

Many people have stated that it is of little importance what price might be paid by the government since our high tax rates, coupled with the concept of renegotiation developed during the last war, provide means for the government to recapture any excessive profits made at the expense of the public. This, however, is fallacious reasoning in my opinion. I believe that the price paid is vitally important because neither taxes nor renegotiation can recover for the government the amounts paid out by contractors for their labor and supplies. Even if one part of that is recovered through taxes, the inflationary effect is enormous. I cannot overemphasize the dangers of inflation which, as I noted earlier, made the present defense dollar worth only about half of the dollar spent for defense before the last war. Further inflation caused by our present military expansion can be disastrous and therefore every effort to hold prices reasonably in line is most important. We are continuously forced to give more and more thought to methods of developing equitable procurement prices through some accounting processes and contractual formulae.

It is in this direction that the accounting profession can be of greatest help. Your cooperation in the development of sound cost-accounting systems for your clients will immensely aid our efforts to determine the price which we should pay. It will facilitate our audits and provide us greater assurance of the accuracy of the figures furnished us by contractors and prospective suppliers. Furthermore, you can greatly assist us and your clients by any suggestions of better means for establishing prices based upon cost than the present cost-plus-fixed-fee, price redetermination, incentive, and other procurement contract forms in use today. Your help and suggestions in this field would be most welcome.

I want to revert for a moment to the \$31 billion to be spent this year upon defense. Although I intimated that this amount reflected inflation and could not be compared directly with previous costs, you must not lose sight of the fact that it is being spent at a time when the armed forces of our country are already at an unprecedented high peacetime level, and there has not been much time for deterioration of the materials which we retained in reserve after the last war. On a comparable dollar basis, our expenditures this year would not greatly differ from those when we were preparing actively for the last war. However, you must remember that in 1941 and 1942 we were starting almost from scratch to recover from twenty years of neglect of our military establishment, but it is necessary for you also to consider that today no small part of the increased cost is due to the great technological developments of the latter part of the war which were perfected during the postwar period. In many respects, these have almost changed the art of warfare. We think ordinarily in this respect only of the atomic bomb, and fail to realize the radical technological changes in many other directions. For example, in my own service, the airplane of today is completely different from the airplane with which we started the last war and as quickly as we can, we are replacing the now outmoded craft with which we ended the last war. For one thing, speed alone has a tremendous effect. In former days, one airplane could shoot at another with ordinary manual sights and manual control of its guns, but with increasing speeds, it became apparent that the human eye and judgment could not keep up and that a man shooting a gun could no longer attempt to "lead" his target. Some mechanical means of calculating speeds and angles had to be introduced, and fire control systems, unknown a few years ago to the aircraft, today represent a very large element of the cost of the airplane. The famous Norden Bombsight of the last war cost us in production about \$3,500. The complicated apparatus for bombing today by radar which permits us to operate regardless of visual conditions and despite enormous speeds now costs over a quarter of a million dollars.

Because of lower volume production, technological changes and inflation, one modern light bomber costs five times as much as its predecessors in the last war. The engines alone on a B-36 cost three times as much as the entire Flying Fortress with which we began the war, and more than an entire B-29, our heaviest wartime bomber. The electronics and armament of a B-36 cost more than an entire B-29. I mention these facts to emphasize to you the importance of industrial costs to our preparedness effort and as further reason for our need of all the help you can give us.

Responsibilities of the contracting officer and related accounting problems

by CORNELIUS LYNDE

IN CONNECTION with the function of the contracting officers, I shall have to cover some of the things that General Rawlings has touched on, but I speak from what can be fairly described, I think, as the working level.

The function of the contracting officer is to negotiate and administer a contract that will produce for the military requirements the articles needed in accordance with specifications in the desired quantities and delivered at the necessary moment and at a price fair to the government and contractor. That is a very broad responsibility, and it is the kind of thing that can't be produced by the mere exercise of command authority. A little bit more than that is indicated.

First as a guidance to the contracting officers, the Munitions Board recently adopted a statement of contract pricing policy, and I would like to run through a few of the suggestions in that in order to relate it somewhat to the accounting profession.

It is implied in this statement that the most desirable form of contract is the fixed-price contract, closely priced. That is, with the price which puts the pressure on the contractor to economize in the use of materials and manpower in order to get the most effective results and thus to increase his profit. Under present conditions, with prices going bouncing off the ceiling all the time, it is quite obvious that that is an objective which will be difficult to obtain.

There is, however, a series of other types of contracts that are permitted, more or less in the order mentioned. The incentive or target-price contract is a device to bring it a little bit closer and apply some more pressure on the contractor for economy in production.

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Fixed-price contracts with price redetermination are permissible. That, under present conditions, is quite important because obviously no one can tell the future prices on all components and materials and probably wage rates, if this present period is to continue long without a more effective system of controls, which seems to be under discussion.

The cost-plus-fixed-fee type of contract is the last one to be used, according to this statement of policy, for the obvious reason that it is very easy to have that drift into nothing but a cost-plus contract. Of course, the auditors, the accountants, are more specifically involved in the administration of cost-plus-fixed-fee contracts than in any other form, but when it comes to the negotiation of the price on either auditing is a very important function.

One of the difficulties we have had in dealing with this problem is a question of semantics. A lawyer talks of an audit and I conceive it to be a certified public accountant's statement made independently concerning a balance-sheet income statement and surplus account. I think the Army and Navy and Air Force, in using that expression, talk about a process. They talk about a process to achieve the result, and if that idea is kept in mind, some of the regulations can be better understood because they are not talking of audit in what might be determined a popular or Wall Street concept. They are talking about a process to get a result.

Where does the accountant come in?

The established procedure followed to the extent possible is for the contractor to submit a statement of his price components, that is, an apportionment of his overhead, an engineering allocation of the materials and manpower and all of the elements and items that go to make up the price he submits. Clearly, audit has to be applied to testing the propriety of the apportionment of overhead and it has to be used on other angles of this approach.

There is an angle, of course, in which the accountants are very much interested, and that is the question of the admissible costs. The cost accounting principles are involved and have been established and there is considerable difference of opinion about them. I don't think those differences are entirely limited to the accounting profession, and you will probably find an echo here and there in the Pentagon. But it seems to me the responsibility for bringing about an acceptable solution of that problem rests more on the members of this association than almost anywhere else. You can talk with much more authority, for instance, to the general accounting office than some contracting officer can.

There is, however, one basic approach which we regard—the section in which I work—as of great importance. Surely, under present conditions—even though the determination be microscopically accurate—finding out historical costs, the record of past events, is not the answer to finding the best kind of a price which will produce economy in the consumption of manpower and materials. It may, under some circumstances where the contractor is producing an article in a competitive field and one which he is accustomed to produce, be of the greatest possible value, a sound basis for the fixing of price, but in many other articles historical costs have less and less effect and should be less controlling.

It seems to me there is a conception in dealing with this matter of accounting which the independent accountants should have in mind. We are all taxpayers. You can recover by taxation and you can recover by renegotiation, but you cannot recover the dollar that goes out and is expended in waste. That is gone. That waste must be reduced if we are able to meet the problem that confronts us under present conditions, and the accounting profession must assume large, and I believe a larger, share of that burden as this thing goes on.

I have been wondering whether it wouldn't be possible for the accounting profession to adopt as professional standards some of the things that are required in proceedings before the SEC. It is my recollection (and it is some time since I have had anything to do with those things) that the accountant is required to report irregularities on matters that might be subject to criticism according to the standards of the SEC. Now, if the independent accountants could adopt some kind of an attitude of that sort in dealing with the accounting problems that they are called upon to solve in connection with procurement, I think it would go very far towards healing a lot of the things that make us trouble. I am hoping that as your professional concepts evolve and continue to grow, as I know they will, something of that attitude can be injected into it.

Questions and answers

MEMBER: *Is there any rule established or to be established determining inadmissible items, particularly with reference to selling expense?*

MR. LYNDE: As I understand it, those rules have been established in the cost principles. The extent to which they are applied is perhaps in some areas a matter of judgment, but nevertheless those principles have been announced, and, if not already included in the Armed Services procurement regulations, they will be. The regulations have not been completed entirely, and I am not quite sure whether that particular subject is included in those that have been finished and promulgated or whether they are still part of the things to be finished, but they will be so included, unquestionably.

MEMBER: *If there is no standard clause in the fixed-fee contract specifying renegotiation, does the general law bring renegotiation up or down into that contract without a specific clause to that effect?*

MR. LYNDE: Certain types of contracts are by law subject to renegotiation, and it is not a mere matter of inclusion in the clauses of the contract.

The fundamentals of statutory renegotiation

by FRANK L. ROBERTS

AT THE TIME Congress enacted the Supplemental National Defense Appropriation Act of 1948, the first of the large military appropriations considered necessary to carry out present national and international policies, it determined that renegotiation should be made applicable to this expanded procurement.

It is, therefore, important that industry have a clear understanding of the principles and procedures that will be followed in the conduct of statutory renegotiation under the Renegotiation Act of 1948.

Statutory renegotiation as established by the Renegotation Act of 1948 will consist of negotiation between boards and contractors subject to the Act in order to determine whether or not the contractor earned excessive profits during a particular fiscal year on its renegotiable contracts. If it is determined that excessive profits were earned, then provision is made for a refund of such profits.

Coverage

The legal basis for the conduct of statutory renegotiation at present is the Renegotiation Act of 1948 which was passed by Congress on May 21, 1948. This Act, which is a part of an Appropriation Act, provides that all contracts in excess of $1,000 obligating funds appropriated or consolidated by that Act (Public Law 547, 80th Congress), are subject to renegotiation. Not only is the prime contract between the government and a contractor subject to renegotiation but all subcontracts, or purchase orders, in excess of $1,000 entered into by a prime contractor or subcontractor to make or furnish any article or perform any work necessary for the performance of the prime contract are, also, subject to the Act.

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The coverage of the Renegotiation Act of 1948 was extended beyond that originally provided when the Secretary of Defense, on June 30, 1948, by virtue of authority contained in the Second Deficiency Appropriation Act of 1948 (Public Law 785, 80th Congress) made subject to renegotiation all contracts in excess of $1,000 for aircraft or aircraft parts which obligated any funds made available for obligation in the 1949 fiscal year. Funds made available for obligation in the fiscal year 1949 were appropriated by Public Law 753 and Public Law 766, 80th Congress. The 81st Congress, in Section 622 of the National Military Establishment Appropriation Act for the 1950 fiscal year provided for renegotiation on a different basis. This Section of the 1950 Military Appropriation Act provides that all negotiated contracts for procurement in excess of $1,000 entered into during the fiscal year 1950, by or on behalf of the Department of Defense (including the Department of the Army, the Department of the Navy, and the Department of the Air Force), are made subject to the Renegotiation Act of 1948. A similar provision is contained in the General Appropriation Act of 1951 with respect to contracts entered into during the 1951 fiscal year. The extension of the Renegotiation Act of 1948 in the aforementioned instances applies, also, to all subcontracts under a renegotiable prime contract.

Of vital importance to the success of the operation of this program is (b) of Section 622 which provides:

(b) Notwithstanding any agreement to the contrary, the profit limitation provisions of the act of March 27, 1934 (48 Stat. 503,505) as amended and supplemented, shall not apply to any contract or subcontract which is subject to the Renegotiation Act of 1948.

This provision, when translated into the language of a layman, makes clear that the Vinson-Trammell Act shall not apply to any contract or subcontract which is subject to the Renegotiation Act of 1948. This action is retroactive to May 21, 1948, the date of the enactment of the Renegotiation Act of 1948.

One further important provision with respect to the coverage of the Renegotiation Act of 1948 is that it does not apply in the event the aggregate of the amounts received or accrued from any contract or contracts or subcontract or subcontracts required to contain the Renegotiation Article is less than $100,000 during any fiscal year of the contractor.

In summary, then, renegotiation applies to certain specific contracts which obligate money made available by Public Law 547, Public Law 753, or Public Law 766, 80th Congress, respectively, and to all negotiated contracts entered into during the 1950 and 1951 fiscal years, when such separate contracts are for amounts in excess of $1,000 and when the contractor has sales under such contracts in its fiscal year aggregating $100,000 or more. In general, since July 1, 1949, renegotiation does not apply to contracts entered into as a result of formal advertising and competitive bidding. In the event that a contractor is subject to renegotiation, the Act provides that whenever, in the opinion of the Secretary of Defense, excessive profits are realized under such contracts, the Secretary is authorized and directed to renegotiate such contracts and subcontracts for the purpose of eliminating such excessive profits.

Delegation and organization

The Secretary of Defense established the Military Renegotiation Policy and Review Board and the Armed Services Renegotiation Board, the latter, a joint board, consisting of three Divisions, to carry out the provisions of the Act. The Military Renegotiation Policy and Review Board members, representing the Army, the Navy, and the Air Force, respectively, are Brigadier General Robert W. Brown, Mr. Richard B. Cross and myself. The members of the Military Renegotiation Policy and Review Board are the Chairman, respectively, of the Army, the Navy, and the Air Force Divisions of the Armed Services Renegotiation Board.

The Military Renegotiation Policy and Review Board has the authority and responsibility to promulgate and publish in the *Federal Register*, after approval by the Secretary of Defense, regulations interpreting and applying the Act, and prescribing standards and procedures for the determination and elimination of excessive profits. It also assigns for renegotiation, contractors and subcontractors to the respective Divisions of the Armed Services Renegotiation Board. The Policy and Review Board examines all determinations made by the three operating Divisions. The Secretary has delegated to it, also, the authority to exempt from renegotiation contracts and subcontracts by general classes or types. The authority to exempt individual contracts rests, respectively, with the Secretaries of the three military Departments within the Department of Defense.

The exemption authority delegated to the Military Renegotiation Policy and Review Board has been exercised in one area which is important enough to justify some comment. I am referring to the exemption from the Renegotiation Act of 1948 of subcontracts entered into on or after January 1, 1949, which are for items customarily purchased for stock in the normal course of the purchaser's business, except when such items are specially purchased for use in performing a contract or higher tier subcontract subject to the Act. This action removed from renegotiation a relatively small segment of business, but one which was very troublesome to all concerned from the standpoint of both administration and equity.

The three operating Divisions of the Armed Services Renegotiation Board conduct renegotiation, make determinations of excessive profits, and provide for the elimination of such profits either by agreement or by unilateral order.

The determination of the Division with respect to each case is subject to review by the Military Renegotiation Policy and Review Board so as to provide for general uniformity in the application of renegotiation principles and procedures. In the case of unilateral action by one of the Divisions, contractors are given the opportunity to have a hearing and review of their case by the Military Renegotiation Policy and Review Board. In such instance the Chairman of the Division who took the unilateral action does not participate in the review.

Military renegotiation regulations

In compliance with the delegation of authority from the Secretary of Defense, the Military Renegotiation Policy and Review Board has promulgated and published regulations prescribing the rules for the conduct of renegotiation under the Renegotiation Act of 1948. These regulations state in considerable detail the coverage of the Act, the procedure for renegotiation, the basis for determining renegotiable sales and costs, and the principles to be followed in the determination of excessive profits, if any.

The regulations are available from the Superintendent of Documents, Washington 25, D. C. The subscription carries with it service for one year covering all amendments, supplements, and periodic lists of contractors and of their contracts containing the Renegotiation Article. A new and collated list of such contracts was published in the *Federal Register* July 13 and will be published later as a supplement to the regulations. This extends the published list through March 31, 1950.

The basic principles to be followed in the conduct of renegotiation are stated in the regulations. They provide general instructions as to procedures and methods for determining and segregating sales between renegotiable and nonrenegotiable business. They provide that all items estimated to be allowable as deductions or exclusions for federal income-tax purposes, to the extent allocable to renegotiable business, will be allowed as costs in determining excessive profits. Of course, the actual calculations of sales and costs will be a much more difficult process than the mere statement of broad principles heretofore set forth. For our purpose, it is enough to point out that the regulations contain the necessary details to give guidance for the actual calculation of renegotiable sales, costs, and, as a result, profits.

The regulations provide that the operations of the contractor will be viewed in the light of six factors for purposes of determining whether or not the profits earned are excessive. These factors are as follows:

(1) Efficiency
(2) Reasonableness of costs and profits
(3) Capital employed and net worth
(4) Extent of risk assumed
(5) Contribution to the national security
(6) Character of business

These are the guiding principles for the analysis of the facts in each case. They form the basis for the exercise of judgment on the part of the renegotiating agency in its determination of the amount of excessive profits, if any, earned by a contractor.

The statutory factors are important and all of them will be considered in all cases. I do wish, however, to emphasize the importance of No. 4 (extent of risk assumed), particularly as it applies to the risk assumed by a contractor as a result of its pricing policy. You will recall that the Military Renegotiation Regulations contain in §424.413-2(b) the following comment with respect to this factor:

> A contractor whose initial prices are calculated to yield a reasonable profit and who revises such initial prices downward when circumstances warrant will be given more favorable treatment under this factor than a contractor who does not follow such a policy.

This statement was carefully considered before it was incorporated into the regulations. We believe that it is an important statement of policy and I assure you that we mean what we say.

Our objective in the administration of the Renegotiation Act of 1948 is not to secure the greatest possible amount of renegotiation refunds. It is, rather, to aid procurement officials to secure material at the lowest possible cost to the government. I am sure that you, who are thoroughly familiar with the operations of our economic system, fully realize that this can best be accomplished by the independent action of contractors through the application of reasonable pricing policies. In the case of subcontractors, it is readily apparent that a proper pricing policy is much more beneficial to the government than a renegotiation refund, because lower prices on the part of subcontractors act to reduce the costs of all who use their products. Likewise, the government benefits more from initial close pricing or prompt revision of prices on the part of prime contractors, because such action makes money available to the government more promptly than through renegotiation refunds. It is because of this, and consistently with our primary objective, that we encourage close initial pricing and prompt revision of initial prices on the part of all contractors. In return for your cooperation in this particular aspect of procurement, we offer more favorable treatment in renegotiation. We believe, in all honesty, that if through your cooperation with respect to pricing we could achieve a situation where no renegotiation refunds are required, we shall have discharged our responsibility completely.

Conduct of renegotiation

Now that we have covered some of the background, let us outline briefly the general procedure which is followed in a particular case.

The Military Renegotiation Policy and Review Board sends out to contractors requests for information as to their status with respect to the Renegotiation Act of 1948. Such requests contain the necessary forms to permit the contractor to indicate whether or not it is subject; and, if so, the extent of its sales and pertinent information about its renegotiable business for the year. This information, when returned to the Military Renegotiation Policy and Review Board, is used as a basis for assigning the case to one of the three operating Divisions. Assignments are generally made to the respective Divisions on the basis of preponderance of the contractor's sales.

Using the Air Force Division of the Armed Services Renegotiation Board as an example, I shall outline the administrative setup. Personnel who conduct renegotiation operations fall into three categories: Board members, renegotiators, and financial analysts. The Board members are the senior officials of the Division and have general supervision over the activities of Division personnel. The Board members, including the Chairman, constitute the group in the Division which determines whether or not excessive profits were earned in a particular case. To aid the Board members to reach a decision, a two-man team, consisting of a renegotiator and a financial analyst, reviews the information submitted by the contractor, secures information from procurement officials, customers and others, holds meetings with representatives of the contractor, and then presents all of the information obtained, together with their recommendation for the disposition of the case, in the form of a report to the Board members of the Air Force Division.

The purpose of this procedure is to enable representatives of the Division to spend the time required to reach a complete understanding as to the facts and figures submitted as well as an understanding of the contractor's operations. Where possible, visits are made to the contractor's plants and in all cases the contractor's representatives are given a full opportunity to present all facts which they deem vital with respect to their renegotiable business. In such presentation we are more interested in the facts themselves than in the form in which they are presented.

Since none of the Divisions of the Armed Services Renegotiation Board has field offices, it will be necessary, in many instances, for contractor's representatives to come to Washington for renegotiation conferences. You may be assured, however, that we will endeavor to hold to a minimum the number of Washington conferences. If conferences in Washington are required, they will be scheduled primarily at your convenience. It may be possible, in areas located far from Washington and where there is a concentration of cases, for us to reduce travel on the contractor's part by holding a series of meetings in the locality.

In order to conduct renegotiation operations, we have been delegated by the Secretary of Defense the right to audit the books and records of any contractor or subcontractor subject to the Act. It is our intention to make use of this power only in cases where fraud is suspected or in cases where agreement cannot be reached as to the proper basis for the allocation of costs to renegotiable business. However, we anticipate that the instance where an audit is required will be few in number.

In order to complete each case, Division personnel, consisting of the team in charge of the case, propose to the contractor's representatives, based on the facts in each case, an agreement for a clearance, or a refund of excessive profits. The contractor's representatives are given adequate time to decide whether or not to enter into the agreement as proposed.

In the event there is no agreement, the government has the right of unilateral action in such case. As I have previously stated, an appeal from the action of the operating Division to the Military Renegotiation Policy and Review Board may be made. At this point, a full and complete hearing by personnel not originally concerned with the case is provided and the original determination may be decreased, increased, or remain unchanged. There exists, under the present Act, the right of appeal to the Tax Court of the United States. It is, of course, our hope that the splendid record of wartime renegotiation experience, with regard to the large number of agreements reached, will continue under the present Act.

The renegotiation operation agencies are established and are actively engaged in the renegotiation of individual contractors. We have, therefore, had occasion to have numerous meetings with contractors. We have been very favorably impressed by their intelligent and cooperative attitude with respect to the disposition of their individual cases. We have found, in general, not only a desired spirit of cooperation on their part, but also a high level of professional competence evidenced in their accounting systems and in the way they have presented, analyzed, or solved various problems in connection with renegotiation.

We, for our part, have a keen sense of our own responsibility in this whole process. We are dedicated to a positive but definitely cooperative approach and treatment of our common problems. Great care is being exercised in selection of our personnel so that we may feel confident that our staff members are well informed, courteous, reasonable, and equitable in their philosophy and application of the regulations under which we operate.

In preparing to administer the Act we have, from the first, followed the policy of securing comments, suggestions, and aid from many different persons or groups interested in renegotiation. These have included procurement officials, contractors, trade associations, wartime renegotiation personnel, and others. The door to the renegotiation office has always been open. It will continue to be so. We can assure you that all comments and suggestions will receive thorough and careful consideration. Such has been the case in the past and will be the case in the future. We, of course, must decide renegotiation policy, based on what we believe to be the best interest of all concerned.

We are ready and willing at all times to give reasonable assistance to contractors, trade associations, or others with respect to their particular renegotiation problems. It is by such action that we can assure the public that a fair and equitable administration of the Act is our only aim.

Questions and answers

THE CHAIRMAN: Mr. Leslie Mills, a member of our committee, will have a microphone in front of him and will assist in the questioning.

LESLIE MILLS: Since the renegotiation subject was put on the program, I received quite a few questions and inquiries from members here and I tried to collate them so we could have Mr. Roberts answer several members in one question. However, as he indicated, the renegotiation activity has issued regulations and they are as complete as the wartime ones which took three years to develop, so a lot of your questions are in the regulations themselves.

There is one general group of questions I got of particular interest to us as professional accountants. These I would like to put to Mr. Roberts.

That is, what does he want and expect our profession to do? He said that he wants to get certified statements when he can over-all, but of course the next problem is segregation. Do you want and expect and hope that the accountant will work on segregation of sales and allocation of costs, or do you consider it a matter between your staff and the contractor? Do you want accountants in on that?

MR. ROBERTS: I would hesitate to recommend outside help.

MR. MILLS: I mean outside regular accountants.

MR. ROBERTS: The use of the regular accountant, I think, is very helpful to us. After all, this is a technical and specialized problem and it takes someone's time to learn it and if it is done by the accounting profession serving many clients, it seems to me to be an economy of time.

MR. MILLS: That sounds all right. There is another general group of questions which seems to be bothering a lot of people on the accounting matter.

Accountants, of course, are supposed to have our own professional opinion on what income is. The Bureau of Internal Revenue, in administering the tax laws, sometimes develops a figure which they call income with which we don't agree. Sometimes, other government agencies develop an income figure with cost and allowances and so on. Now, the question is put to me, what can the contractor do with his accountant when he finds items which are not allowable as tax deductions in the year we are talking about, but we think they belong in the computation of income of government contracts? Can you give us some flexibility on that?

MR. ROBERTS: The regulations provide that the deductions used for tax purposes, and it is implied that they will be in that year, will be those used. However, the regulations also provide that there can be a deviation from the tax accounting by agreement with the renegotiating agency.

We do think that there are special situations which should be handled in a manner other than the straight income-tax accounting.

MR. MILLS: When is that brought up? Does that contractor bring that up with you when he files and say whether he thinks some other accounting methods better reflect government contracts?

MR. ROBERTS: He should bring it up in his dealings with our staff when we are talking about acceptable costs and talking about cost allocations.

I don't like the use of the word methods. As I visualize it, there will be particular items which will lend themselves to a differing treatment. However, a completed-contract basis, in many cases, is the only sensible basis to use and when the information is presented the Board will consider it and if it agrees will approve that method.

MR. MILLS: There is another question that may be on over-all policy, Mr. Roberts, but I think I might put it to you and you can say whether or not you are prepared to talk on it, if that is feasible.

Taking the over-all problem that these other gentlemen have been talking about, I get comments from people in this group that, "What's the use of close pricing and price redetermination and all of that?" When everything is done, the Renegotiation Board comes along and looks at it all over again. The specific question is, as a matter of practice, what possibility is there for a contractor with a government contract in his negotiations with the government getting an agreement that the contract with all these protections provided will be free of renegotiation?

MR. ROBERTS: There is no fixed procedure by which the contractor can, through agreement to accept certain features of a contract, get an automatic exemption from renegotiation.

I would like to point out that the Act provides that the Secretary of Defense in his discretion may exempt contracts either individually or by general classes and types. In his creation of the authority to carry out this responsibility, he has delegated the authority to exempt individual contracts to the Secretary of the three military departments of the Department of Defense. He has delegated the authority for class exemptions to the military Renegotiation Policy and Review Board, and it was under that authority that I spoke about the exemptions, the two exemptions which I went into.

I would like, Mr. Mills, to comment further on your general question. Renegotiation is not designed to perform a critical review and see how many dollars it can take away from a contractor. Its administrators believe in the free enterprise system; they believe a contractor who has justifiably earned a reward for good performance, in accordance with the terms of his several contracts or subcontracts, should be permitted to keep extra dollars. Certainly, that is the only way that a law like renegotiation could be administered to make it fit into our present system.

MR. MILLS: If I may ask one more question which was put to me: A lot of criticism was directed at the last wartime Renegotiation Act because of its annual concept; that is, I believe it came up in the Congress. Sometimes, the contractor lost money on war business in 1943 and he made a profit in 1944. He renegotiated on his 1944 without regard to what happened in 1943. Can you do any better for business this year? The contractor loses money on contracts of 1949 and it looks as though there would be excessive profits in 1950.

MR. ROBERTS: We believe that the statutory factors that have been adopted which provide the measurements of judgment of what is an excessive profit are sufficiently broad to enable that particular problem to receive due consideration. It does not mean the abdication of the annual basis. It means consideration of all factors surrounding a contractor's operation.

MR. PELOUBET: I understand that there is a new Renegotiation Act now in the works. It isn't passed yet, but it has been through some drafting stages. My recollection is that in that Act the raw material exemption is not included, and I would like to ask Mr. Roberts if that is a matter of policy or whether he favors the inclusion of such a provision or whether he would prefer to see a Renegotiation Act without it in there?

MR. ROBERTS: Mr. Peloubet, let me confine myself to a statement of the history of the introduction of that bill.

As you all know, there was in existence a so-called Emergency War Power Act. Title 16 of that Act was the renegotiation provision. Mr. Vinson decided that he would like to introduce a renegotiation bill in connection with the expanded appropriations that were being asked of the Congress and therefore asked the Administration to supply him with a renegotiation bill. Title 16 was lifted out of the Emergency Manpower Act and was delivered to Mr. Vinson who introduced the bill. It, as a matter of coordinated policy of all the independent departments of government, did not contain the raw material or agricultural exemptions to which you refer. I might say that as a result of the hearings before the House Ways and Means Committee, to which the bill was referred, there was introduced in the amended bill an agricultural commodity exemption. So far, there has been no raw material exemption put in the bill.

MEMBER: May I reframe my question to cover the situation? The old Renegotiation Act was primarily a one-way street. As I understand the bill today, it called for renegotiation up or down, depending upon the facts. Has that been an accepted policy that goes through to the Renegotiation Board, or is that a renegotiation phase that is limited to the contract laws?

MR. ROBERTS: I would like to answer that specifically and say that in renegotiation there is no provision for any upward adjustment. You are tending, and it is a danger that we all have to watch, to confuse redetermination of individual contracts and renegotiation, which is a statutory measure designed to view all receipts and accruals from the contractors' renegotiable business. It is the aggregate of all the receipts and accruals under all subcontracts, all prime contracts, and all purchase orders and so forth, and has no relation to an individual contract.

I understand that the redetermination clauses that are available do have provision, in some instances, for an upward as well as a downward redetermination of price.

Manpower problems in mobilization

by WILLIAM M. BLACK, CPA

CAN PUBLIC ACCOUNTING FIRMS expect to get occupational deferments for any or all of their employees? The answer to that question, is "not at the present time," because the accounting profession has not been designated as being necessary to the national health or safety interests. However, the officials of the Institute have visited with and have made application to the proper committee in Washington on Selective Service that occupational deferments be considered. That was done about two weeks or so ago and we do not know what action has been taken, but it will be aggressively pursued.

CHAIRMAN: What are the bases for deferment which might apply to employees in public accounting?

MR. BLACK: There are two principal ones, I think, and it gets down to physical disability or so-called 4-Fs. I do not think we have too many of them in public accounting. The rate of deferment with relation to individuals that have been called up to date on Selective Service has been running about 60 per cent. It has been very, very heavy, and I think the House Armed Forces Committee may take corrective action. That Committee commenced holding hearings on the subject September 28 and 29 and will continue on into this week [week of October 1].

Certain of the things they desire to do away with are to permit deferment only where there are collateral dependents, collateral dependents in their eyes meaning a wife or a child.

So, to answer the question, employees in public accounting have the two bases of physical disability and dependency for deferment.

CHAIRMAN: Will men who have already served in the armed forces be drafted?

MR. BLACK: No. They will not be drafted unless the present Act is changed or unless Congress declares war. I think we are technically in the state of war from the last war at the moment, but it is only if we declare war anew.

Specific exemptions are granted to men in the 19-to-25 age class with certain stated periods of service.

CHAIRMAN: What veterans are returning to the armed forces at present?

MR. BLACK: The ones that are returning are those who have been attached to the active Reserves. Also, certain individuals with highly specialized training. Generally as yet, public accountants have not been taken in that class. I understand that anyone who is in the Marine Corps active service has been taken. Others have been taken as their units are called up.

There is just no specific rule that you can apply, no formula that you can give as to whether an individual is going to be called up or not. It depends on what his unit's place is. In other words, if he is in a particular unit of the National Guard which has been called up, he is going to be called up with them.

CHAIRMAN: Is there any age level above which it is relatively safe to count on retention of employees?

MR. BLACK: I think the only safe level you could consider at the moment is from 35 up. Ages between 26 and 35 are temporarily safe, but at the moment the 35 figure is the one that should be kept in mind.

CHAIRMAN: Can you tell us in what order will men be drafted?

MR. BLACK: That is kind of difficult, but generally the instructions are to take men in the age 25 group first and then start moving down to the 19-year-olds. I might say on

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the 19-year-olds, Major General Hershey, before Representative Vinson's committee on September 28 suggested that age be dropped to $18^1/_2$. They are just not getting the necessary manpower for the draft starting with the 19th birthday.

CHAIRMAN: Are men called into service to have the same re-employment rights as for World War II?

MR. BLACK: Yes. Our understanding is that any employees of public accountants who are taken into the service will require to be re-employed, and their employers will be required to re-employ them on a similar seniority basis and retain them for a period of 12 months after they have been re-employed.

CHAIRMAN: What is the American Institute of Accountants doing to determine qualified CPAs are placed in positions in the armed forces where they will be able to make a worthwhile contribution to the national defense effort, having regard to their specialized training?

MR. BLACK: The Institute has a committee on national defense. If the defense program goes forward as anticipated, it would be far too much work for the Institute committee to handle and consequently it gets down to handling it on a state and local level. With that in mind, the president of the Institute is going to ask the presidents of the various state societies if they will appoint a comparable committee to act in liaison with the Institute committee on national defense. Each situation will have to be worked out on its own individual merits.

I am glad General Rawlings is here because one case has come up (you might almost call it a pilot case) of utilizing the services of qualified accountants. I do not mean young students who have just come with us and have been in the profession for a matter of six months, but a man who has had experience of three, five, seven years, and then is taken in some particular branch of the services and put in a place where his accounting ability is not utilized.

We all know that on our staffs we have a great number of ex-Air Force officers who were active as pilots, bombers and gunners during the last war, but the span of years that has gone by since then has put them out of that useful category. In the meantime they have replaced fighting training with a vast knowledge of real good common sense in public accounting. Those men should be placed in the Finance Divisions of the respective branches of the military service when they are called.

Major General Foster has given our chairman some encouragement on that particular subject. I think the chairman can deal with it a lot better than I can.

CHAIRMAN: General Foster, who is Chief of Finance, in reply to a letter which we addressed to him along these same lines, wrote us they were screening all men called back to active duty very carefully, looking out for CPAs. He named three or four different places where he needed certified public accountants and he said he would, as far as he was able to do so, ask for these men and try to get them to do the work for which they were best equipped.

I am sure that Generals Rawlings and Ramsey would be also quite willing to listen if we had any similar situations.

JOSEPH M. MURPHY: As the Commanding Officer of the Finance Training Corps Unit District, I would like to get in a plug for our outfit.

We are looking for auditors and we would like to get the auditor that is mentioned in the Air Corps. I am a former Air Corps officer of the last war. I have been in three times, and this could be my fourth but, as the General now says, when you get up into the forties you are an old man.

We are forming in this area, under General Foster, an auditing outfit for the country. It is a wonderful thing that he has chosen Boston to pick out the auditors, knowing that New York has been the center in the past in the Finance Department. Our General Carter and all those came from there.

We have found out at the Army Base that if you are a Reserve Officer, inactive, you may get called to service before one of us who are active. If you are an inactive Air Force officer—we won't say Air Force, but you might be an inactive field artillery officer—and a CPA, you may get called to duty first because they are going into the pool of inactives before they touch these T.O. organizations.

Budget and Accounting Procedures Act of 1950

by WALTER F. FRESE, CPA

I APPRECIATE VERY DEEPLY the opportunity to appear here and to acquaint you with some of the things which are being done in the government today from the standpoint of improving the government's accounting and its system of fiscal administration generally. I do not have a prepared paper and will speak informally.

I should mention the relationship which this topic has to your general topic of mobilization. The program which has been developed, which has been in effect for two and a half years and which has been recently crystallized into law, is an important program, an extremely urgent program without mobilization, without the problems that it brings about.

However, with the problems of mobilization, with the increase in government expenditures, the increase in appropriations with which Congress will have to deal, the problem of getting the government's accounting and fiscal administration on an efficient basis becomes much more urgent and much more critical. At the same time, the speed with which the program can be carried into effect in all nooks and crannies of the government where it has to reach will, in fact, have a direct relationship to the extent to which professional accountants, members of the American Institute, will see in it an opportunity for real public service and contribute their talents to it.

The whole program is tied up with a professional accounting approach to the problems of developing accounting systems and to the problem of utilizing those accounting systems as a basis of control and for the exercise of the independent audit function.

Our problems naturally become much more difficult to solve as the result of the manpower problems, but I hope that you will interest yourselves in the approach which is being taken, of which this afternoon I will be able to give you only a very sketchy outline, and to take advantage of the challenge which is presented in terms of the contribution that professional accountants can give to their government in this tremendous undertaking.

The topic which I am about to discuss is the recently enacted Budget and Accounting Procedures Act of 1950 approved September 12. That Act crystallized into law the framework which those of us who have been working on this problem for the past two and a half to three years felt was necessary to round out and to effect the improvements which have been started under the joint accounting improvement program mentioned by your chairman as having started in January of 1948.

Some little background on the joint accounting improvement program is necessary, I think, to understand completely the facts. I don't mean to dwell here on the defects of the government's accounting system. Those have been brought to your attention in various spectacular fashions at different times. Suffice it to say that as a general propostion the accounting systems in the government do not satisfy all the purposes which progressive business has learned to expect of an accounting system. Accounting systems in the government have not, generally speaking, been the dynamic, constant aid to good management in the control of costs and keeping expenditures at a minimum, in making for intelligent appropriating and budgetary action, and as a means of control, that they should be. Some of the defects have been exaggerated, but, generally speaking, the need for improvement cannot be denied.

WALTER F. FRESE, CPA, has been Chief of the Accounting Systems Division of the General Accounting Office since 1948 when he was chosen to organize the new division to improve accounting in the government.

One of the basic difficulties involved prior to the institution of the joint program was the fact that the problem of prescribing accounting systems was approached too much as a separate and detached proposition. There wasn't sufficient coordination between the executive branch of the government and the General Accounting Office, an agency of the Congress, to develop the accounting system from all viewpoints which were involved.

Attempt was also made to prescribe accounting systems from a central viewpoint in too much detail. There wasn't enough recognition given to the multiplicity of functions which accounting in the government must serve: as a tool of management in the executive agencies; and as an underlying basis of control which the Comptroller General exercises on behalf of Congress through his audit function and otherwise.

The inevitable result was that accounting was a stagnant type of thing in numerous agencies. It provided meticulous accounting of what happened from an accountability standpoint, including a rather complex maze of procedures from the standpoint of making sure that obligations and commitments were not incurred in excess of available appropriations, but placed very little emphasis on developing costs and related data taken for granted in private business as necessary for enabling management to do the job that it has to do in the most efficient manner. There was also insufficient integration between the accounting in the agencies and the budgetary processes of the government.

Recognizing the multiplicity of purposes, that a cooperative approach was in order, and that all interests had to be represented, the Comptroller General, representing the legislative branch, the Secretary of the Treasury, and the Director of the Bureau of the Budget, the two central fiscal agencies of the executive branch, organized in January of 1948 the Joint Program To Improve Accounting in the Federal Government. Working arrangements were made so that the interests, viewpoints, responsibilities, and needs of all concerned could be given effect in the reorganization, the development, and the growth of the government's accounting function. That approach provided a basis for elimination of much of the overlapping, duplication, and wasteful accounting processes which were then in existence and which as a general proposition were required by existing laws and concepts of central control.

Agencies throughout the government were required, by reason of the law and established procedures, and by reason of previous approach to audit, to transmit many types of documents and reports to Washington where they were recorded in central accounting records which overlapped those that are in the agencies to establish controls which were, to a very considerable extent, illusory in character.

The most important underlying principle to this new approach is that the key point of control of the government's operations has to be in the various agencies responsible for such operations. If accounting is to serve its real function, that is where it has to be established, and that is where it has to grow and develop. Any central responsibilities for control of the public funds, for seeing that they are spent in accordance with appropriations, for seeing that they are used effectively, for developing budgets, and so on, should be able to utilize results from accounting systems established in the operating agencies. With the cooperative approach to the problem, there was no reason why a basis couldn't be established to do that.

Along with the work of developing accounting systems and improving them at those points, there was inaugurated a comprehensive audit program on the part of the Comptroller General. Under this program the auditors go out to the agencies, audit their books in a professionally accepted sense, evaluate their internal control mechanism, evaluate their internal procedures, and related administration practices, and make a selective examination regulating the amount of detailed work to be done in the light of the auditor's professional judgment. The program was designed to take full advantage of the improved accounting systems in the agencies and to eliminate, as rapidly and fully as possible or appropriate, the necessity for sending documents, reports and that type of thing to Washington or other central points for audit and to take full advantage of the accounting system and related procedures for internal control in the agencies.

The comprehensive audit program was placed by the Comptroller General in the hands of the Corporation Audits Division of the General Accounting Office which was organized by your distinguished member, Mr. T. Coleman Andrews, and carried on subsequently under Mr. Stephen B. Ives and Mr. Irwin S. Decker, well-known members of your organization. That Division has consistently been staffed according to the highest possible standards of professional competence.

Along with that went the necessity for integrating with this comprehensive audit approach the procedures necessary to determine the matter of compliance of receipt and expenditure transactions with law, regulations, and other legal requirements as a basis for the settlement of accounts of accountable officers by the Comptroller General. Here again the quality of internal control by the agency is the basis for determining the extent of detailed examination of individual transactions necessary.

One other thing that was resolved in this Joint Program was the matter of a clear-cut understanding as to the areas of responsibility as between the Comptroller General and Executive agencies. There was no doubt from the very beginning as to who had the function of maintaining the accounting systems. There had been a lot of fuzzy thinking, a lot of fuzzy talking about the Comptroller General keeping the government's accounts and also auditing them. There had been disagreements in the past between the Treasury Department and the General Accounting Office as to who should keep the central accounts of the government. Under the Joint Program the maintenance of accounting systems was unmistakably recognized as a function of the executive branch and it was a fundamental principle from the start of that program that accounts should be kept at the various points where the transactions take place, in the agencies responsible for those transactions, and that to the fullest extent possible any overlapping and duplicating in the central accounting or audit processes for the government be eliminated.

Along with that approach came the possibilities for eliminating or modifying the so-called warrant procedures consistent with the concept of establishing effective control procedures at decentralized points of operation in the agencies.

Mr. Stewart has just suggested that I explain what the warrant procedures are. I will try to do that in a general way.

The warrant procedures date back to Alexander Hamilton, or possibly before. I am not criticizing them, however, merely because they go back that far; things are not bad just because they are old, but some of the warrant procedures have become outmoded by changes in the fiscal responsibilities and in the accounting and disbursing methods.

The Constitution contains a provision that no money may be withdrawn from the Treasury except pursuant to an appropriation made by law. Early legislation, as subsequently amended, provides that disbursements from the Treasury shall be upon warrants drawn by the Secretary of the Treasury and countersigned in the General Accounting Office, and that receipts for moneys received by the Treasurer of the United States shall be endorsed upon warrants signed by the Secretary of the Treasury. Elaborate warrant and accounting procedures have grown up to implement this legislation.

Appropriation warrants are used to set up the appropriations made by the Congress in the books of the Treasury, the General Accounting Office, and the various administrative agencies of the government. Transfer appropriation warrants, transfer and counter warrants, and adjustment warrants were used until recently for effecting all legally authorized transfers between appropriations as originally set up. Requisitions and accountable warrants are used to make advances to disbursing officers under each separate appropriation. Accounts are maintained by the disbursing officers, the Treasury, the General Accounting Office, and the administrative agencies for these advances and the disbursements made by the disbursing officers. Covering warrants are used for receipts and for repayments to appropriations. These are recorded by the Treasury, the General

Accounting Office, and the administrative agencies.

In the early days, these procedures were doubtless desirable and effective, especially since actual money was being moved around. With the far-flung operations of the government today, and in the light of modern fiscal operations, they become cumbersome and unduly time consuming. Some of them have lost most of their effectiveness and are entirely inconsistent with the greater decentralization of operations and responsibility for the control over appropriation expenditures as they are being incurred. For example, a decentralized agency which is authorized to operate with receipts has to deposit its money in the bank; a certificate of deposit has to be sent to Washington through the banking channels of the Federal Reserve System to the Treasury; it has to be covered-in by warrant, and an appropriation warrant has to be drawn and an accountable warrant, and then the disbursing officer has to transfer it back to the original place of receipt, a process which sometimes takes quite a lengthy bit of time and is completely inconsistent with the idea of control by an effective system of internal control in the agency conducting the operations.

The Certifying Officers Act of 1941 transferred the responsibility for the proper expenditure of appropriated funds from the disbursing officer to certifying officers in the administrative agencies, and changed materially the basis on which many of the warrant procedures and the accounting maintained by the disbursing officers had been established. Likewise, maintenance of central accounts in the Treasury Department and the General Accounting Office can either be materially simplified or eliminated if we have proper accounting and control in the agencies at the point of primary responsibility.

We were able to make some progress in simplifying these procedures before enactment of the Budget and Accounting Procedures Act, but we were not able to go far enough. Under this Act we will be able to eliminate or revise the warrant and central accounting operations as much as may be desirable, consistent with the maintenance of effective control through proper accounting systems, and related procedures in the agencies, together with decentralized external audit.

It has also become apparent that the responsibilities of the Comptroller General for prescribing accounting systems and the responsibilities of the executive agencies for maintaining them needed redefining. A new concept for the prescription of accounting systems was developed under the Joint Program. Instead of attempting to prescribe in terms of detailed procedures, such as the details of all accounts, journal entries and everything like that, the policy adopted under the Joint Program was that the responsibilities of the Comptroller General would be exercised to an increasing extent in terms of broad principles, standards, and related requirements, giving the agencies a flexible framework in which to develop and mold their accounting system to their management needs. It should be recognized that we have as much diversity in the Federal Government in terms of types of operations as there is in private business. We have the counterpart of almost every type of business. It is entirely inconsistent with the development of accounting as a management function for any central authority, no matter where located, to attempt to prescribe standard procedures in detail for all these diversified agencies. If accounting is to be properly developed as the aid to management that it should be, it must be developed from the point of view of management's responsibilities in the various agencies. We felt we could get a fuller and more effective exercise of the Comptroller General's prescribing function by working cooperatively with each of the agencies and by prescribing the basic principles and standards as the framework of the accounting system within which each agency can exercise its initiative in developing its own system in relation to its particular management problems and operations.

These concepts were adopted by agreement between the heads of the three central fiscal agencies and in the cooperative work of the General Accounting Office with numerous agencies in working out improved accounting systems. However, it was felt that they needed some firm foundation in law, which the new Act provides.

This Act provides another thing—the specific authorization needed to change the antiquated warrant procedures which I mentioned earlier.

Moreover, before this Act was passed there was no clear-cut authority to make a selective on-site audit. There was also no clear-cut authority to leave the documents to be audited at the points where they originated, and to make the audit there. We made arrangements in some cases to leave them out there as a temporary proposition, but with the proposition under existing law staring us in the face that ultimately they might have to be brought in to the seat of government.

With that background, I would like to summarize very briefly the basic requirements of the new law. I promise to make this as short as possible.

The law does two general things. It pegs down the responsibilities in accordance with the concepts of the Joint Program that I have mentioned. In the first place, in that connection, it adopts completely the concept that the central authority shall prescribe accounting systems in the government on the basis of broad principles, standards, and related requirements; supplementing this with provision for cooperative assistance in the development of accounting systems and review of such systems in operation.

That authority is left in the Comptroller General as the agent of the Congress. This is a point, of course, on which there has been considerable dispute. This Act is consistent with the long-established policy of Congress. Regardless of that question, I am convinced that any central authority, wherever located, must prescribe systems on that basis. Our government organizations are entirely too big and too complex to expect accounting systems to be developed soundly on a useful basis without qualified impetus and assumption of responsibility within the various agencies.

In the interest of such basic considerations as full disclosure, efficient external audit, over-all financial statements, and so on, certain basic requirements must be established to obtain the essential degree of uniformity for the government as a whole within a framework of basically sound accounting principles but with provision for the exercise of initiative and responsibility in each agency so that accounting can grow from within the agencies as a dynamic management tool.

That principle was recognized in Title IV of the National Security Act Amendments of 1949 which set up the structure for the development of the accounting function in the Defense establishment. In that case, the law established a comptrollership organization and provided for the coordination of the various functions customarily involved in that concept.

By the new Budget and Accounting Procedures Act, the Comptroller General's authority was redefined along the lines I have indicated. He has, however, some latitude to continue to the extent necessary to prescribe more detailed procedures in those agencies not as yet staffed or ready to discharge their expanded responsibilities in the field of accounting developments. That was put in to take care of recognized transitional problems.

For the first time the law pegs down a definite responsibility to the agencies. This is the first time there has been any specific recognition in the law, aside from special laws like the National Defense Law, that there is a definite accounting responsibility on the head of each agency. Section 113 of the new law reads this way:

Sec. 113.(a) The head of each executive agency shall establish and maintain systems of accounting and internal control designed to provide: (1) full disclosure of the financial results of the agency's activities; (2) adequate financial information needed for the agency's management purpose; (3) effective control over and accountability for all funds, property and other assets for which the agency is responsible, including appropriate internal audit; (4) reliable accounting results to serve as the basis for preparation and support of the agency's budget requests, for controlling the execution of its budget, and for providing financial information required by the Bureau of the Budget under Section 213 of the Budget and Accounting Act, 1921 (42 Stat. 23); (5) suitable integration of the accounting of the agency with the accounting of the Treasury Department in connection with the central accounting and reporting responsibilities imposed on the Secretary of the

Treasury by Section 114 of this part. (b) The accounting systems of executive agencies shall conform to the principles, standards, and related requirements prescribed by the Comptroller General pursuant to Section 112(a) of this part.

That pegs it down as a Congressional and legislative recognition of the real spot where accounting responsibility has to be lodged in an operating and development sense.

I might say also in connection with the Comptroller's function of prescribing, he is required, before prescribing requirements, to consult the Secretary of the Treasury and the Director of the Bureau of the Budget relative to their accounting, financial reporting, and budgetary requirements. He is also required to consider the needs of the other executive agencies, to cooperate with the agencies in the development of their systems, to review the systems and approve them when adequate and in conformity with prescribed principles and standards, and to make such reports to the Congress as may be necessary in that connection. The prescribing function, of course, will be coordinated to the fullest extent possible with the audit function from the standpoint of determining needs to be served and defects which need remedying.

Another responsibility was pegged down as a definite, specific responsibility of the Secretary of the Treasury to prepare composite financial reports for the government's financial operations as a whole. That, as you know, has been a neglected area in government accounting and financial reports.

As you are aware, such central reports as we have now are primarily cash statements—cash receipts and expenditures relating to the flow of funds in and out of the Treasury. The budget summaries are also pretty much on a cash basis. We believe that the development of more comprehensive reports should be accomplished on the basis of an integrated accounting structure in which each agency's accounting system is geared to the Treasury's system on much the same basis that any firm has its cash accounts reconciled with its bank. With that reciprocal kind of relationship, we feel the matter of over-all statement preparation will be primarily one of statement consolidation and elimination of reciprocal accounts. Of course, a great deal of high level constructive thought needs to be given to the types of statements that will be most meaningful. In that way, the effects of the government's operations in terms of cash receipts, disbursements, and position can be expanded to reflect and give effect to its liabilities and its assets according to a clearly defined fund structure.

The responsibility for the over-all reports is on the Secretary of the Treasury under the Joint Program and the new Act. The Comptroller General is required to provide for suitable integration between the agencies' accounting and the Treasury's accounting. He is also required to cooperate with the Treasury in the development of its system of central accounting and reporting and the agencies, in turn, are required to provide the integration necessary between their accounts and the Treasury accounts and to prepare and submit to the Treasury such reports as the Secretary by regulation may require.

The audit function of the General Accounting Office is redefined along the lines of making provision for increased application of an approach comparable to the type that you professional accountants use with business concerns. That means more audits comparable in scope to the type the Corporation Audits Division has been making for quite some time for government corporations.

One of the policy declarations in the Act provides that auditing shall be directed at determining, among other things, the extent to which accounting, financial reporting, and internal control fulfill the purposes specified in the Act. Under the Act, the Comptroller General is required to give recognition to generally accepted principles of auditing, regulating the amount of detailed work which he will do on the basis of his evaluation of internal control, accounting systems, and related administrative practices of the agencies. This means that where sound internal practices are found, the work can be held to a minimum and still be effective. Where that isn't the case, more detailed examination, of course, will be necessary.

We, in the Accounting Systems Division, of course, look for the audit function to be an extremely effective device in connection with our work with the agencies in bringing about accounting system improvements from two standpoints: (1) in following up on systems installations which we have worked out cooperatively with the agencies in determining how well they are working and whether there are any areas which need further attention, as a basis for our working together with them in working out the necessary improvements; and (2) in bringing to our attention the inadequacies of the accounting systems where we haven't yet done systems work.

I hope what I have said will give you a general idea of what the new law provides.

I would like to add that most of the improvements contemplated by the new law were being developed under the Joint Program prior to the enactment of this law which gave us the foundation, the authority, and the momentum necessary to follow through on them. Although in view of the magnitude of the job and transitional and staffing problems it will take time, there is no question in my mind but that this program is going to succeed in accomplishing the basic objectives for accounting improvement on which I am sure all of us can agree. I say this in full recognition of the contributions and opinions of some of the distinguished members of your group with whom I have had the pleasure of working.

I am talking now not about the question of central jurisdiction over accounting systems but rather in terms of the objectives for improved accounting—the kind of accounting systems we need, the kind of central reporting we need, and the kind of audit we want. Difference of opinion has been primarily on the question of central jurisdiction over accounting requirements, which Congress, in the enactment of this Act, kept in its own agency by unanimous action in accordance with its long-established policy. I realize some of you have a good honest difference of opinion on the placement of this authority, but the new law settles the point as far as the Congress is concerned. The basis on which it is being carried out, as an essential function of Congress, is a great aid in the development of audits and in maintaining a proper measure of legislative control. At the same time this is being done on a basis completely consistent with accounting as a management function. There is no difference between the objectives just mentioned, of the Joint Program as embodied in the new Act, and those of the proponents of other theories of jurisdiction. The new law gives us solid statutory foundation for reaching those objectives.

I am sure we will accomplish our objectives because of the work that we have been able to do in the two and a half years that the program has been in existence. In other words, we are fortunate, before enactment of this law, to have had these cooperative working relationships that the law requires.

We have two and a half years' experience in very specific terms and on an extremely wide front. Our work has concentrated heavily on cooperative work with the individual agencies, and we have used every means that we can, direct and indirect, to get the agency to grab the ball and develop accounting as something that they need and want, in the management of their jobs as distinguished from something they have to keep just because somebody told them to. It will never work or develop properly on the latter basis.

Our results have, of course, varied in different agencies. We have improvements going on, and I believe I can say with considerable assurance that there is an entirely new atmosphere, an entirely new climate for accounting development. It is growing, it is developing, it is taking shape. Administrators are recognizing the importance of it on a constantly widening front.

Naturally, the progress in some agencies is more than in others. Some agencies have been slow in developing it and have restricted it to just relatively minor phases of their accounting system. In others, it has blossomed into full-blown accounting reorganization and full-blown new systems.

I might just mention briefly some of the types of things that have been done, some of the basic principles that are involved in accounting improvement programs.

First of all, the expanded application of the accrual basis of accounting. That is vitally necessary. We have had two extremes in accounting in the government. First of all, we have had the simple cash basis which, as you all know, has definite limitations from a management viewpoint and as a basis for disclosure of operating results. On the other hand, we have had the so-called obligation or encumbrance basis. The obligation or encumbrance has its place, when viewed in proper perspective and handled in a sensible manner, in controlling entering of contracts and commitments, but certainly the totals of obligations or encumbrances entered into do not provide any kind of a basis for measuring actual performance, for giving cost, for giving the type of information to indicate how efficient operations have been carried out. Certainly they do not provide the information that is so badly needed for the progressive development in budgeting represented by the so-called performance budgets which emphasize the function and activities to be performed by the government and the costs of them, or a basis for the type of disclosure that is needed for Congress or the public generally to reflect the results of the financial operations of the government.

We have had, naturally, the need for the carrying of the accrual basis to different degrees in different situations—from simple administrative types of spending in agencies where the main problem is simply to reflect unpaid liabilities in the expenditures and reflect the costs of properties acquired, particularly consumable properties (and in those cases such elements as depreciation do not have any particular managerial or financial significance because fixed assets are financed by appropriations) to industrial types of operations where we should go all the way.

In effecting a transition to the accrual basis of accounting and to the modern business-type statements, and that type of thing, we have also worked out changes in the appropriations structure and the methods of financing. Revolving funds are being used in several places.

For example, the Bureau of Engraving and Printing went along in establishing a working capital fund with a fixed capital investment. The agencies which use the services of the Bureau—such as stamps produced for the Post Office, currency produced for the Federal Reserve Banks, and currency and bonds produced for the Treasury—are charged for the actual cost of these products, thus maintaining that fixed investment in the fund. There is very much the same approach in the National Bureau of Standards and in other operations where this approach will provide more informative and useful cost data.

The National Security Act Amendments permit the setting up of industrial-type funds, working capital funds, in the military establishments and that development is now taking place.

Then, in other cases, under certain appropriations, we have used the accrual basis of accounting effectively as the basis for integrating cost accounting, with a much simplified system of appropriation accounting.

Appropriation accounting, in terms of recording obligations and encumbrances and all that elaborate procedure with which you are familiar in governmental organizations, has been expanded out of all proportion to its usefulness without provision for classifying costs. Encumbrances and obligations were classified with the result that control categories were set up in the thousands to develop that kind of a pattern.

We have to develop with the agency, or the agencies have developed (I am not trying to claim the credit for our organization for what has been done—it is a cooperative effort that has produced this) and application of funds technique for reflecting the detailed classifications on a cost basis, with reconciliation of the total obligations, which is the basis on which Congress appropriates, by reflecting fluctuation in inventories and unliquidated contracts and that type of thing. That made it possible to simplify procedures and make for more meaningful results. In one agency, for example, 120 forms and procedures were reduced to 10 as the result of making a cost system an integral part of the accounting system as distinguished from making it a separate one.

Another rather important development is the fact that we have made extensive use of branch-house accounting techniques to move accounts in the big agencies to the points of operation without overlapping or duplicating central procedures. Under old concepts of accounting there were frequently two or three layers of accounts—in the field where they had to keep some accounts and finally in Washington. But, by the use of branch-house technique, accounting has been made a much more useful instrument in day-to-day management and overlapping has been eliminated. That kind of improvement is being made in quite a few agencies.

We have also worked out a basis for simplifying the integration of accounting in each agency with the Treasury as a basis for accomplishment of our ultimate objectives in financial reporting.

Along with that, we have been able to effect tremendous simplifications which now will be greatly accelerated as the result of the authorizations contained in this new Act. For example, in one case, in collection control in the General Accounting Office, we were able to eliminate certain copies coming in which aggregated almost a million pieces of paper. We were able to eliminate three voluminous monthly reports to the General Accounting Office on the status of appropriations, and so on, largely through work with the Bureau of the Budget and Treasury Department in improved forms of reports which were previously also prepared for their purposes. That work provides the basis, incidentally, for the increased use of the accrual concept for determining the results of operations under appropriations.

There are numerous improvements in accounting and reporting which I won't have time to mention. There are many other illustrations of an individual character which could be gone through to indicate how we are trying to coordinate the more effective systems in the agencies with the elimination of these central and over-all requirements.

Coordinate with individual agency work we have done considerable work with the Treasury on the basis of concepts and plans for the future development of this central reporting function, and that work is now actively going on.

Naturally, we are able to move more completely in effecting accounting systems improvements along those lines in cases where the comprehensive audit approach has been instituted. Prior to the enactment of this new legislation, that type of audit was scheduled in 12 agencies. The big problem there is manpower for the Corporation Audits Division. Naturally, that type of audit requires a professional approach. It offers a real challenge to making accounting a much more meaningful mechanism and for making a full disclosure of the results of operation which the government should make. No business has a greater obligation for making disclosure on the results of its operations than the federal government has and there is nothing more important in doing that than the kind of audit that is made by professional accountants. I hope that all of you will seriously consider this challenge and do all you can to help the Corporation Audits Division obtain qualified staff members.

Nowhere is there more urgent need for increased application of professional accounting techniques in the audit field on a synchronized basis with this work in the systems field than there is in the government, both from the standpoint of more effective results from a management viewpoint in the Executive Branch, from the viewpoint of Congress, and adequate disclosure to the public.

I should mention another project which is of tremendous significance. We are now completing a government-wide joint survey with the Bureau of the Budget on the relationship between budgetary and accounting classifications. There has been a tendency for those not to be properly synchronized, with the result that many of the budgetary reports don't have the reliability that would come from a basis of sound accounting classification. Progress has been made in improving this situation in various agencies but much work needs to be done on the basis of the surveys made.

I should mention another Act which is closely related to the new Budget and Accounting Procedures Act—the Post Office Department Financial Control Act of 1950. This Act applies the same principles to the Post Office Department as incorporated in the Budget and Accounting Procedures Act. Under prior law the General Accounting Office was actually keeping the Department's general accounts. The Department will now be responsible for its own accounting system. The General Accounting Office will cooperate with the Department in developing an improved accounting system for management purposes consistent with a framework of principles and standards to be developed by the Comptroller General. The Department will maintain its own system and its financial transactions will be subjected to a comprehensive audit by the General Accounting Office.

Another big opportunity that we are trying to take full advantage of in connection with all our cooperative work is the utilization of modern mechanical methods. We try to keep in touch with everthing being done in the agencies and industry, and tremendous strides have been made in that field. I might say that in the application of mechanical methods the government has made tremendous progress through the years.

My time is growing short. I wish I could have talked a little bit longer in more specific terms because this is a program that, in order to be evaluated, has to be dealt with in specific terms.

In closing, I do want to call your attention to the great challenge that lies ahead of you. Of course, from the standpoint of the General Accounting Office the big need is for professional accountants, to expand the program as rapidly as possible in terms of doing a professional kind of a job. Naturally, the agencies have a tremendous need for qualified accountants also—some of which you heard this afternoon from the people in the Department of Defense.

Along those lines, we are also working with the Civil Service Commission for improved concepts and standards for accounting positions in the government. We are also working on many other angles of that kind which are fundamental to the effectuation of this program on the basis contemplated.

I hope all of you will supplement these few remarks by looking further into the provisions of this Act, which has received the enthusiastic endorsement of the President and members of the Congress. The Act provides the necessary foundation for fiscal reforms which are empty shells without adequate accounting and auditing.

I have dealt with the accounting and auditing provisions of this Act; I have not dealt with a revised budgetary set-up also provided by the Act which, of course, has to be supported by good accounting results in order to make it effective. The budgetary provisions of the Act revolve pretty much around the performance concept of the Hoover Commission.

I am sorry to have taken so long—sorry for rambling, but I will be glad to answer any questions you care to ask.

THE CHAIRMAN: That was a very instructive and interesting talk on improvements in accounting in the government.

I would like to call on Mr. Maurice Peloubet, student of government accounting for many years past, to see whether he wants to make a statement or ask some questions.

MR. PELOUBET: I don't think I am going to ask any questions, because I think he pretty well covered the waterfront.

I do think I ought to say something about the Institute's governmental accounting committee which suddenly found itself the accounting policy committee of the fiscal task force of the Hoover Commission. The bill incorporates in one form or another most of the recommendations of the Accounting Policy Committee.

It is a little ungracious to only mention objections. However, in doing that, I want everybody to thoroughly realize that anything that isn't objected to is heartily approved of.

Financial statements—the bridge between disclosure and information

by EDWARD T. McCORMICK, CPA

THERE IS a peculiar fitness in my addressing you this afternoon. Accounting is my profession and I earn my living as a member of a government agency more deeply concerned than any other with accounting methods and standards. The laws administered by the Securities and Exchange Commission, with their stress on information, give it express power to define accounting terms and prescribe accounting methods. And most of the regulatory problems we face sooner or later require some reference to accounting facts and methods.

It may be a mere accident that the present Commissioners of the SEC include two accountants as well as lawyers and a banker—but it is a happy accident. No matter how much native talent and good sense you bring to the solution of corporate problems, sooner or later you must depend on the concepts and methods of accounting in organizing and appraising financial facts. As the legal and accounting professions learn to grapple with the problems of corporation finance they discover that each must in some way understand the work and share in the skills of the other. Particularly at the SEC, lawyers, analysts, and accountants are each parts of an organized team whose efforts are joined in a single purpose—to assure adequate information to the investor. Whether he is a lawyer, analyst, or accountant, a good man who has been on our operating staff for any length of time would find it hard to tell you whether he spends most of his time legalizing, analyzing, or in accounting.

These housekeeping details about the SEC are related to the main message I want to leave with you this afternoon. One of the foundation stones of our structure of federal securities legislation is the Securities Act of 1933. Under that Act securities offered to the public must be registered unless they are exempt. Generally, the registration statement is divided into two parts: a prospectus which is supposed to set forth in brief the salient facts about the company (including financial statements) and an appendix which contains more detailed information.

The prospectus is the document which must be given to each buyer of the security in the course of the sale. It is, under the policy of the law, the primary vehicle of investor information in newly distributed issues of securities.

I want to stress the word "information." It is not the same as "disclosure." It is the end product of successful disclosure—it is the enlightenment of the investor about the facts he needs in order to make an intelligent investment decision. There has never been much doubt that both the Securities Act and our administration of the Act have resulted in ample *disclosure*. But we, at the SEC, have never been content with our achievements in *informing* the investor. We have attacked that problem in two ways: we have tried to improve the mechanics of getting timely disclosure to the investor and we have tried to improve prospectuses to make them more readable and understandable.

Our efforts have resulted in rules and policies that permit and in fact require the dissemination of data about public offerings during the waiting period (that is

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between the time a registration statement is filed and the time it becomes effective). And for years the Commission has been studying and debating methods of statutory amendment to improve the mechanics of prospectus distribution. But we have recognized that it does not make sense to struggle for improvements in prospectus distribution without being concerned with the usefulness of the prospectus when it gets to the investor. For that reason the Commission has repeatedly reviewed its forms in order to get rid of useless requirements and throughout the years, by a patient process of education, it has tried to get those responsible for preparing prospectuses to make them simple and brief.

The statute does not in so many words require that the prospectus be written in the English language. But it is obvious that the Commission would not let a prospectus be used if it is written in Latin—no matter how complete a disclosure it contained. Undue complexity, the recital of prolix material in legal or technical gobbledegook can often hide essential facts as effectively as if the prospectus were written in Latin. They act like a moat, or deep ditch, between disclosure and information. The Commission has consistently tried to lower the drawbridge over that moat; and for that reason the Commission has always considered simplicity and brevity in prospectuses to be necessary in order to make the policy of the Act a living reality.

The Commission's task in getting prospectuses simplified has not been an easy one. Lawyers who are trained to think in terms of the liability provisions of the Act have always tended to stuff prospectuses with every fact which some court might conceivably regard as important in possible future litigation. The Commission itself has had to accumulate a good deal of experience and confidence before it has been willing to make aggressive efforts at simplification.

Nevertheless, we have recently had, I think, remarkable success. That success has, however, been only partial. Those of you who are familiar with the typicial prospectus know that it consists of two main sections. The business, the management, the securities, and other non-financial facts are described in textual form. In addition, the prospectus contains the conventional form of balance sheet and income statement. Our success has, so far, been largely in cutting down the volume of text, and in having the text material presented in a form which highlights the important facts in a simple and precise way.

But we continue to cling blindly to tradition in the presentation of *financial* facts. Proper disclosure is rooted in the financial statements. Yet, while the Commission has made great strides in reforming the presentation of all other types of information, it has rested content with the classical forms of balance sheet and income statement as the vehicles for disclosure in the prospectus. The strength of this tradition is revealed in the way we at the Commission have tended to refer to an example of a concise and readable prospectus. You may hear our staff describe such a prospectus as "only 10 pages long, *exclusive of financials*," implying that simplification must stop at this ancient wall of convention surrounding the classical forms of balance sheet and income statement.

But I think the time has come to ask ourselves how useful, really, is the traditional form of presentation to the lay investor? I wonder how many of you have ever tried to put yourselves in the position of an individual without financial or accounting training, set adrift on the sea of a formal balance sheet and income statement, and attempting to find his way through to some sort of adequate appraisal of the company's financial affairs. I know of one case where an intelligent schoolteacher, when she saw the balance sheet of a prosperous company, became very dubious about the investment because, after observing that the total of assets equalled the total of liabilities, she concluded that the company "owes every penny it's got." Unaware that it is only a convention that capital stock, reserves, and surplus are listed as liabilities, such an investor may well be baffled by the meaning of these accounts until they are explained.

It is extremely easy for a lay investor to mistake a dollar statement of earned surplus for actual cash on hand. He is likely to make the mistake of believing that, should he purchase an investment in the company, he would be buying a share in an earned surplus having a present value equivalent to the amount set forth in the balance sheet. These and other conventional accounting concepts reflected in the accumulation of figures called the balance sheet add up to an unassembled jigsaw puzzle to the nonprofessional.

The income statement is likely to be more pertinent and informative. But, by itself, it still does not permit an adequate over-all appraisal of the company.

We are so deep in the woods that we are in danger of seeing only the trees. The journals of our profession storm with disputes about accounting theory and the meaning and application of accounting concepts. But neither the profession nor, I must say, the Commission has as yet paid enough attention to the basic problem whether the usual *form* of presentation of accounting facts is a meaningful presentation to the untrained investor. The analyst who is accustomed to using financial statements accepts the traditional form of balance sheet and income statement as a matter of course. His trained eye directs him to the pertinent parts of the statements containing the essential ingredients of his analysis. Because of his training he can relate the balance sheet, income statement, and analysis of surplus in such a way as to enable him to make an appraisal.

But I can well imagine many investors scanning the usual types of financial statement in despair, and giving up the search because of their lack of familiarity with the terminology and the basic conventions of accounting presentation. Yet, since the Securities Act was passed, millions of prospectuses have been printed and distributed to investors on the theory that the usual type of balance sheet and income statement serves the statutory end of informing the ordinary investor.

We, ourselves, as well as the accounting profession, have at times confused disclosure with information. Many of us, trained in accounting and members of the accounting profession, are justifiably proud of the achievements both of the Commission and of the profession in making the modern financial statement a full and complete index of the financial position of an enterprise. But we have tended to forget that only a trained individual can make use of that index. And, while we have made significant progress in simplifying every other part of the modern prospectus, we have made relatively little headway in the form of presenting financial data.

Let me make it clear that I am not dealing here with substantive accounting concepts or with disputes in accounting theory. My concern is with methods of presentation, rather than with principles. As I see them, the balance sheet, the income statement, and the surplus analysis are really an integrated presentation of the status of the enterprise. I am concerned with the fact that in disclosures to ordinary untrained investors convention continues to require the making of separate statements, often containing overelaborate detail and in a form which is dictated by tradition rather than by its usefulness as an instrument of investor appraisal.

As I said before, a typical registration statement consists of two parts: the prospectus and the appendix. Only the *prospectus* is intended for actual distribution to investors. It is not intended to be the repository of detail which might be significant to a sophisticated analyst in making slide-rule appraisals of investment value down to fine decimals. That type of material, as well as material useful to the Commission in examining the statement, is contained in the appendix. These appendices are, of course, public information—and while they are not distributed to investors, they are frequently used by investing institutions, and by analysts and services in appraising registered issues.

Progress in simplifying the prospectus does not mean that information of importance to one skilled analyst must be sacrificed. To a great extent, simplifying the prospectus has meant shifting detailed data to the appendix rather than eliminating it altogether. Thus, while I discuss the problem of integrating and condensing the statement of financial condition I want it understood that I am talking about the *prospectus* and not the registration statement as a whole. The appendix is, in my view, the proper place for the traditional, detailed presentation.

In the course of preparing these remarks I had before me the prospectus of an industrial company containing a fairly typical set of financial statements. The current asset statement alone was broken into ten items. The current liability section contained six items. The income statement of this company was one which would be deemed, by ordinary standards, to be an excellent presentation. Yet in going from sales to net income twenty-five items were set forth. From the statement of surplus at the beginning of the year to the statement of surplus at year end took an additional ten lines of items.

The inclusion of such a statement in a prospectus destined for the use of investors assumes the fantastic proposition that an investor could and would peruse the statement, item by item, through this catalogue. Not a single item was out of place—every item represented one of the necessary components of a calculation of net income. But to present that specification of items to an ordinary investor is about as sensible as presenting me with a set of engineer's blueprints to convince me that I can safely use the Pulaski Skyway.

Both the balance sheet and the income statement of this company were copiously footnoted. One item alone, that of depreciation, was footnoted with a schedule which gave pages of detail on expenditures and retirements, breakdowns of additions to reserves in various categories by income charges, breakdowns of reserve deductions through retirements, renewals and replacements, breakdowns of total asset and related depreciation reserves into five categories of capital assets, breakdowns of types of capital assets by cost, statements of ratios of annual depreciation accruals to the carrying value of various types of equipment—all of the above breakdowns given for a three-year period. In addition, the note explained the difference between charges to plant asset accounts, depreciation accounts, and maintenance and repairs—gave details as to the depletion policy with respect to certain natural resources owned by the company and gave a summary history of the depreciation policies of the company for a twenty-year period.

To the trained analyst this note is a revealing statement. To the ordinary investor it is a frightening jumble of words and numbers which he cannot understand, and which has, as its most likely result, that of discouraging any reading whatever of the financial statements.

Other notes to the financial statements of this company were just as exhaustive. Yet the document in which this treatise was set forth is called a "prospectus" and was seriously prepared and promulgated to investors who have had no training in accounting or financial analysis.

So far I have described the detail which overburdens the financial presentation in prospectuses. However, I think we need not only to condense and generalize the statements of financial information, but that we need, also, to reorganize the form of presentation.

Just as we realize that the formal financial statements really aim at an integrated presentation to an expert so should our aim be to provide the investor with a single, integrated, simple story or picture. It should cull from the balance sheet, the income statement, and the surplus analysis whatever pertinent facts are essential to an understanding of the financial pos tion and operating results of the company. It should present them in layman's language and in an order which follows the rational order in which an investor would normally ask for information about the company.

I cannot believe that we lack the ingenuity to develop a means of furnishing to untrained investors the essential accounting information necessary to make a reasonable appraisal of the situation of any particular company. I do not think that we must remain wedded to the idea that the information must be presented in highly technical language and in the traditional form of a balance sheet and an income statement set up in the conventional manner. I suggest we start from scratch and develop a technique for presenting this highly important information to the *layman* —to the man who cannot be expected to bring a technical background to the reading of financial statements.

I don't pretend that these goals can be

achieved by a twist of the wrist. A good deal of hard thinking and reorientation will be necessary. Nor do I think that I am outlining a course which is the easiest to administer. Like the accountants who prepare financial statements, the men at the SEC who review them are trained in the traditions of accounting. It is easy to follow the traditional course. But in order to do satisfactorily a real job of simplifying, condensing and integrating financial presentation in the prospectus both practicing accountants and Commission accountants will have to put aside their traditional approach to the *form* of presentation. They will have to put themselves in the position of the investor in order to anticipate his questions and answer them in the simplest and most direct way.

Accounting has in recent years made great strides toward uniform terminology and objective methods and principles. Whatever view one may take of the technical language of accounting, the fact remains that financial statements presented according to uniformly applied principles mean the same thing when they use the same words. As you can readily appreciate, objectivity and uniformity are among the prime goals which the Commission has tried to achieve in its approach to accounting.

It is obvious, therefore, that in making any necessary revision in its thinking on this matter the Commission cannot lightly sacrifice these values. One of the tasks that lies ahead in simplifying and integrating financial statements is to preserve this uniformity and objectivity. However, the task will be considerably lightened when it is understood that we are not attempting to open the door to experimentation with accounting principles but, rather, trying to find simpler and more homely ways of talking about financial facts determined according to objective and uniformly applied principles and methods.

I venture to predict that the success or failure of a proposal such as the one I am making here will hinge largely on keeping this distinction clearly in mind. Of course, attempts to conceal financial facts, attempts to abandon objective principles in the guise of simplifying accounting statements will be resisted by the Commission. They will be resisted, also, by those elements of the accounting profession that are not willing to sacrifice the progress we have made toward uniformity and objectivity.

However, I believe the path will be considerably eased when the true purpose of this proposal is understood. Perhaps I can best summarize the proposal in three simple points. (1) I believe that we should abandon in the prospectus the formalistic presentation of financial data now in common use. (2) I believe that we should try to substitute for technical terminology in the prospectus simple and homely words to describe financial facts determined according to objective and uniform methods. (3) I think that we should eliminate unnecessary detail which is of limited usefulness to the ordinary investor and which serves only to encumber and obscure the financial story.

Again let me repeat that I am by no means suggesting that accounting presentation in Securities Act prospectuses shall substitute economic analysis for objective facts. Nor do I suggest the slightest departure from accepted accounting principles as we have evolved them and will continue to evolve them. Furthermore, I am not suggesting that the traditional form of balance sheet and income statement be deleted altogether from the registration statement. The appendices may be the appropriate place for them. I am suggesting merely that we take the long-delayed step of bringing home to investors the facts so expertly collected by accountants and that we apply the pruning shears to the financial presentation in prospectuses as we have to other parts of the prospectus. I am suggesting that it is false to think of the prospectus as a divided responsibility of lawyers and accountants. We should think of the prospectus as a joint responsibility for accurateness, clarity and simplicity in presenting the facts to the investor. I am asking the accountants to join with us in an attack on that part of the prospectus—the financial presentation—which has so far shown so little improvement. I am asking that we assume fully the responsibility of the accounting profession opened up by the passage of the securities laws.

The Securities Act has given the accounting profession a new stature. The Act recognizes that the accountant is a big wheel in the whole investment process—it recognizes that accounting is one of the prime instruments of getting disclosure to masses of investors brought under the protection of these laws.

If the Securities Act has given stature to the profession, events have given the profession a great mission and a great opportunity. Our economy has come to depend to a great extent on the relatively small individual investor for the necessary supply of equity and venture capital. In order to attract that capital industry has got to tell its story. And the vital part of that story is told by the accountant.

Accounting has been useful to management. It has been useful to bankers and the large institutions, it has been useful to the taxing authorities. But the Securities Act opened a new field for the profession—to be useful to the mass investor.

The continued cooperation of the SEC and the accounting profession has produced remarkable results. We have, together, achieved a system in which accounting remains a professional endeavor rather than a mechanical means of adhering to a rigid code. That system has come about, not only because of the willingness of the SEC to cooperate with the profession but because the profession has so frequently demonstrated its sincere belief in the disclosure principle of the Acts we administer.

I think that a wholesale study of the form of accounting presentation in prospectuses should be a mutual endeavor. I hope that the profession and the Commission can, by successfully solving that problem, again justify the cooperation that has marked our relations in the past.

Bankers' problems with respect to financial reports

by MILTON J. DRAKE

THE TERM "financial reports" includes every report stated in dollars, but the banker is interested primarily in the balance sheet and income and surplus statements along with any accompanying footnotes, management comments, supplemental statements, and the opinion of the certified public accountants who reviewed the statements. These statements are part of the foundations upon which the banker bases his credit analysis, but a credit analysis, like a building, can be no better than the foundations upon which it rests. Bankers frequently supplement the basic reports they receive with other studies of a financial character made by themselves, but these are of little value if the underlying information from the basic reports is unreliable, incomplete, or does not inspire confidence.

The questions the banker must ask himself about each group of statements are: Are these figures dependable? Are they in sufficient detail? Who prepared them? It is difficult enough to make most credit analyses where substantial amounts of money are involved without having also to be concerned with the sufficiency and reliability of the data. The banker wants his information in reasonable detail, wants it to be dependable and unprejudiced. For these reasons, in most cases he insists on having the financial statements accompanied by an opinion of certified public accountants. Such an opinion is to the banker a trademark of the professional accountant and has implications which should serve to relieve many of his anxieties about the figures.

Over the years accountants have established sets of principles and rules to govern their work. Bankers have come to accept and rely upon these in their interpretation of financial statements accompanied by accountants' opinions. Experienced bank loan officers and credit men, who are used to dealing with large figures, are well aware of the accounting problems which are constantly besetting the business community. They are also acquainted with the problems of the accountant and the many difficulties which face him in performing his work and giving an opinion which is clear-cut and unequivocal. Some in the banking field may not have quite as clear an appreciation of accounting problems and of the sometimes difficult relationships between the accountant and his clients. Nevertheless, they are inclined to believe the accounting statements prepared by certified public accountants to be reliable and dependable, and that they contain sufficient information to enable them to make a reasonable credit and financial analysis.

While the level of understanding of accounting problems and responsibilities may vary with the size of the bank and the community, sound accounting principles and proper standards of auditing procedure do not. The accountant's responsibility to follow the accepted rules of the profession might be regarded as being universal. Experienced bankers, of course, recognize that there are many limitations and difficulties in the application of these rules and make allowance for them. Departure from generally accepted dogmas is the accountant's prerogative but there needs to be clear explanation, and reasons should be given.

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The banker learns from experience, however, that there are many variations in accountants' reports between what is ideal and what is done in practice. As is well known, a study was made, by a member of the Institute in Detroit, of about three hundred accountants' reports. This study indicated that the normal auditing procedures had not been followed in a large proportion of the cases studied but that unqualified opinions were given by many of the accountants despite the omissions. This sort of practice raises many problems for the banker who depends upon adherence to normal procedures by the accountant to protect him in the use of the figures.

It is easy for the banker to be critical of the accountant under such circumstances as well as to complain about the content of many of the audit reports he receives. On the other hand, it is not easy for him to come out and say unequivocally what he wants in an accountant's report. This inability of the banker to generalize his requirements has often subjected him to criticism from the accountants, many of whom have felt that the banker should at least be able to state his requirements clearly. The reason for the banker's inability to state his needs clearly is that the amount of information which he requires varies with the individual situation. Frequently it will be found that the larger the borrower the less information is needed, while the smaller the borrower the more information is needed. This may seem paradoxical. It is because large, well-managed companies, whose operations are complex, have to be viewed in terms of summaries. A mass of detail might only confuse the analysis. The small company, on the other hand, will sometimes have less able management and not in the same depth so that there are more possibilities for management errors. In these cases the banker needs protection in the form of sufficient information to reveal such errors.

The size and term of a loan also will have an important bearing on how much information the banker needs. A very small loan does not have to be as well supported as a larger one simply because the risk to the banker is not large and no really detailed analysis is going to be made. A longer-term loan is normally paid from future net income. This implies that the risk from a management and economic standpoint is considerably greater than in the case of the short-term loan which is normally paid from a liquidation of assets. In addition to the factors of size and term, such elements as security, the risk inherent in the particular line of business, present economic conditions, and the outlook for the future each will have an important bearing on the amount of information needed.

There are three basic risks with which the banker must deal and which he must appraise. One is the character risk, which is dependent on the individuals with whom the bank is dealing. The second is the economic risk, which is measured by general business conditions, the term and purpose of the loan, and the conditions within the industry. The third risk, and the one with which the banker is often most concerned, is the financial risk. This risk is measured by financial reports.

The appraisal of the financial risk is based on information, the amount of which varies with the individual credit situation, as just indicated. The banker does not expect the accountant, to the extent that he is responsible for the preparation of this information, to interpret his requirements or to analyze the statements. He should, however, be able to rely on the accountant having followed all of the procedures appropriate to the particular situation and expect that any exceptions have been disclosed clearly. The banker also should be able to rely on an unqualified opinion meaning what it is presumed to mean according to the standards of the Institute, as well as expecting a qualified opinion to be given when called for. Statements without opinion or adequate disclaimers should, as far as the banker is concerned, be eliminated. In other words, when an accountant holds himself out to be a professional practitioner, the banker has a right to have complete confidence in the statements and opinions professionally rendered. The accountant should understand that the banker is relying on him to meet the standards of the profession in all respects.

Bankers recognize that accountants often have limitations placed upon their engagements because of the desires of clients or the amount of fees which can be paid. Bankers also understand the ethics of the accounting profession and the relationships between accountants and their clients. I am sure that all bankers are quite willing to make allowances for the problems arising from these. On the other hand, bankers are not willing to make allowances for shortcomings in the accountant's report which arise from these limitations but which are ignored in the final opinion. The banker has become more and more dependent on the accountant's report over the years and, if he is to continue to have confidence in it, he must have assurance that it follows the standards of the profession. Without such assurance, his information may be questionable and, therefore, his analysis may be faulty. When this results in a loss to the banker, he hardly can be blamed for claiming that the accountant is at least partially responsible for his troubles.

The standardized short-form report or opinion was not developed casually. Each phrase and sentence is heavily weighted with specific meanings and implications and, as a whole, if it is used without qualification, it is supposed to be indicative of the fact that all appropriate auditing procedures have been followed and that the accountant has no reservations regarding the financial statements involved. Unfortunately, the general adoption of the short form of opinion has enabled many accountants to hide poor workmanship behind stereotyped phrases that have sometimes lulled both him and the banker into a sense of security not warranted by the facts. The banker recognizes that mere words do not assure a competent job of auditing. On the other hand, some accountants have found the standardized wording of the short-form report a convenient vehicle in which to transport a poor commodity.

It seems to me that it is because of the abuse of this instrument that many bankers insist upon the long-form report. In it the accountant is more likely to state limitations upon the scope of his work and the omissions of the usual procedures. Furthermore, the banker realizes that the short-form report is ideal for very large enterprises, while the long-form report is much more desirable in making a credit analysis of the small- or intermediate-sized business, especially where the financial position is barely satisfactory or the record of earnings is spotty.

Accountants frequently ask what bankers expect to find in the typical long-form report. When it is considered that the banker, in making a credit analysis, approaches the financial statements from the standpoint of quantity, quality, and proportion, the accountant's questions pretty generally can be answered. The banker's approach is one of the proportions that exist in a given financial report, and the results of operations. Therefore, the banker must know that the assets and liabilities, and the income and expenses are stated properly in amount. Furthermore, he must know what the quality of the assets is because it is from them that the liabilities must be discharged. For these reasons, the banker normally likes to have an age analysis of receivables, a breakdown of inventory into its important components, some detail regarding fixed assets, reasonable details on other assets of a significant amount, reasonable classifications of liabilities as to type, and statements regarding income-tax clearances or proposed assessments and contingent liabilities. In each of these cases there needs to be some explanation of unusual items in receivables, inventories, or liabilities. Such items might be unusual as to either amount or character. In the income statement, the banker needs a sufficient breakdown of income and expenses by general classes to enable him to see clearly what has happened to them as compared with previous periods.

It should be recognized, too, that the banker, except in the case of long-term loans which are to be repaid from future earnings, looks to working capital and liquidity rather than to fixed and other assets. This is why the banker is so insistent upon having the current assets and current liabilities covered in detail in the accountant's report.

In addition to detail of this type, there are some general problems that concern the banker as much as they do the accountant. One of these relates to consolidated statements. Where substantial amounts of assets in a consolidated statement are owned by subsidiary companies, against which there may be claims that would rate in priority to those of bank loans made to the parent company, it is clear enough that there should be adequate disclosure of the facts. This is best shown in consolidating statements which clearly reveal the relative position of the different creditors and the location of the assets.

The banker is interested also in the inventory valuation method used by the business being analyzed. Where possible, there should be a statement of the differential between inventory values as shown in the financial report where the LIFO method of valuation is used and current market. This is particularly significant because the banker, in making a credit analysis for short-term loan purposes, approaches the statements from the standpoint of what would happen to the creditors in the event of liquidation. While this method of analysis may have its shortcomings, nothing has been devised which is a satisfactory substitute, and until something is, the current replacement value of the inventory is a fundamental element in the analysis.

Significant events occurring after the balance-sheet date but before the issuance of the accountant's report have been the subject of some discussion recently. From a banker's point of view, these may be of the utmost importance and when the accountant knows of such developments, it seems to me that he is bound to disclose them in his report. There have been many cases where such developments have completely changed the credit and financial situation of a prospective borrower and where the banker would have made a serious error had he not been apprised of the facts.

It is not my intention or desire to give the impression that bankers find nothing but criticism in their relationships with accountants. On the contrary, we have all had great help and support from accountants and, I believe, have developed a fine working understanding. What I am attempting to do is to outline our position in connection with financial reports, the problems which confront us, how we use accounting information and why we need it, and to point out the deficiencies that we find most often—deficiencies, I am happy to say, that appear in the work of a relatively small part of the accounting profession.

All bankers recognize that great strides have been made by accountants in the past twenty-five years, both in the clarity of their reports and in the formulation of basic principles upon which such reports are based. Accountants, through the Institute, have done a much better job of setting guideposts for the conduct of the profession than bankers have been able to do in setting forth their requirements for the information to be included in financial reports. The recent American Institute of Accountants' booklet entitled "Audits by Certified Public Accountants" is a great step forward in educating bankers to understanding the accountant's position and, I think, in bringing to the attention of many accountants what their responsibilities really are. The Robert Morris Associates have been working in the same direction, attempting to give bankers something which will explain to their customers what information they need and why.

It is clear that the objectives of accountants and bankers are similar and that they are mutually dependent. The better they understand each others' problems the more progress they will make toward safer credit granting and more informative financial reports.

Contrasts in reporting for widely held and closely held enterprises

by WILLIAM D. CRANSTOUN, CPA

THE TASK to which this paper is addressed is the discovery of and comment on differences between the scope and content of reports of accountants on financial affairs of enterprises with wide security distribution and on those of closely held corporations.

Security distribution alone does not suffice to create significant differences in reporting methods. The contrasts which presently will be mentioned must arise rather out of attendant circumstances which are characteristic of a sufficient portion of each group to form an acceptable basis for discussion. It will be assumed that the term "widely held" implies size, that enterprises so described represent big business, and that "closely held" refers to smaller organizations in which stockholders represent management or are closely associated with management. There are many enterprises in each of these categories as to which these assumptions would not be valid, but they will not be considered in this discussion. The attendant circumstances referred to relate to the degree of effectiveness in the accounting and financial departments of these enterprises and to the nature and degree of interest in enterprise affairs characteristic of those for whom reports are intended.

Orderly approach to the task undertaken requires that some hypothesis be adopted as to the considerations which ordinarily determine what the scope and content of accountants' reports should be, and that these considerations then be applied to the enterprises under discussion. This will inevitably lead to a review of the attendant circumstances alluded to.

The considerations governing the scope and content of accountants' reports seem to be:

1. The specific objective or objectives of the auditor's examination.
2. The nature and extensiveness of audit procedures.
3. The requirements of those for whom the report is intended and their receptivity.

The inclusion of nature and extensiveness of audit procedures in the considerations cited, as will be noted later, does not suggest that audit procedures are in themselves suitable report material. Their use as such should be discouraged.

Having adopted a hypothesis as to considerations governing the scope and extent of reports, it will be in order to ask what significant differences develop in the application of these considerations to the two types of enterprise under discussion and how such differences are reflected in reports.

As to the first consideration, we will find that the objective of an accountant's examination of a widely held enterprise is usually limited to the expression of an opinion on the fairness of financial statements. On the other hand, the same objective may be sought as to the closely held company, but other ends are also desired and more often than in the case of larger enterprises examinations are made by the accountant to serve special purposes.

The nature and extensiveness of audit procedures differ greatly as between the two types of enterprise. Partly because of the difference in objectives but more importantly because of conditions within the organizations themselves, audit pro-

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cedures are usually simpler and relatively less extensive in the examination of widely held corporations.

Finally the breadth of interest and the receptivity of those for whom the reports are intended will usually be much greater in the case of closely held businesses than in the widely held corporations. The security holders and others for whom reports on the latter are intended are far removed from active participation and are, therefore, less able to understand or profit from extended comment on company internal affairs than are the recipients of reports on closely held enterprises.

The effect of these considerations is reflected in the general use of the short-form report in the case of widely held corporations and in the tendency to employ more discursive methods of presentation in the case of closely held companies.

Supplemental long-form reports covering the examination of large corporations were submitted to some extent by accountants in the past but that practice has been largely discontinued at the suggestion of management.

The use of the short-form report by widely owned enterprises is consistent with the three considerations which have been adopted as our hypothesis. Management does not need more than the short report. The extensiveness of audit procedures is not designed to furnish subject matter for a long-form report. The people for whose use the report is intended do not need and could not benefit by the information generally included in a long-form report.

Big business, because it is big, can afford and usually has a relatively complete and efficient general organization. Experts are found in every department of activities. Financial and accounting affairs are seldom in incompetent hands, and accounting staffs are large enough and sufficiently skilled to develop and present currently all useful data on costs, sales, and expenses, classified and assembled in form most helpful to business administration. Under these conditions, comments by the outside accountant on details of operations or on accounting methods is of little or no value to management and might be much less authoritative than the views of the company's own specialists.

Security holders of these enterprises have no intimate knowledge of the affairs of the corporations in which they have invested. They are absentee landlords concerned chiefly with the income they receive and, therefore, look to the accountant simply for disinterested opinion on the fairness of financial statements.

If the curiosity of these holders goes further, it is usually met by remarks included in the president's report, and only occasionally do these remarks dip into things on which an outside auditor's opinion is of value. The margin over interest requirements or the amount earned per share is the thing on which the attention of security holders of great corporations is focused. If the report of the accountant registers at all, it is only as it appears to confirm or qualify the significance of these figures.

The reasons adduced are sufficient to explain why the report of the certified public accountant on the affairs of widely held corporations usually is limited to an opinion on the statements, preceded by a brief expression with regard to his examination. The words and phrases used in reports of this type show great similarity and their choice rests on a very sound consideration. People who receive and read these reports are, in most cases, those who have occasion to examine many reports of the same general class. They look for uniformity of presentation and expression. They desire uniformity not simply because it facilitates interpretation, but because it seems to permit ready comparison with reports on various enterprises. Uniformity may not always be real and reliance on it may lead to false conclusions, but in the main it is helpful to security holders and investment analysts.

Obviously the deliberate limits set on the scope of reports relating to widely held corporations reduce the required extent of audit tests and procedures, but another factor contributes to the same result. Under accepted auditing standards the auditor gives consideration to effectiveness of internal control in determining the nature and extent of audit tests. The well-rounded organizations of big business usually include superior accounting methods and effective systems of internal control, and the auditor's tests, for that reason, are ordinarily held to a minimum. Accepted standards permit and practical considerations require that tests be directed principally to assurance that internal control is functioning. Time and effort required for exhaustive tests designed in themselves to establish the authenticity of recorded transactions would not be justified when controls are effective. While this restriction of audit tests is a normal and sensible policy, it is obvious that matters are withheld from observation thereby, which, in the case of closely held enterprises, might furnish material for useful comment.

Reporting on the financial affairs of closely held enterprises presents aspects differing from those which confront the accountant in the case of widely held enterprises. Perhaps the most notable distinction lies in the greater liberty with which he approaches his task. The accounting profession and regulatory bodies have in a large measure set the pattern for reports on the affairs of big business, but the individual accountant is not bound to use that pattern in reporting on closely held business. He may adopt whatever methods seem best under the particular circumstances, and include the subject matter which seems to him appropriate. He has a distinct advantage in the identity or close association of stockholders with management. Investment analysts rarely have to be considered. The group which he addresses has intimate knowledge of the matters on which he will comment. The close tie between owners and their business creates opportunity for distinctive service, and other opportunities arise out of handicaps characteristic of small business.

Small business directly managed by its owners often fails to recognize need for a well-rounded organization or may be unable to obtain the services of skilled executives in all departments. Big business may have the greater lure for desired people and absorb the available supply, or financial considerations may make their employment impracticable. Production and sales are more apt to be in competent hands, but accounting methods and financial policies may suffer from both lack of personnel and absence of skilled executives. Weakness in accounting methods and controls is usually reflected in failure to provide management with adequate information on internal matters of vital importance.

In such situation the certified public accountant can render a greater service than mere certification of a balance sheet and profit and loss statement. Information and data which in a better integrated organization would be produced within the organization can add much to the interest and usefulness of his report. Criticisms and recommendations relating to deficiencies which he notes will constitute valuable subject matter. Comparative statistics and financial facts restated from more than a single viewpoint may serve the needs of management and stockholders more than conventional methods of presentation with which they may not be familiar.

The accountant may find occasion to disclose weaknesses which have been the cause of past losses attributed by management to other factors. He may point up comments on operations by the use of graphs indicating, among other things, break-even points in business volume. Comparisons can be made of expenses by periods and distribution of these between departments or divisions, where practicable, may be offered.

The report may include charts of trends developed by analysis of reports for past periods, and a study of capital requirements in relation to volume, gleaned from the same source.

Recommendations of the accountant may include suggestions as to accounting procedures directed to the development of useful information, such as the productivity of salesmen.

Occasionally the accountant may have had access to an entire field of useful information previously hidden in the maze of recorded transactions because transactions had not been assembled in a significant manner. In such case he may bring the information to light and advise management as to accounting methods designed to provide better current disclosure in the future.

The auditor may have a better chance to gain knowledge of these matters than he would have in the case of a widely held enterprise even when his examination is undertaken for the sole purpose of expressing an opinion on financial statements. The reason is not difficult to see. If weakness in accounting methods and control exists, that condition obliges the auditor to make wider choice of procedures and to extend tests beyond the requirements of an audit under ideal conditions. The additional work, however, is apt to disclose matters of interest to management which would not be developed by a less thorough check.

The extent and thoroughness of audit procedures affect the content of the accountant's report in a manner not yet mentioned. The sufficiency or insufficiency of procedures must be reflected in the opinion, reservation, or disclaimer of opinion required in connection with all financial statements issued on an accountant's stationery, or associated with text over his signature. Statement 23 issued by the committee on auditing procedure of the American Institute emphasizes an obligation to make clear the degree of responsibility assumed by the accountant in such case. This obligation had long been recognized in reports on widely held companies. Reports on smaller companies must now conform to the same requirement.

The accountant has one advantage in addressing himself to management and stockholders of closely held business which he does not have with the more distant and detached stockholders of big business or with the investment analyst. The smaller group may be expected to possess much livelier interest in the business they own, have greater pride in its efficient operation, and perhaps a larger sense of the responsibility of proprietorship. They may, therefore, be eager to secure whatever helpful advice and comment an auditor's report may yield. The intimate knowledge which the owners-managers possess as to details of their business promotes understanding and appreciation of the auditor's comments and recommendations. The security holders of big business have no such advantage and could hardly profit if similar subject matter were included in the reports which they receive.

The accountant has another advantage in reporting on affairs of closely held enterprises. He is not held to the stereotyped phrasing that practical considerations impel him to adopt in the short report. He is relieved from the fetish of uniformity. He is dealing with a different group and with differing requirements in each engagement and, therefore, is free to adopt the method of presentation in each case which seems suitable, so long as he neither exceeds proper limits of accounting practice nor departs from accepted principles and procedures. He is under no compulsion to adhere slavishly to conventional forms or to employ technical terms or expressions sanctified by repeated use. The entire language is available. Only general rules of good writing need be observed.

The interests of creditors other than security holders have not been considered in this discussion. It may be suggested, however, that creditors of small closely held business would be well served by the type of report appropriate for stockholders and management. Management might not, to be sure, care to divulge all the comments which a report contained, nor feel any obligation to do so.

The general objective of every examination by an accountant is expression of opinion, comments, or recommendations for the information or guidance of specific individuals or groups. The accountant's report is not a message to the world at large, but a direct communication to those for whom it is intended, on matters of interest and importance to them. It should, therefore, be expressed in terms which they understand.

This is the conclusion of the whole matter. Reports on the affairs of widely held corporations are intended chiefly for those whose interest in the reports lies only in the help they may give in deciding whether securities of these corporations should be bought, held, or sold. Holders usually have a market in which their securities may be sold.

The stockholder of the closely held enterprise may have no easy means of escape. He may be wedded to his investment—for better or for worse. Any exposition of affairs which can help him to avoid the poorer alternative should find him receptive.

The concept of independence in accounting

by DONALD C. COOK, CPA

THE LAST TIME a member of the Commission addressed the annual meeting of this Institute was in 1947. To have been invited again so soon may be interpreted as evidence either of your fortitude or of the number of common problems we have which it is mutually advantageous for us to discuss. I should like to assume that it is our common interests which motivated your decision to invite me today.

In 1947 Mr. Caffrey, then chairman of the Commission, discussed with you the relationship between rigid independence in accounting and the presentation of the facts of business life. Today I should like to elaborate upon a portion of that theme and discuss the basic concept of independence.

During the early years of accountancy around the turn of the century, the business world had not yet come to recognize the need for this concept. Generally, an accountant's duties consisted of opening and closing books, detecting frauds upon the owners of the enterprise, and straightening accounts which had become charmingly mixed up by amateur bookkeepers. As one writer expressed it, the general notion seemed to prevail that an accountant was "merely a man of figures, a rapid and unerring calculator who could add up two or three columns of figures at a time, could tell you immediately the square or cube root of any given number, or say off-hand, for example, what one dollar put out at six per cent compound interest per annum at the time Columbus discovered America would amount to today."[1]

Perhaps the greatest impetus to the new profession was given by the passage of the Sixteenth Amendment in 1913 and the War Revenue Act of 1917. Commercial banking institutions and mercantile creditors were quick to avail themselves of the services of the new profession, and it grew. These creditors required audits and verified financial statements. I believe full maturity was reached upon passage of the Securities Act of 1933, which for the first time imposed the legal requirement that statements be certified by independent accountants.

You will remember that General Carter, who testified on behalf of the accounting profession at the hearings upon that bill, experienced some difficulty in persuading the Senate Committee that there were professionally qualified persons who could and would audit accounts of registrants and express an independent opinion upon their correctness, uninfluenced by the fee they received. Senator Barkley was frankly skeptical about such a procedure and suggested that if an independent audit were really necessary it might better be obtained by the use of accountants employed by the government.

General Carter then observed, in a statement that I am sure was not justified by some of the incomes enjoyed by public accountants in the early thirties, that the government could not afford to employ the necessary number of qualified accountants. The Senate hearing committee did not then pursue Senator Barkley's suggestion.

At another point in the hearings Senator Barkley asked whether there was any relationship between the corporate comptrollers, who had testified that they were responsible for the accuracy of the financial statements, and the public accountants. General Carter answered, "None at all. We audit the controllers." Senator Barkley

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[1] Anyon, James T., *Recollections of the Early Days of American Accountancy*, p. 41.

then asked, "Who audits you?" to which General Carter quickly replied, "Our conscience." It is your conscience which is my subject today.

General Carter's reply sums up a substantial part of the concept of independence. It is not tangible, nor even in most instances clearly demonstrable. It represents a state of mind. In the entire field of human relationships it is difficult to find an exact analogy. The independent accountant must combine the impartiality of a judge with the high sense of responsibility of a fiduciary. In addition, he must possess a full knowledge of the tools and methods of his profession. Though hired and fired by management, he must divorce his mental processes from any bias in their direction when making accounting judgments. Such a standard of professional conduct must be maintained if the auditor's certificate is to be more than a snare and a delusion and the public obligation of the accountant satisfied.

Of course, we are all fully aware of the difficulties inherent in enforcing such standards. The influences which may affect accounting judgment are extremely subtle and tenuous. In their most dangerous form it is possible that the accountant himself does not recognize their effect. Under such circumstances an accountant may be lacking in independence despite the highest professional qualifications and the most complete integrity. It is our duty—both the Institute's and the Commission's—to guard the public against such unconscious bias.

That is by far the most important purpose of our rules and interpretive opinions governing the qualification of accountants. No serious administrative problem arises in the obvious case, where an accountant is plainly derelict, where he certifies to statements he knows to be misleading, or where he consciously and deliberately falsifies the facts.[2]

Even the common law, with its cultural lag, holds the accountant responsible if he should supply a certification when he knows or should know of its inaccuracies. I am sure you are all familiar with the case of *Ultramares* v. *Touche*, decided almost twenty years ago by the New York Court of Appeals. In that case Justice Cardozo, then chief judge of that court, made clear that every accountant who certifies a financial statement owes a duty to the public. If he should be grossly negligent in the discharge of that duty, he may be compelled to pay damages to any person who relied upon that statement. That was the first complete articulation of the legal concept of independence, which has now been generally accepted by all the courts which have considered the matter.

The legal liability which flows from this concept was extended and enlarged somewhat by the Securities Act. Section 11 of that Act imposes upon the accountant the duty to make a reasonable investigation into the truth and completeness of the statements he certifies. This necessarily implies that the audit should be thorough and that the system of internal controls carefully checked. Such matters as depreciation and obsolescence allowances, legal requirements inhibiting dividend payments, and all similar items requiring the assistance of experts should be carefully scrutinized. The accountant is held to the same standard of care as that required of a prudent man in the management of his own property.

Negligence in this respect is strong evidence of lack of independence. Or, if an accountant, either directly or through an affiliate, enters into an agreement which attempts to immunize the accountant from liability for his negligent acts, I believe he thereby forfeits his independence.

The self-regulation undertaken by the profession has, of course, outstripped the limited concept of legal liability. Five rules of the Institute relate to this concept. They are: Rule 5, which prohibits false or misleading statements; Rule 9, which prohibits, except in limited circumstances, the use of contingent fees to pay for accounting services; Rule 13, which directs accountants to refrain from expressing any opinion upon the statements of any enterprise in which he may have a financial interest; Rule 3, which prohibits the payment of any portion of an accountant's fee to non-accountants or the acceptance of any portion of the fees or profits received by non-

[2] See, e.g., *American Terminals and Transit Co.*, 1 SEC 701 (1936).

accountants from work turned over to them by accountants as an incident of their services to a client; and Rule 4, which discusses occupations incompatible with public accounting.

The Commission has attempted to adapt the concept of independence to the needs of investors. When a registration statement or annual report is filed with the Commission it is designed for use by the public. In lieu of government examination of each financial statement the certificate of an independent accountant is required. I believe that the duties inherent in furnishing such a certificate impress upon the auditor a fiduciary obligation toward the public as well as toward the client if full confidence in the publicly-held securities is to be maintained. The Investment Company Act expressly recognizes this obligation by providing that the accountant's certificate "shall be addressed both to the board of directors ... and to the security holders." If investors are to be fully protected, the accountant-fiduciary must be free of all the entangling alliances which might be engendered by relational or contractual connections with the registrant. He must be free to approach his task with complete objectivity, intent upon a critical examination of all the practices and procedures of the registrants. We have expressed this view in a rule as follows:

> The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct, or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.
>
> In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.[3]

To me that rule means two things. First, it states that independence is a question of fact, and if it can be shown as a matter of fact, regardless of the absence of any business or personal relationship, that an accountant's decisions are controlled or influenced by someone else, that accountant is not independent. Secondly, and this is perhaps of more significance, it points to certain relationships which indicate a lack of independence and provides that when these or similar relationships which might influence an accountant's judgment exist, the accountant cannot be considered independent regardless of the amount of proof available that his judgment was, in fact, uninfluenced.

Proof of the actual abdication of judgment to another is nearly always difficult. The coincidence of the result of a decision with the wishes of another can, in many instances, be explained as the result of independent logical reasoning. It is in the selection of the applicable accounting convention, about which there are sometimes great differences of opinion among the authorities, that judgment must be exercised. Even when the decision cannot be logically justified, who can say whether the error was an honest one? It is in this context that independence is particularly important.

Usually, it is only when the accountant has been foolish enough to venture his personal judgment and it can be shown that this is different from that reflected in the financial statements that absolute proof of lack of independence can be shown.[4] Even when misleading or fraudulent statements

[3] On July 12, 1950, the Commission promulgated for comment a proposal that the rule be amended to read:

"The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

This was intended as a codification of the Commission rulings upon independence and not as a change in view.

[4] See *Metropolitan Personal Loan Co.*, 2 SEC 803 (1937); *A. Hollander & Sons, Inc.*, 8 SEC 586 (1941); *Associated Gas and Electric Co.*, 11 SEC 975 (1942).

are certified there can be only a strong presumption of lack of independence, which must be coupled with other factors if there is to be clear evidence of actual subservience to management influence.

In the only three cases thus far decided involving lack of independence in which the Commission has taken disciplinary action against accountants the mental state of the accountants could be proved. In the first[5] the accountants gave management a private audit report materially different from that furnished the public. The public report failed to disclose, among other things, that the client was carrying a trading account in the name of the accountant. Although the accountant protested, he did not take effective steps to stop the practice for two years.

The second case,[6] a year later, was very much like the first. It differed only in the fact that the accountant knew of the trading account and acted as an accomplice of management in the stock market enterprise. The client and the accountant did not even profit financially from the trading. They suffered substantial losses despite market advice by the president, the secretary-treasurer, and a director of the company. I suppose this proves both the biblical precept that the wicked shall reap no profit from their wickedness and the Wall Street axiom that market speculation should be left only to the professionals.

The third disciplinary action[7] was not until seven years later, when an accountant blandly certified accounts which carried a leasehold at $100,000, which was 90 per cent of stated assets of the enterprise, although he knew only $15,000 had been paid for the property the year before and it was assessed at only about $5,000. Since it was also shown that the accountant assisted in the promotion of the venture, the proof of lack of indepencence seemed conclusive. Three other disciplinary actions against accountants[8] raised questions of independence because of the technical incompetence of the accountants there involved, but the Commission's decisions were based principally upon the omission of specific auditing procedures prescribed by Commission rule. The certificates in those cases represented little more than the loan of the accountant's name. Therefore, insofar as they pretended to be an objective and critical analysis, they were false and misleading.[9]

The paucity of disciplinary actions and the nature of the offense charged in those cases indicate how reluctant we are to institute such actions. However, I do not believe the profession may assume that appropriate action will not be taken unless there is evidence of corrupt and venal conduct. I believe every accountant is chargeable with the knowledge of the mechanics and the ethics of his profession. They are the rules of the game and their observance is essential if we are both to fulfill our high public trust.

Most of these rules, like those which govern any fiduciary, are prophylactic in nature. They are designed to prevent any conflict from arising between the accountant's duty to the public and his personal interests. Thus, just as a trustee of an estate in reorganization under the Bankruptcy Act may not ally himself with any creditor or stockholder interest in the estate, trade in securities of the estate, or purchase trust property, the accountant may not have any financial interest in a client's enterprise, even if it can be shown that the personal financial stake of the trustee or the accountant will have no effect upon his judgment. As a matter of fact, persons sensitive to their obligations may lean over backwards and act in opposition to their personal interests.

Nevertheless, I believe it is a salutary principle which arbitrarily denies to fiduciaries or people in a quasi-fiduciary position such as accountants the right to risk their independence. Not all people are strong enough to resist temptation, particularly when it may easily be hidden behind a convincing rationalization. Even if there is no conscious attempt to favor a personal interest, unconscious pressures may

[5] *Puder & Puder*, Securities Exchange Act Release No. 3073 (1941).

[6] *Kenneth* v. *Logan*, 10 SEC 982 (1942).

[7] Accounting Series Release No. 68.

[8] Accounting Series Release No. 48 (1944); Accounting Series Release No. 59 (1947); Accounting Series Release No. 67 (1949).

[9] For other examples of such examinations see *National Boston Mines Corp.*, 2 SEC 226 (1937); *Red Bank Oil Co.*, Securities Exchange Act Releases Nos. 3110, 3770 (1946).

cause a shift in the normal judgment exercised by the accountant. For both these reasons, and because the public will have greater confidence in certifications when they know there is no conflict between personal desires and professional opinions, the accountant must carefully scrutinize his relationships with his client.

I recognize the impracticality of restricting or denying all intercourse between accountants and their clients. Nor do I believe this is either necessary or desirable. The accountant cannot be an ivory-tower examiner, inaccessible to his client and remote from the market place. The nature of his business demands constant communication with management and recognition of all creditor and stockholder interests. In our opinions and interpretations at the Commission we have tried to stake out the safe and unsafe areas which the accountant who wishes to protect his independence should observe.

I assume that all of you are familiar with Accounting Series Releases 22 and 47, in which there are summarized Commission decisions and informal rulings upon the question of indepencence. Since 1944, when release 47 was published, five Commission decisions and some one hundred staff opinions have dealt with this problem. Apparently there is still some need for clarification and delineation.

The problems fall, roughly, into three groups. First, there are those instances in which the accountant has a managerial or financial interest in his client such as when he is an officer, director or partner, or when he owns stock in the enterprise. Secondly, there are those instances in which there is a family relationship between the accountant and the client; and thirdly, there are those instances in which the accountant also acts for the client in some capacity other than as an accountant. Many problems, of course, involve more than one of these relationships, and within each classification a single factor may not disqualify an accountant but it may raise sufficient doubt so that if any other similarly inconclusive factor is present the accountant should be disqualified. I believe we may best discuss these problems by referring to our rulings under each of these classifications.

The question most frequently asked us is what constitutes a financial interest. Seven of the twenty illustrative cases which appear in Release 47 deal with this problem. Until recently we have analyzed that interest and if it was substantial we have decided the accountant could not be independent. An interest which exceeded one per cent of the personal fortune of the accountant was considered substantial. Experience has demonstrated, however, that even less than a one per cent financial interest may result in a conflict of interest. For instance, the percentage of net worth might be less than 1 per cent although the proportion of income represented by the holdings might be substantial; persons may be affected differently by losses or gains or comparatively small sums; often exact values cannot be calculated. Accordingly, we take the view that any financial interest in a client, no matter how small, will disqualify the accountant and it is proposed that Rule 2-01 be revised to reflect this viewpoint. This financial interest may be in the form of a contingent fee contract, or a contract which is expressed in terms of a fixed fee plus a percentage of sales, or an investment in an underwriter, a promoter, an affiliate, a parent or a subsidiary of the client, for the definition of financial interest should be broad enough to insure the complete objectivity of the audit. In this connection I believe it would be wise to adhere strictly to Polonius' injunction, "Neither a borrower nor a lender be" to any client, even if the borrowing or lending is only of office space.[10]

Nor can a firm of accountants be insulated from the holdings or acts of any partner, even if that partner should separate himself from any connection with the audit. Thus, an accounting firm was held to be lacking in independence where the partner who held stock in the client did not participate in the audit and the certificate was signed jointly by the partner who had performed the audit and the firm.[11] Nor would the situation be remedied by the sale of these shares subsequent to the audit.

[10] See *Southeastern Industrial Loan Co.*, 10 SEC 617 (1941).

[11] See *Rickard Ramare Gold Mines, Ltd.*, 2 SEC 377 (1937).

This disqualification will extend even to the audit for years prior to the date when the stock was acquired when a registration statement is filed which includes financial statements for those years, for a certification speaks also as of the date the registration statement becomes effective. Consequently, a financial interest at that time would interfere with the complete objectivity of the entire audit.

Similar problems are presented when an accountant or a partner in an accounting firm serves as a promoter, underwriter, voting trustee, director, or officer of a client, or administrator or executor of an estate with an interest in a client. It seems to me obvious that an accountant should not certify accounts which cover the period of time when he held office. I am amazed at the requests for an opinion in these circumstances.

In one instance a member of a firm of certifying accountants, although not an officer, consulted with management on accounting matters and exercised some supervisory powers with respect to the corporation's accounting procedures. We held that despite the lack of a formal title, the accountant acted in the capacity of controller and he and his firm were therefore disqualified from certifying the financial statements.

A more difficult problem is presented after the accountant disposes of the financial interest which has disqualified him and resigns his office with the company. It has been urged that since he has cured his disability he should be henceforth fully qualified to exercise an impartial judgment. I believe that if he participated in the formation of significant accounting policies which persisted beyond the year in which he resigned or gave up his financial interest, he should not be permitted to place himself in a position to audit those decisions. A variation of this question is presented where another firm audits the accounts for the years when he was connected with the company and he attempts to rely upon this audit in submitting a certificate covering those, as well as subsequent years, when he had no connection with the client. The Commission has held, properly, that such a certification will not be accepted. The accountant may not rely on others, for part of his certification unless he would be fully qualified to perform that audit himself and did, in fact, supervise it.

This does not mean, however, that these earlier years may not be covered by a separate certification by others.

The second category of cases dealing with the independence of accountants on which we are frequently asked to express an opinion deals with family relationships. The typical case is one in which the accountant is the father, son, husband, brother, cousin or uncle of an officer, director, or bookkeeper of a registrant.[12] In accordance with well-recognized legal doctrines governing fiduciaries, we have taken the position that such a relationship disqualifies the accountant. Obviously, if the persons involved live under the same roof and are part of the same economic unit, the accountant has a direct interest in the finances of his client. To the extent that the client pays the officer, it contributes directly to the support of the accountant's household. Even if the relative is not part of the same household it would be very unrealistic not to recognize the strong influence exerted upon the accountant by virtue of a close relationship.

Disqualification because of family relationship extends also to instances in which the relative has a financial interest in the client's enterprise. Thus, we ruled that where the wife of an accountant had a $47^1/_2$ per cent interest in one of three principal underwriters of a proposed issue, the accountant could not be considered independent.

The third category of rulings we have rendered dealing with independence involves nonfinancial relationships. It is clear, I believe, that membership in the same civic, fraternal or social organizations as a client does not disqualify an accountant. I fully realize that many young men must get their start by enlarging their circle of acquaintances, and membership in organizations is a well-accepted method of accomplishing this. Even when it was shown that an accountant and his client

[12] See examiner's report adopted by the Commission in *American Metal Mining Co.*, Securities Exchange Act Release No. 3537 (1944), where the wife of the accountant was bookkeeper for the registrant.

became joint obligors, together with others, upon a mortgage to secure a clubhouse, and that this accountant prepared personal income-tax returns and audited the personal books of the principal stockholders of a registrant, it was not considered controlling by the Commission.[13] The possibility of improper influence arises when the relationship becomes more closely connected with either the finances of the accountant or his duties as an auditor.

In one case the stocks and bonds of a registrant, an investment company, were kept in a safety deposit box in a bank and the members of the accounting firm were given exclusive custody of the key to the box. We ruled that the custodian of portfolio securities could not be considered independent for the purpose of certifying the financial statements. In another instance, it was found that a registrant who proposed to issue preferred stock was indebted to a bank in a substantial sum and the member of the bank's examining committee which reviewed loans requiring special attention was a partner in the accounting firm which proposed to certify the financial statements. I believe the Commission properly ruled that the accountants could not be considered independent.

Finally, included in this category are those cases in which the accountant engages in an occupation incompatible with the concept of independence. Thus, he may not serve as a securities salesman and audit the accounts of brokerage houses or serve as a partner in a law firm engaged by one of his accounting clients to pass upon the legality of securities being registered.

These are the general problems with which we are presented upon the question of independence. They admit of many ramifications, permutations and combinations. Not all are easy of solution.

All of the factors which might possibly influence the accountant's judgment are considered. Often it is clear that any one factor would be insufficient to affect the honest discharge of an accountant's duties, but that, when taken in combination with others, it would be ground for disqualification. In such circumstances I cannot offer you the certainty of a rule of thumb. I can only suggest several of these to you as pitfalls to be avoided.

Among the most troublesome cases are those dealing with employees of an accounting firm as distinguished from partners. Adequate review procedures should be maintained to guard against employee inefficiency or deliberate falsification.[14] For a lapse in this regard I believe the firm is responsible. Either it has been negligent or it does not have the minimum knowledge of auditing procedures required of independent accountants. However, when the employee is both efficient and honest but it appears he has some disqualifying interest in the client, a more difficult problem is presented. If he should participate in the audit, it would, of course, invalidate that audit. Assuming, however, that he does not participate in the audit, what should be the effect of his interest? The employee is not in a policy-making position. Presumably, therefore, he has no influence over the accounting judgments exercised. On the other hand, the firm should not be placed in the position where it audits the actions of one of its employees. Certainly the firm may not loan an employee to a client to do bookkeeping, and then be permitted to audit that work. Even when the bookkeeping consisted simply of posting general ledger entries and making closing entries covering a month's work, we have refused to consider the firm employing that accountant independent. The same considerations are applicable where the employee has served as a director or officer of the client. If the accounting firm must audit his decisions, it cannot be independent.

In these cases the employee's interest is considered as one factor and all the surrounding circumstances are examined to determine whether there is any possibility that the accounting judgments might have been swayed. For instance, if another employee was a second cousin of an officer of the client the two factors together might invalidate the audit although neither, alone, might be sufficient. Similarly, if it is shown that the wives of partners in an accounting firm engaged in speculative

[13] *A. Hollander & Sons, Inc.*, 8 SEC 586, 616 (1941).

[14] See *Interstate Hosiery Mills*, 4 SEC 706 (1939), where the employee forged checks, falsified the statement of assets and made unverified summaries instead of applying generally accepted auditing procedures.

transactions in a registrant's stock prior to the audit, that fact would adversely affect, if not destroy, the firm's independence. Certainly, if there were also other borderline factors present the firm could not be considered independent.

I know that you in the accounting profession agree with our concept of independence. In fact, credit for the inclusion of that concept in our laws belongs largely to the profession. Nevertheless, some of my friends in the profession have said:

> Oh yes, we believe wholeheartedly in this ideal of independence but it is sometimes impractical. If a client refuses to permit us to verify inventories of if an inactive partner happens to own a few shares of a client's stock do we have to give up the account? Why can't we simply make full disclosure of the limited nature of the audit or the financial interest in our certificate? The public can then assess those factors for themselves in analyzing the accounts.

To me, that represents a completely erroneous viewpoint of the nature and purpose of the concept of independence. I am reminded of a poem I once learned which ran something like this:

> There was a little dachshund once,
> So long, he had no notion
> How long it took to notify
> His tail of his emotion.
>
> And thus it was that while his eyes
> Were filled with tears and sadness,
> His little tail kept wagging on
> Because of previous gladness.

If a qualified certificate were permitted we might very well have a certificate filled with tears and sadness while the financial statements express only the previous gladness. Moreover, it seems to me that such a certification would be no better than no certification at all, for there would be no independent audit such as the acts and rules of the Commission require. I remember one case in which the certificate had so many exceptions that all but $35,000 of total stated assets of $9,000,000 were excluded from the purview of the certificate.[15]

On all these matters which I have discussed the Commission has proceeded slowly, with an eye to the needs of the investing public and a full realization of the effects of its rulings upon the accounting profession. We are thankful for the full measure of support and cooperation you have given us. Without it, I believe our task would be well-nigh impossible. We could easily have a system in which accounting was the handmaiden rather than the measure of management. That we do not have such a system is a great credit to a young profession. I will hazard the guess that even Vice President Barkley, who as a Senator was skeptical of the practicality of using an accountant's conscience as his guide, has been convinced by the uniformly impressive achievements of the past seventeen years.

[15] *Resources Corporation International*, 7 SEC 689, 739 (1940).

Appendix

Opinions of the Commission

Summarized below are the salient facts in all of the decisions of the Commission which deal with the independence of public accountants:

1. *Cornucopia Gold Mines*, 1 SEC 364 (1936): In a proceeding brought pursuant to Section 8(d) of the Securities Act, the following facts about the relationship between the registrant and the accountants were adduced:

(a) An employee of the accountants was comptroller of the registrant. He received no salary from the registrant but received his entire remuneration from the accountants.

(b) The actual accounting and audit were performed chiefly by the comptroller of the registrant.

(c) The contract between the accountants and the registrant provided that the accountants were to receive $5,000 per annum, plus 1% of the gross proceeds of metal sales, in return for which they were to install an accounting system, set it up in proper order, make audits, and furnish office space for use by the registrant.

(d) The comptroller of the registrant, who was employed by the accountants, owned 1,760 shares of registrant's stock.

The Commission held:

> The inference from these facts is irresistible that a person in [the accountant's] position would be apt to approach accounting problems of the registrant as one of its officers and stockholders, and not as an "independent" accountant. It would be unreasonable to suppose that he could cast aside these relationships and view the accounting problems with the objectivity of an "independent" accountant criticizing and correcting accounting practices and methods of the corporation's own staff ... Furthermore, we conclude that the contract between registrant and [the accountants] by its very nature clothed [the accountants] with a disability which prevented them, during the duration of the contract, from being an "independent" accountant as respects the registrant.

2. *American Terminals and Transit Company*, 1 SEC 701 (1936): This was a proceeding under Section 8(d) of the Securities Act to determine whether a stop order should issue suspending the effectiveness of a registration statement. It appeared that the accountants certified to a balance sheet which contained a fictitious cash asset and a fictitious reduction in an equivalent amount for accounts receivable. In addition, there were various other items in the financial statements which did not reflect sound accounting practices. The Commission held that:

> Where the accountant has consciously falsified the facts, as here, an inference of actual absence of independence would seem to be justified. He who, as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts, cannot be said to qualify as an "independent" expert.

3. *National Boston Montana Mines Corporation*, 2 SEC 226 (1937): In a proceeding brought pursuant to Section 8(d) of the Securities Act of 1933 the following facts about the relationship between the registrant and the accountants were adduced:

(a) The only books or records available to the accountant in preparing a balance sheet of August 1, 1933, consisted of uncertified consolidated balance sheets of the registrant's predecessor and subsidiaries, dated May 31, 1933, the registrant's minute book, and a cash book of the predecessor from June 1 to August 1, 1933. The accountant had never audited the books of the registrant's predecessor and he had no access to the predecessor's books to verify the items going into the consolidated balance sheet.

(b) The accountant admitted that in determining certain items of the registrant's balance sheet, particularly the item of $20,000 for accounts payable, he relied entirely upon unverified information furnished by the chairman of the board.

(c) In preparing a balance sheet for September 30, 1934, the accountant relied in great part upon unverified information furnished by the chairman of the board and by other officers and employees of the registrant. He rarely verified items of expenses, even when these expenses amounted to a sizable part of the total receipts.

(d) The accountant himself set up certain books of account for the registrant but, with the possible exception of a cashbook, the books were not posted until the time of the audit when an attempt was made to record what had already happened, in some cases from memory. The Commission held:

> We find that these circumstances cast further grave doubt on [the accountant's] independence ... and in any case establish his reckless disregard of careful accounting procedure.

4. *Rickard Ramore Gold Mines, Ltd.*, 2 SEC 377 (1937): In a proceeding brought pursuant to Section 8(d) of the Securities Act it appeared that a partner in the accounting firm which certified the financial statements owned 11,000 shares of the registrant. In an apparent effort to avoid conflict an amended financial statement was filed which was prepared by an employee of the accountant and certified jointly by the employee of the accounting firm and the accounting firm. The employee received from the registrant a cash payment for his services and had no other interest in the registrant. The Commission held:

The purpose and intent of [the rule] requiring accountants to be independent would be defeated and evaded if [the accountant] is to be disqualified by its provisions but his partner or employee is not. It must be concluded that the amended balance sheets are not certified by independent accountants.

5. *Metropolitan Personal Loan Company*, 2 SEC 803 (1937): In a proceeding brought pursuant to Section 8(d) of the Securities Act the accuracy and sufficiency of the certificate of certain certified public accountants was challenged. It appeared that:

(a) The annual reports of the accountants disclosed the fact that the accountants had failed to visit and examine all offices of the registrant, that there was no verification made of the cash on hand, cash in banks, or loans payable.

(b) The accountant testified that he generally did what his clients requested, completely subordinating his judgment as an accountant to the desires of his client. He further testified that he was not sure of an accountant's function in this respect.

(c) The accountant testified that he knew that a certain credit of $7,000 to income was improper, but he allowed such credit to be made because the officers of the registrant so ordered.

(d) The accountant testified that he accepted the president's statements as to the worth of accounts and securities with little or no investigation.

(e) The accountant also testified that he exercised "no independent judgment" with respect to the adequacy of reserves. Although the audit reports for 1933, 1934, and 1935 advised that the reserves of $4,916, $5,881 and $5,639, respectively, were inadequate, he testified that he thought a reserve of $1,835 in 1936 was adequate because the registrant's officers told him so. The Commission held:

The record shows, and we find, that [the accountants herein were not] "independent" ... therefore the rule requiring certification by independent accountants was not complied with and the representation that they were independent was misleading.

6. *Interstate Hosiery Mills*, 4 SEC 706 (1939): In a proceeding brought pursuant to Section 19(a)(2) of the Securities Exchange Act it appeared that:

(a) An employee of the accountant falsified the financial statements of the registrant by overstating cash, accounts receivable, inventory, and surplus. In addition, this employee also forged several checks drawn on the company's bank account.

(b) The employee of the accounting firm did much of the bookkeeping for the registrant.

(c) The certificates to the final audit designated monthly reports to the client as "monthly detailed audits," when in fact they were merely unverified analyses and summaries of information in the corporate books. The Commission held that:

The procedure upon which [the accountants'] certified reports were based could not accurately be described as an independent audit ... We entirely agree with the testimony ... that an audit should be a check by an outsider of original work done by the client's employees; "if an accountant is permitted to do original work the whole purpose of the audit is lost."

7. *A. Hollander & Son*, 8 SEC 586 (1941): In a proceeding instituted pursuant to Section 19(a)(2) of the Securities Exchange Act, the following evidence concerning the relationship between the registrant and the accountants was adduced:

(a) The accountants were guilty of various improprieties in failing to write off the original cost of the acquisition of a subsidiary which became valueless and in concealing the joint venture in which the company lost approximately $150,000.

(b) Two principal members of the firm and their wives owned stock in the registrant varying in market value between $78,200 and $350,000 and from 1/2 of 1 per cent to 9 per cent of their combined net worth during a four-year period when this stock was held.

(c) A false account showing a balance due the registrant from the accountant was carried on the books to help conceal market operations in the registrant's stock. It also appeared that the accountant knew of a false account and requested and received indemnification against liability from the principal stockholder in the registrant. The accountant permitted the account to be continued for a year following his protests.

(d) Private audit reports submitted to the management differed from the report made public.

(e) The management of registrant and the accountant made substantial loans to one another.

(f) Management and the accountants were fellow members of various civic, fraternal and social organizations, were associated in numerous charity drives, and joined together in signing a bond to secure a mortgage on a clubhouse.

(g) Various personal services were performed by the accounting firm for management in their individual capacities, preparing their personal income tax returns and auditing the books and preparing financial statements of real estate and security holdings of management.

The Commission held that the factors mentioned in (f) and (g) were not necessarily an indication of lack of independence. However, the other factors had considerable probative value upon this issue and the circumstances of the case. Neither the firm nor the individual partners involved were independent public accountants "within the meaning of our statute and regulations with respect to the financial statements filed by the registrant." Disciplinary action was taken against the accountants in Securities Exchange Act Release No. 3073 (1941).

8. *Southeastern Industrial Loan Company*, 10 SEC 617 (1941): In a proceeding instituted pursuant to Section 8(d) of the Securities Act, it developed that the registrant was a segment of a large holding company system with which the accountant was actively associated. The record disclosed that:

(a) The accountant was paid from a pool contributed by all the members of the system.

(b) The accountant was auditor for one of the companies in the system and vice president and director of the entire system.

(c) The accountant had his office located in the same building as two of the companies in the system and had his office rent paid by one of them.

(d) The accountant borrowed money from some of the operating companies in the system.

(e) The accountant performed various acts for the system such as arranging for renewal notes, extending maturity and payments, arranging for refinancing, insurance and printing of stationery, passbooks and stock certificates and distributing funds to various subsidiaries in payment for loans. The Commission held:

> From this mass of facts, only one conclusion is possible: ... the certified public accountant was not independent as to the registrant or as to any other person or company connected directly or indirectly with the Southeastern system. The registrant was but a segment of the system with which [the accountant] was actively associated. His close identity with the financial destinies and his personal concern with the managerial policies of the system and its distressed customers were in conflict with the duties of an independent accountant.

9. *Kenneth N. Logan*, 10 SEC 982 (1942): This was a proceeding instituted under Rule II(e) of the Commission Rules of Practice, to determine whether Kenneth N. Logan, a certified public accountant practicing before the Commission, was lacking either in the requisite qualifications to represent others or in character or integrity or had engaged in unethical or improper professional conduct. The record in this proceeding shows that:

(a) Logan owned 554 shares of stock in his client, purchased at a total cost of $10,754.14, which was approximately 8 per cent of his net worth. The client had 122,718 shares outstanding.

(b) Logan permitted his name to be used for a deceptive account through which officers of the client traded in the client's stock.

(c) No disclosure was made in any of the financial statements of the trading carried on in that account. The Commission held:

> We think that the record demonstrates beyond question that Logan's conduct in the transactions described herein was grossly

improper. We attach great importance to the requirement that financial statements filed with us be certified by independent accountants and that certifications by such accountants state the truth.

(10) *Associated Gas and Electric Company*, 11 SEC 975 (1942): In a proceeding instituted pursuant to Section 19(a)(2) of the Securities Exchange Act, the record disclosed that:

(a) The accounting firm continually submerged its opinion to that of the registrant about various accounting practices.
(b) The accounting firm failed to make audits sufficiently comprehensive in scope to justify their expressing an opinion as to the financial statements in question.

The question of whether the accountants were independent within the meaning of the Commission rules was not raised in the order or in the hearings, and consequently no finding as to this issue was made. However, the Commission pointed out that "an accountant who consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent."

11. *Red Bank Oil Company*, Securities Act Release No. 3110, Securities Exchange Act Release No. 3770 (1946): In a consolidated proceeding brought pursuant to Section 8(d) of the Securities Act and Section 19(a)(2) of the Securities Exchange Act, it appeared that:

(a) The accounting firm engaged the treasurer and bookkeeper of the registrant to do the detailed auditing work, including the preparation of working papers and draft of financial statements.
(b) The accounting firm engaged another accountant to certify the statements filed with the Commission who did little more than lend his name to the certification.
(c) The accounting firm failed to investigate transactions between the registrant and its parent and affiliates so that there was no disclosure of substantial amounts of receivables and payables which were due from or to the parent and affiliates. The Commission held that:

The audits for the years under consideration were inadequate and not performed in a manner consistent with generally accepted auditing standards. The issues of independence and scope of audit tend to merge since it is highly doubtful whether an accountant lacking in independence can ever exercise the objectivity, vigilance and inquisitiveness essential to his task and required by generally accepted auditing standards ... Since we have found that [the accountants] were not independent and that the scope of their audit was inadequate, we further find that the financial statements have not been certified by independent public accountants.

12. *F. G. Masquelette & Co., et ano.*, Accounting Series Release No. 68 (1949): In a proceeding instituted under Rule II (e) of the Commission's Rules of Practice, it appeared that:

(a) The resident partner in charge of one of the offices of the accounting firm conducted an audit and certified a statement valuing a leasehold at $100,000 which had been acquired for $15,000, and had been assessed at $5,250. A note to the balance sheet stated that the values of the leasehold was purely arbitrary and had been acquired at a cost which "exceeded $2,000."
(b) The balance sheet certified by the firm improperly included various items which had not been verified.
(c) The resident partner of the accounting firm actively participated in the promotion of the registrant.
(d) Although the certificate affixed to the balance sheet stated that the accountants had reviewed the accounting system and procedures of the company, made an audit of the transactions, examined or tested accounting records, and made an examination in accordance with generally accepted auditing standards, it appeared that, in fact, the company had no books of account and no accounting system, and had no accounting records other than a few vouchers and rough notes in the accountants' own files.

The Commission found that the certification had not been prepared by an independent accountant and disciplined both the firm and the resident partner who actually made the audit. The Commission overruled the defense asserted by the accounting firm that no disciplinary action was warranted against its branch offices in cities other than the one involved in the proceeding because each branch office was a separate partnership. Some of the partners in the firm were members of every partnership, and no matter what the composition of the firm it used the same firm name in every city.

Accounting Series Releases

In addition, six of the accounting series releases have dealt, directly or indirectly, with problems which involve the independence of public accountants. They are as follows:

1. *Accounting Series Release No. 2* (1937): This is an opinion of the Commission dealing with a case in which a partner in an accounting firm owned stock in a corporation which contemplated registration. The Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of the corporation.

2. *Accounting Series Release No. 22* (1941): This release summarizes several of the opinions of the Commission dealing with the independence of public accountants, discusses the reasons for the requirement that certifying accountants be independent, and rules that indemnification agreements between an accountant and a corporation will prevent the accountant from being recognized as independent.

3. *Accounting Series Release No. 47* (1944): This release summarizes a number of those opinions and rulings issued by the Commission and its staff dealing with the independence of public accountants which were issued subsequent to the promulgation of *Release No. 22.*

4. *Accounting Series Release No. 48* (1944): This release contains the opinion of the Commission in a disciplinary action against an accountant who made no audit of the registrant's affairs but accepted without question the financial statements prepared by the registrant's employee. It was held that the accountant was disqualified.

5. *Accounting Series Release No. 59.* (1947): This release contains the opinion of the Commission in a disciplinary action against a firm of accountants who stated in their certificate that they had audited the books of the registrant in accordance with generally accepted auditing standards when it appeared that, in fact, certain important steps in the auditing procedure had been omitted. Although there is no discussion in the opinion of the question of independence, the requirements of the standard audit are considered in relation to the accountant's obligations to the public.

6. *Accounting Series Release No. 67* (1949): This release contains the opinion of the Commission in a disciplinary action against a firm of accountants which certified financial statements without making a physical check of inventories or adequately supervising the audit. The independence of the firm was not challenged but there is a full discussion of the responsibilities of the firm to investors.

7. *Accounting Series Release No. 68* (1949): This release contains the opinion of the Commission in a disciplinary action against a firm of accountants and a partner thereof who inflated assets in a balance sheet to which they certified and actively participated in the promotion of the venture in which the registrant was engaged. It was held that in such circumstances the accountants could not be considered independent.

Rulings of the Commission and its staff

Summarized below are a number of the informal rulings issued by the Commission or its staff since January 25, 1945, which deal with the independence of certifying accountants. The rulings issued prior to January 25, 1945, have been summarized in *Accounting Series Releases 22* and *47.*

1. A partner in an accounting firm owned approximately 2% of the preferred stock of a registrant at the time his firm made the audit of the accounts of the registrant. *Held,* the accounting firm of which this accountant was a partner could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission. The sale of such shares subsequent to the completion of the audit did not alter the

fact that the firm of accountants was not independent at the time of the audit.

2. In 1937 an accounting firm was held to be lacking in independence with respect to a registrant because a partner in the accounting firm was a director of the registrant. The partner resigned as director and his firm withdrew from the 1937 audit but resumed certification of the registrant's statements for 1938 and subsequent years. In 1944 it was disclosed that the partner in the accounting firm owned 2,153 shares of the registrant of which 963 shares were owned in 1937 and 1,190 shares were acquired in the intervening years. The 2,153 shares represented ownership of 1.025 per cent of the outstanding shares of the registrant. They were carried on the accountant's books at $15,558 and had a market value of $27,989. *Held*, the accounting firm of which this accountant was a partner could not be considered independent for the purpose of certifying the financial statements filed with the Commission.

3. The wives of partners in an accounting firm purchased about $^1/_2$ of 1 per cent of the outstanding capital stock of the registrant at regular market prices and the funds so invested represented less than 5 per cent of the combined wealth of the partners and wives involved. These shares were held at the time of registration with the Commission. *Held*, the accounting firm of which these partners were members could not be considered independent for the purpose of certifying financial statements of the registrant filed with the Commission. *Held*, further, the purchase and sale of a material amount of the registrant's stock by the wives of the partners of the certifying accounting firm during a period immediately prior to registration would adversely affect, if not destroy, the accounting firm's independence. Speculation of this kind in a registrant's stock is incompatible with the maintenance of an objective and impartial viewpoint which is essential to an independent status.

4. In the year of a proposed financing by a registrant, an accountant acquired about 1 per cent of the outstanding shares of capital stock of the registrant for an amount which represented less than 5 per cent of his net worth. After the proposed financing, the shares held by the accountant would have a market value of 10 per cent of his net worth. The accountant had audited the accounts of the registrant for several years prior to the acquisition of the stock. *Held*, the accountant could not be considered independent for the purpose of certifying financial statements of the registrant for the year in which the stock was acquired for the two years immediately preceding the year in which the stock was acquired. *Held*, further, the sale of the stock after the close of the latest fiscal year for which statements are required to be filed would not remedy the situation.

5. The wife of an accountant had a $47^1/_2$ per cent interest in one of the three principal underwriters of a proposed issue by the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying financial statements of the registrant.

6. An accountant who certified the financial statements of a registrant was appointed treasurer of the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant filed with the Commission. *Held*, further, the accountant could not be considered independent for the purpose of certifying the financial statements of another company registered with the Commission, the outstanding shares of which were held in trust by officers of the registrant for the shareholders of the registrant.

7. A partner in an accounting firm had previously been an accountant on the staff of another accounting firm which certified the financial statements of a registrant. While with that firm, the accountant was in charge of the audit of the registrant for 1940 and 1941. On November 1, 1942, the accountant became treasurer of the registrant. He held this position until November 15, 1943. On or about that date, the accountant left the employ of the registrant and organized his own firm which audited the registrant's accounts for 1944. Inquiry was made as to whether in statements to be filed with the Commission the accounting firm of which the former treasurer of the registrant was a partner could certify to the

financial statements of the registrant for 1945 and 1944 and refer to the audit made in 1943 by the independent firm, which it was willing to accept. *Held,* the accounting firm could not be considered independent with respect to the registrant for the purpose of certifying financial statements to be filed with the Commission.

8. In addition to auditing the accounts of a hotel, an accounting firm provided the hotel with the services of a resident auditor, and a food controller who has no control over policies, personnel, or records and is responsible only for gathering statistical data, both of which remained in the employ of the accounting firm. *Held,* the accounting firm could not be considered independent with respect to the hotel for the purposes of certifying financial statements to be filed with the Commission.

9. A member of the firm of certifying accountants was a director of the registrant, owned stock in the registrant, and was one of the trustees under a testamentary trust which controlled a substantial portion of the stock of the registrant. Inquiry was made as to whether the accounting firm could certify the financial statements of the proposed registrant if the member resigned as director of the corporation, or failing this, whether one of the duly qualified members of the firm could certify if the designation of the accounting firm as accountants for the corporation was cancelled. *Held,* the accounting firm of which the director was a member and each of the members thereof could not be considered independent for the purpose of certifying the financial statements of the registrant even though the member of the firm resigned his directorship and the accounting firm was not designated accountants for the corporation.

10. From September, 1943, until January 31, 1946, a partner in an accounting firm was at all times available for conferences with the registrant on accounting matters. The accountant also exercised some supervisory powers with respect to the corporation's accounting procedures. *Held,* the accounting firm of which the accountant was a partner could not be considered independent for the purpose of certifying the financial statements of the proposed registrant for the fiscal years ended March 31, 1944, 1945, or 1946 inasmuch as the corporation's accounting procedures were subject to the supervision of the partner acting in the capacity of quasi-controller during part of the 1944 and 1946 years and all of the 1945 year.

11. An accountant was a partner of a registered broker-dealer with a 1 per cent interest in the company. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the broker-dealer.

12. An accountant was an inactive partner in one firm of accountants, "A", and an active partner in another firm of accountants, "B". The accountant's share of the earnings from firm "A" consisted of an annual payment representing a percentage on his investment. The active partner in firm "A" was formerly the resident manager of an office maintained by an accounting firm which was the predecessor of firm "B". All the partners of "B" were partners in the predecessor firm. The active partner in "A" was a director and owned a small stock interest in the registrant. Inquiry was made as to whether firm "B" could certify the financial statements to be filed with the Commission by the registrant. *Held,* accounting firm "B" could not be considered independent with respect to the registrant for the purpose of certifying statements to be filed with the Commission. *Held,* further, the resignation of the active partner of firm "A" as director of the registrant and the sale of his shares in the registrant would not alter the status of firm "B" with respect to the registrant for the period in which he served as director or for any subsequent period if the active partner in "A" had participated in the formation of significant accounting policies persisting beyond the year in which he resigned of such a character as to place firm "B" in the position of auditing his decisions.

13. An accountant who certified to the financial statements of a registrant was the father of the secretary-treasurer of the registrant. The secretary-treasurer was employed by the registrant on a half-time basis. Prior to holding such position, the secretary-treasurer was employed by the registrant as its full-time principal account-

ing officer. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission.

14. An accountant certified the financial statements of a brokerage firm in which his brother was a partner. *Held,* the relationships between the certifying accountant and his brother were such that the accountant could not be considered independent for the purpose of certifying the financial statements of the brokerage firm to be filed with the Commission.

15. A partner in an accounting firm loaned $600,000 to a former officer of a company which held a significant interest in the registrant. This loan was secured by substantial blocks of stock of the registrant and of an affiliate of the registrant together with options to purchase the shares pledged. The accounting firm of which this partner was a member withdrew from the audit of the registrant. Subsequently, question arose as to whether the accounting firm could certify to financial statements to be filed with this Commission by a subsidiary of the registrant. *Held,* the accounting firm which was not independent with respect to a parent corporation could not be considered independent with respect to its subsidiary.

16. An accounting firm certified the financial statements of a registered investment company. The stocks and bonds of the registrant were kept in a safety deposit box in a bank and the members of the accounting firm had exclusive custody of the key to the safety deposit box. *Held,* the accounting firm acting as custodian of the registrant's portfolio securities could not be considered independent for the purpose of certifying the financial statements of the registrant.

17. An accounting firm certified the financial statements of a bank. A partner in the accounting firm acted as representative of the director's examining committee of the bank. In this capacity, he reviewed the loans made by the bank and made reports to the committee with respect to loans requiring special attention. A registrant, which was indebted to the bank for a substantial amount and whose loan had been reviewed by the accountant, intended to issue preferred stock amounting to about 75 per cent of the loan. The preferred stock was to be junior to the bank loan and the proceeds from the sale of the stock were to be used for working capital purposes. The accounting firm of which this partner was a member had been asked to certify the financial statements to be included in the registration statement. *Held,* the accounting firm of which this partner was a member could not be considered independent for the purpose of certifying the financial statements of the proposed registrant.

18. A partner in an accounting firm which audited registrant's accounts was appointed agent in control of certain buildings by the children of the controlling stockholder of the registrant. In such capacity, the accountant negotiated a lease with the registrant which occupied office space in one of the buildings. The partner in the accounting firm also acted as trustee of a trust of which the wife and children of the controlling stockholder of the registrant were the beneficiaries. *Held,* the accounting firm of which this accountant was a partner could not be considered independent with respect to the registrant for the purpose of certifying its financial statements to be filed with the Commission.

19. A partner in an accounting firm which certified the financial statements of a registered broker-dealer maintained a cash account with the broker. The accountant effected transactions through the broker and left the securities in his possession. *Held,* the maintenance of an open account with a broker, represented by cash or securities, or both, by a partner of a certifying accounting firm, casts doubt upon the independence of the accountant and the firm of which he is a partner with respect to the broker.

20. Two of the partners in an accounting firm certifying the financial statements of a registrant were also partners of a law firm engaged by the registrant to pass upon the legality of the securities which were being registered. *Held,* the existing relationship was such as to jeopardize the status of the accounting firm in which these individuals were partners with respect to the registrant.

21. A partner in an accounting firm owned an undivided one-third interest in a block of a corporation's stock amounting

to approximately 70 per cent of the stock outstanding. The accountant was also an officer-director of the corporation. The accountant's firm did not audit the accounts of the corporation. The block of stock was sold to a registrant, a client of the accountant's firm. The accountant resigned as officer-director of the corporation and the corporation was merged with the registrant. *Held*, the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant to be filed with the Commission.

22. The bookkeeper-cashier of a registrant entered the armed forces and a junior accountant on the staff of the accounting firm which audited the accounts of the registrant was loaned to the registrant one day a month to perform certain bookkeeping tasks. The following represented the maximum work done in any one month by the junior accountant. He footed the books of original entry, posted to the general ledger, took off trial balances, reconciled bank statements, occasionally made entries in the blotters from company records of purchases and sales, made journal entries for regular monthly accruals, prepared journal entries correcting errors and omissions made by company employees, and prepared and entered closing journal entries at the end of the year at the direction of the registrant. He also prepared balance sheets and profit and loss statements from book figures. *Held*, the accounting firm of which this junior accountant was a member could not be considered independent with respect to the registrant for the purpose of certifying its financial statements.

23. An accountant certified the financial statements of a registrant which were filed with the Commission. Prior to certification, the accountant posted to the general ledger entries covering a month's transactions and made all the closing entries. *Held*, the accountant could not be considered independent for the purpose of certifying financial statements filed by the registrant.

24. Members of a firm of certifying accountants set up a registrant's books and maintained them for about six months until the registrant engaged a bookkeeper. *Held*, the accounting firm could not be considered independent with respect to the registrant for the purpose of certifying its financial statements for the year in which the accountants kept the books.

25. An accountant certified financial statements of securities dealers filed on Form X-17A-5 with the Commission. The accountant was considering an offer to serve as salesman for one of the securities dealers and inquired as to whether this would affect his independence with respect to dealers other than his prospective employer as to whom he acknowledged his lack of independence. *Held*, accepting employment as a security salesman would place the accountant in the position of engaging in a line of endeavor incompatible with that of an independent public accountant and would affect his status with respect to certifying financial statements filed with this Commission. In this connection, Rule 4 of the Rules of Professional Conduct of the American Institute of Accountants was cited to the accountant.

26. An accountant who was elected director of a company in which his client held a 30 per cent common stock interest submitted his resignation immediately after he was notified of his election. Inquiry was made as to whether the accountant could withdraw his resignation and, if not, whether his election disqualified him for any period of time. *Held*, if the client and the company to which the accountant was elected a director were affiliated within the meaning of that term as defined in the General Rules and Regulations under the Securities Act of 1933, then serving as a director of either company would disqualify the accountant from certifying financial statements to be filed with the Commission. With respect to the interval of time during which the accountant served as a director, no question was raised, since it was indicated that the accountant resigned as soon as he was notified of his election and did not participate in a directors meeting or act in that capacity.

27. After the close of the fiscal year October 31, 1946, "A" corporation distributed 250,000 of the 300,000 shares of its wholly-owned subsidiary to its shareholders and retained 50,000 shares to use in lieu of cash to discharge some of its obligations. On November 29, 1946, 5,642 shares were

given the accounting firm which audited "A" corporation's statements as part payment for fees due it. On December 8, 1947, these shares were sold through a brokerage house for cash. Inquiry was made as to whether the accountant could certify financial statements of "A" corporation for the fiscal year ending October 31, 1947. *Held,* that since the accountants no longer had any financial or personal interest in either "A" corporation or its former subsidiaries, no question would be raised with respect to the certification. However, in the event of some adverse development in connection with the financial statement filed, the fact that at one time the accountants possessed a financial interest in the corporation would be given further consideration.

28. An accounting firm is paid a retainer for consultation services and to make studies and investigations for a hotel company. *Held,* the accounting firm may be considered independent for the purpose of certifying the financial statements.

29. From 1940 to September, 1946, a partner in an accounting firm was a director of a business corporation and during part of that time served as a member of its executive committee. Inquiry was made as to whether the accounting firm was qualified to certify the financial statements of the firm for the year 1947. *Held,* that since the audit did not cover any of the time during which the accountant served as a director, no question would be raised with respect to the certification. However, since the independence of the accountant was a matter of fact, this opinion might be altered if it should develop that the 1947 audit was improperly influenced by the accountant's background of directorship or if any significant accounting policies formulated prior to 1946 persisted beyond that year.

30. A company which was liquidating and held only two blocks of securities had leased for a period not to exceed eighteen months one room in a suite of offices held by an accounting firm. The company paid the same rental per square foot as the accounting firm for the remainder of the office space. Inquiry was made concerning the propriety of this arrangement, since the accounting firm certified to the financial statements of the company. *Held,* arrangements of this type cast doubt upon the independence of the accountant, but in view of the special circumstances of this case the accounting firm would be permitted to certify the company's financial statements.

31. An inspection of a broker-dealer revealed that a member of the accounting firm which certified the financial statements of the broker-dealer also did the bookkeeping work and prepared the financial statements. *Held,* the accounting firm cannot express an unbiased and objective opinion of work performed by its own staff.

32. An accountant certified financial statements used in a registration statement for the period ending December 31, 1947, under certificate date March 17, 1948. Because of the resignation of the general manager of the company on May 7, 1948, and the general knowledge possessed by the accountant of the company's activities, he was engaged by the directors to reorganize the office and reallocate the duties of the executive personnel. Inquiry was made as to whether the accountant was qualified to certify the financial statements used in the registration statement for the purpose of a post-effective amendment dated June 30, 1948. *Held,* that the accountants could be considered independent with respect to the financial statements for the period ending December 31, 1947.

33. A partner in an accounting firm responsible for the audit of the financial statements of an oil company and the son of the president of the company jointly acquired a 25 per cent stock interest in an oil equipment company. In connection therewith they obtained a bank loan of $200,000 signing a joint note and pledging the stock of the oil equipment business as collateral. The president of the oil company indorsed the $200,000 note and pledged as additional collateral 2,500 shares of the oil company's stock. Inquiry was made as to whether the partner in the accounting firm, who has now resigned from the firm, is qualified to practice before the Commission. *Held,* that these actions on the part of the accountant prevent his recognition by the Commission as an independent accountant with respect to any financial statements which the oil company has filed.

Independence from the viewpoint of the certified public accountant

by E. B. WILCOX, CPA

WHAT I AM about to say regarding independence from the viewpoint of the certified public accountant will necessarily be from the viewpoint of one certified public accountant—namely, me. I profoundly trust, however, that my viewpoint is not an isolated one.

Independence is a matter of professional ethics. It is that aspect of professional ethics which is of unique importance to the professional certified public accountant. In other respects he shares the ethical obligations of other professions. When anyone offers highly skilled and specialized services which are beyond the capacity of his clients to judge or measure, he incurs a professional obligation. This is the obligation to render a truly sound and useful service in spite of the fact that he could probably fail to do so without being caught at it. Whenever the purchaser of any service must rely on confidence in the person serving him rather than on measurable results, that service is professional in nature, and its practitioners must be governed by ethical considerations or their activities will degenerate into deception. This is true of professions generally, and it applies to all of the work which public accountants are generally called on to do. But it does not necessarily involve independence.

That part of public accounting which does clearly require independence relates to the expression of an expert opinion on representations in financial statements. The purpose of the expert opinion is to add to the credibility of the statements. Those who rely on this credibility are apt to be creditors or investors, or sometimes employees, customers, or governmental agencies. They are without even that basis for reliance on confidence which may be enjoyed by those who select the accountants. Yet it is for their assurance that the expert opinions are provided. As in other areas of public accounting the expert incurs professional obligations of an ethical nature, to do a sound, competent job. But he also incurs more than that. He incurs an obligation to his unknown audience for integrity. He must protect them even though he does not know who they are, and he must do so even when it means opposing and denying the wishes of those who have employed him, and who he knows may cease to do so. This is independence. It is an ethical requirement unparalleled, so far as I know, in any other field. It places such demands on the integrity of professional public accountants, that there are those who doubt that it is or can be achieved, and yet the very prestige of the accounting profession today is evidence that it is achieved. We are entitled to great pride in all this, but the exacting nature of the ethical requirement laid upon us is a constant warning that relaxation of standards can lead to their deterioration and the end of much of our usefulness.

I have said that independence is an ethical requirement. It seems obvious that it would be most unethical for an accountant who merely took orders from a client, to represent to others that he provided an independent check on the representations of that client. Perhaps it would be clearer in such a case to say simply that the accountant was a liar, but he would probably say

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"I am not," and there, in the absence of libel suits, the matter would rest. Effective professional ethics cannot be achieved by such oversimplification, and it is an important practical matter to understand clearly what we mean by professional ethics.

Recourse to dictionaries is apt to be fruitless in such cases, but in this one it is enlightening. Most dictionaries give two definitions of ethics. One is that it is the science of moral duty or of ideal human character and the ideal ends of human action. The other is that it is a system or code of moral principles. It should be readily apparent that these two definitions are not the same. The distinction is between ideals on one hand, and a code on the other. If we are to be careful about our semantics we may speak of ethics (1) and ethics (2), but we must not conclude that what is true of ethics (1) is therefore true of ethics (2). I recall even now, an article on "Ethics of the Accounting Profession" in *The Journal of Accountancy* for November, 1941, which stated that all that can be said on the subject of ethics might be compressed into the four words, "All men be good." This might be true for ethics (1) dealing with moral duty and ideal human character, but it clearly does not apply to ethics (2) which deals with a code. Mr. Carey, in the introduction to his book on *Professional Ethics of Public Accounting,* clearly distinguishes between the two meanings of ethics. He says, "The book does not attempt to appraise the ethics of the accounting profession in the light of philosophical concepts of ethical conduct in general: it does not argue moral questions."

Mr. Carey was wise, and the rest of us will be, too, if we stay clear of confusion on this point. A brief look at some of the various philosophical concepts of ethics (1) will show why. Perhaps the best known philosopher on ethics was Immanuel Kant. His categorical imperative required that each person observe maxims such that he will do what everyone else ought to do in the same circumstances. This may be unassailable but it furnishes no guide to distinction between good and bad acts. Nietzche, on the contrary, proposed a double standard for slaves and masters, but each master was self-elected to that class and was a law unto himself, and the slaves obeyed the masters. Ethics based on social approval break down because of conflicts between groups at different times and different places, and because there is provided no standard by which ethics of a group at any time and place can be questioned. According to social approval, Socrates and Christ were among the wickedest of men. On the other hand attempts to define absolute goodness result in the sterile and dogmatic unsupported "I ought," and attempts to base ethics on theology, science, or metaphysics encounter the unknown. They either become circular in reasoning as that what God wills is good because God is good, or they become excuses for doing what is natural because nature is beautiful. Hedonistic ethics rest on the fallacy that it is psychologically impossible for men to desire anything but pleasure. Ethics based on the approval of one's own conscience are so highly subjective as to furnish no guide to conduct. No doubt Booth was a good man from his own subjective standpoint when he assassinated Lincoln. These classical approaches to the problem of ethics—ethics (1)—provide nice mental exercises, but they do not provide practical guides to choices of conduct or reasons for such choices.

By comparison, a code of professional ethics is relatively mundane but it furnishes a guide to choices of conduct much more clearly defined, and much easier of application. It avoids many difficult conflicts by being restricted to its own field. For example, most of us believe that free competition is generally desirable, yet in public accounting we restrict advertising, solicitation, and competitive bidding because we know that these things tend to undermine and destroy the value of our services. A code of professional ethics carries with it fairly obvious reasons why it should be followed. In public accounting, the primary reason for adherence to a code of professional ethics is that the existence of professional accounting depends on public confidence. The public must know what it can expect of the professional accountant, and this expectation must not be betrayed if public confidence is to be maintained. The continuation of opportunities in public accounting depends on observance of its ethics—ethics (2)—and this is reason enough why our code of ethics should be followed. There is no aspect of the ethics of the accounting profession of which this is more true than independence.

There can be no denying that independence is essentially a state of mind. Neither can it be denied that the attainment of an independent state of mind is what really matters, and that so long as such a state of mind is maintained, independence will not be impaired, no matter what the accountant does. It might appear, therefore, that an appropriate rule of professional ethics would be that an accountant should be independent, period. This would be fine except that a state of mind is highly subjective, reflecting the variations of individual backgrounds and interpretations, and provides no practical guide to choices of conduct. It is almost as useless as an appeal to conscience or an injunction to be good. Substantially, it is ethics (1), not ethics (2). It is not an agreed code but rather an aspiration to ideal human character. To provide even reasonably uniform understanding and behavior a code of professional ethics must be much more specific than that.

There is also another reason for more specific rules of professional conduct. Bearing in mind that the purpose of the code of ethics is to maintain public confidence by deserving it, we would be foolish indeed to lose the confidence, however much we might merit it. It then behooves us to make our merits apparent. We must behave not only with genuine uniform independence, but also with clearly evident independence. We must not do those things which will raise doubts about independence. To be strongly suspected of failure would be as destructive of the usefulness of public accounting, as failure itself. Our code of professional ethics therefore should prohibit acts which will cast doubt on independence, and these prohibitions must be selected with the greatest possible wisdom, not alone from the standpoint of maintaining independence but also from the standpoint of public relations. This consideration is entirely proper for a code of professional ethics—ethics (2)—but it will be observed that it has little discernible relation to basic goodness—ethics (1).

I think it is no disparagement of a code of professional ethics that it rests on this down-to-earth practical kind of a foundation. It would be no good if it didn't. It must describe with reasonable clarity the areas of conduct which are approved and disapproved, taking care only to keep these descriptions in sufficiently general terms so that rigid rules do not provide loopholes for evasion or result in violations more technical than real. The code must describe these areas with an eye to public relations, and another eye to acceptability by the professional group. Like governments, codes of ethics derive their just powers from the consent of the governed. A code of professional ethics, therefore, represents the extent of agreement in the profession at any time on what its members will undertake to do and not do. It is, or certainly should be, a growing and evolving thing, and at all times some members of the profession will see ways in which it should be extended and improved while others will chafe at existing burdens or restrictions, and will be reluctant to incur new ones. There will inevitably be some lag between the recognition of need for changes and their adoption.

The rules of professional ethics of the American Institute of Accountants do not mention the word "independence" and this may be a lag in choice of words. The literature of the profession, however, and the Institute, itself, have not been silent as to this word. The term "independent certified public accountant" has become a synonym for the professional practitioner. Chapter 1 of Mr. Carey's book on ethics published in 1946 is entitled "Independence." "In the last analysis," he says, "it is his independence which is the certified public accountant's economic excuse for existence."

At its spring meeting in 1947 the council of the Institute adopted a statement on independence, prepared after three years of consideration, reciting the necessity for independence and the relationship to it of certain rules of professional conduct. This statement says:

The independent accountant should conduct his examinations in accordance with accepted auditing standards irrespective of limitations of time or fee. Once he has accepted an engagement to culminate in the issuance of his opinion, he is under the professional duty of making an adequate examination.

The final paragraph of the statement on independence says:

Rules of conduct can only deal with objective standards and cannot assure independence. Independence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature.

One of the greatest forward steps of the Institute was the issuance of its statement on auditing standards by the committee on auditing procedure, in 1947. In this statement the second general standard reads, "In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors." "Independence," the statement says, "in the last analysis bespeaks an honest disinterestedness on the part of the auditor in the formulation and expression of his opinion, which means unbiased judgment and objective consideration of facts as the determinants of that opinion." At the annual meeting of the Institute in 1948 the members approved a resolution submitted by the committee on auditing procedure and recommended by the council, making it clear that when the phrase "generally accepted auditing standards" is used in the opinion of an independent auditor, it shall be deemed to refer to the standards set forth in the statement issued by the committee. One of those standards is independence.

In May of this year the Institute published a pamphlet only after years of study, entitled *Audits by Certified Public Accountants.* In the chapter on auditing philosophy this pamphlet repeats some of the foregoing words. It says:

Independence, both historically and philosophically, is the foundation of the public accounting profession. The CPA must not only possess extensive technical skill; he must also maintain the highest standards of honest, objective judgment and consideration. Independence is one of his most important personal qualifications.

Independence is an attitude of mind much deeper than the surface display of visible standards. The standards may change or become more exacting but the quality itself remains unchanged. Rules of conduct cannot of themselves, therefore, assure independence. They can, however, provide objective standards to guide the CPA in all his professional endeavors.

These documents: Mr. Carey's book, the statement on independence, the statement on auditing standards, and the more recent pamphlet, all emphasize the paramount nature of independence. There can be no doubt that the requirement for independence must be regarded as generally accepted. The approval of the statement on auditing standards by the members of the Institute in 1948 would be enough to establish that, and the weight of other pronouncements would also, I think, be enough. Taken together their acceptance cannot be questioned. Yet they are not tied into our rules of professional conduct in so many words. These rules do not refer to independence or auditing standards. It is true that paragraph 5 of the rules refers to gross negligence and to failures to acquire adequate information or to disclose material facts, misstatements, departures from generally accepted accounting principles, and omissions of generally accepted auditing procedures applicable in the circumstances. It is hard to see how an accountant who was not truly independent could avoid violation of this rule except by good luck or fear of consequences. But the rule covers failures which could result from lack of independence, whereas the documents I have cited set up independence itself as a clear requirement.

In emphasizing the basic quality of independence as a state of mind and character, these documents come close to what I have called ethics (1), but they do not confuse ethics (1) with ethics (2). Rather they remind us that rules of conduct can only deal with objective standards. Therefore, even if by inference or amendment we could read independence into our rules of professional conduct, there would be little point in doing so. For example, we could amend paragraph 5 to require adherence to generally accepted auditing standards when an opinion is expressed. That would bring the concept of independence within the wording of our rules. But the concept so introduced would be that of a state of mind or character, and both understanding and enforcement would be difficult if not impossible. We have seen that a code of ethics should be sufficiently specific to minimize variations in subjective judgments and to maximize public confidence. A rule that says in effect, "Be independent," does not do this. Quite possibly the absence of any specific reference to independence in our rules may, as I have suggested, be due to a lag in bringing the words up to date, but I have a considerable doubt that the broad concept of independence is appropriate to a code of ethics—ethics (2).

The Institute's formal pronouncements about independence are comparatively recent, but the deep and abiding knowledge that the public accountant is either independent or he is nothing, is as old as the profession. The council's statement on independence says, "Historically independence was the first requirement; the need for that was recognized even before the need for technical competence; it was the climate into which the profession was born." Almost as old is the understanding that a code of ethics must be reasonably specific. Both these facts are evidenced by certain paragraphs in the Institute's rules of professional conduct which set forth areas of conduct clearly related to independence. These rules forbid acts which might either increase the accountant's temptation and thus impair his actual independence, or raise doubts about his independence in the minds of others, or both.

Paragraph 3 forbids commissions and fee-splitting. In some cases a commission could depend on the financial condition or the earning power of a client, and, under these circumstances, the accountant might be tempted to deviate from his independent judgment. Paragraph 4 forbids occupations incompatible with public accounting. If, to cite an extreme case, an accountant were a salesman of the securities of a client, he would find his independence as the accountant rendered difficult, to say the least, and quite probably doubted by his customers. Paragraph 9 forbids contingent fees, except for tax cases. For example, an auditor's fee, contingent on successful public sale of securities of his client, would give him a financial interest in a favorable showing. Paragraph 13 forbids the expression of an opinion by an accountant when he has a financial interest in his client, if it is financed by public distribution of securities, but permits an opinion on statements used for credit purposes, if the accountant's interest is disclosed in his report. The reasons why a financial interest in a client might actually impair independence in any but the strongest of characters, and why it would probably impair public confidence, are obvious. The reasons for the distinction between a prohibition in the case of publicly held securities, and reliance on disclosure in the case of credit seeking, are not so clear. It may be that the distinction is one of emphasis, since public financing of securities does involve greater professional responsibility because the public is involved. It may be that the rule is intended to guard only against the appearance of evil, and is therefore more appropriate to cases of public financing. Or it may be that this is a case of incomplete development of an evolving code. Whatever the status of this particular point, however, these rules I have mentioned set forth the objective standards in our published code as it now stands, which relate to independence.

Other areas of independence further illustrate the evolutionary status of our rules of professional conduct. Some state societies have rules against competitive bidding, and these are in part based on the view that an accountant loses much of his independence in a scramble for an engagement. Not all state societies have taken this step, however, and the Institute has only gone so far as to require its members to observe the rules in the states where they exist. There is no rule of ethics forbidding the public accountant from acting as a director or other officer or employee of his client, but the Institute's committee on professional ethics has again and again urged against this practice. Neither is there any rule against furnishing an opinion on financial statements by a public accountant who has kept the books of his client, although this practice has often been questioned. Most of the criteria of independence suggested by the Securities and Exchange Commission fall into or are closely related to the previously mentioned categories, with the possible exception of indemnification of an accountant against losses resulting from certification. This one has not been dealt with by the profession.

As is to be expected among free and thinking individuals, there is much disagreement on all these points. Some urge that they can be truly independent in spite of stock ownership, commissions, contingent fees, or so-called incompatible occupations, and of course they can. Some would scorn to be led by competitive bidding into any agreement to slight auditing standards or to modify independent judgment. Many see no reason why an official position in a client's organization or actual bookkeeping would impair their independence in the slightest degree, and it is even urged that an accountant who is an officer, director, or bookkeeper for his client is in a position to have greater knowledge of that client's affairs than he would have if he avoided those relationships.

All this has merit, but when we deal with thousands of people we encounter all degrees of corruptibility or incorruptibility, and a code of ethics cannot be effective if it is appropriate only to the most upright and rigidly honest. In fact, a code of ethics intended for persons possessed of ideal human character would be a contradiction in terms. To the extent that it was designed to bring about uniformity of behavior instead of permitting variations of individual subjective judgments, the ideal character of the persons concerned would be irrelevant; to the extent that it was designed in furtherance of integrity it would be unnecessary. Moreover such a code would fail completely in its public-relations aspect, and any failure of that kind would defeat the usefulness of independence almost as much as loss of independence itself.

Getting down to brass tacks, I suggest that paragraph 13 of our rules of professional conduct, dealing with financial interests in a client enterprise be amended to eliminate the existing permission to express an opinion on financial statements used as a basis of credit, subject only to disclosure of any financial interest of the accountant. This distinction sets up a double standard, and seems to relegate credit granting to an inferior position. Obviously, it does not refer to credit granting where bonds are sold to the public, but it would apparently refer to credit granting by a bank or insurance company administering other people's money. It seems to me to be a distinction without much difference.

I further suggest that the Institute's rules of professional conduct should forbid competitive bidding for accounting engagements instead of merely supporting the state societies which have already done so. Some years ago the executive committee of the Institute issued a statement setting forth that competitive bidding for engagements to render professional service is unsound and illogical and leads to poor quality of work. There can be no doubt that it impairs independence.

And finally I suggest that the Institute adopt rules of professional conduct forbidding the expression of an opinion on financial statements when the accountant is a director, officer, or other employee of a client or keeps its books. Some state societies have taken this position, and the Institute's committee on professional ethics has urged it even in the absence of a rule.

These are specific steps to be taken, as I see it, in the evolution of the objective standards of independence appropriate to our code of professional ethics. They would further both of the basic purposes of that code: to enhance actual independence, and to strengthen public confidence in it.

Raising or even maintaining standards of professional ethics is, by its very nature, uphill work. There is a natural tendency to deterioration of standards. They can easily gravitate to lower and lower degrees of effective observation. One man will violate or appear to violate a rule, and another man will then say bitterly, "They're all doing it and I'm not going to be a sucker." In other circumstances grand gestures of tolerance for others will lead to lax interpretation of rules, with forgetfulness of the reasons why the rules are necessary, or, for himself, a man will say, "I can be truly independent in spite of financial interests or other relations, and the rules are not meant for me." These kinds of deterioration can only be prevented by conscious effort. Vigorous leadership and conscientious example are necessary to overcome laxity not only to move forward, but even to hold the positions already taken.

And this brings us back, full circle, to the broad concept of ethics as the science of ideal human character. For the code of professional conduct—ethics (2)—must rest for its foundation and depend for its inspiration on ethics (1). The independence of the professional accountant relates clearly to this. In the broadest sense, I think ethics consists of the intelligent choice of the greatest good. The ethical man must be impartial. He must be bigger than himself. The essential character of the ideal life is its largeness. The ethical man has ideals higher than those of the community around him, and he will not be moved by the opinions or insulted by the jibes of that community if he is criticized and ridiculed as impractical. "Woe unto you," said Jesus, "when all men speak well of you."

It is no disparagement of the ethical man's quest for the greatest good that his goals coincide with his own best interests so long as those interests are not its limitations. That these goals do coincide with respect to independence of professional public accountants is clearly evident. But the requirements on those who would be the leaders call for more than mere expressions of piety. There is need for intelligence, courage, and self-discipline as well.

In considering existing rules of professional conduct those who would contribute to the independence of the public accounting profession must always keep in mind the purposes of the rules and must lend their influence and example to observation and interpretation in the light of these purposes. They must actively and effectively further the evolution of their professional code to cover areas heretofore neglected or only partially covered. They must have the courage to be independent not only of clients, but of political and social influences, governmental regulatory bodies, and even widely accepted accounting practices when departure from them is appropriate. They must have the sturdy independence necessary to follow their own intelligent judgment in cases where there are no written rules to follow. Yet they must also, as Mr. Samuel J. Broad pointed out years ago, be governed by what is generally accepted as sound practice even though they may disagree with it. They must be independent of themselves. And they must achieve that most necessary and yet most intangible of all qualities, genuine independence of mind, not as a substitute for established rules of professional conduct, but in furtherance of their observation. It is not easy to combine difficult judgment with difficult objectivity; yet this is the challenge to the public accounting profession, and in it is our opportunity for continued service.

Development of an accounting practice

by **RALPH J. WHITINGER, CPA**

THE DEVELOPMENT of an accounting practice is similar in many respects to the development of any other successful business enterprise. As in other professions, a good educational background and certain basic experience are required before entering into private practice. Four years in college specializing in business and accounting education combined with three years of experience in a public accounting office are considered minimum requirements before starting. Knowledge of related subjects such as insurance, finance, banking, etc., is very desirable.

The accountant should have sufficient capital to provide adequate office facilities and the necessary working capital for accounts receivable and supplies. There is no way to estimate the cash required to carry on the practice during the initial loss period. It is suggested that the individual desiring to start in practice have sufficient funds to pay his living expenses for at least six months. In addition to this, he will need a minimum of $500 for fixtures and equipment for each individual employed by the firm, and dependent upon the type of practice, will require from $1000 to $3000 of working capital for each employee.

The accountant should be thoroughly conversant with the state laws governing the practice of accountancy in the state in which he desires to practice. Some states require a license while others require the certificate as well as the license.

In choosing the location for the accounting practice, the individual should first determine the type of practice in which he wishes to engage. Tax work, auditing, system installation, or a combination of these will depend to some extent on the community chosen. In some areas, tax practice is quite lucrative while in other areas, it might be more desirable to specialize in system installation or auditing. Many factors influence the earnings which may be anticipated from an accounting practice. The individual's ability is probably the most important factor. Personality and the ability to secure clients are two other very important factors. The accountant should anticipate that earnings will increase over the period of years commensurate with his accounting ability and success in obtaining clients. It is assumed, however, that the individual who decides to open an office has appraised these personal factors in their proper perspective and, therefore, is confident that he will be successful.

Aside from these personal factors, the size of the community, the number of business establishments in the community, and the number of accounting firms already in business in the community are points which must be considered objectively before starting in practice.

It is suggested that a community should be analyzed by reviewing, among other things, the following pertinent factors: Is the community growing or is it standing still? Are the businesses locally owned or are they branches of nationally owned firms? Are the surrounding communities stagnant or are they aggressive? Is there a diversification of manufacturing, or does the community have a few large manufacturing plants? Is the community well diversified in its manufacturing, agriculture, mining, etc.? Are the accounting firms already in existence successful?

It is assumed that the individual developing an accounting practice will want continued growth, and therefore, the community chosen at the start must provide

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sufficient potential to make this desired growth possible. Business concerns generally do not change accounting firms often, and therefore, beginning practitioners must realize that most of the new clients will be those who have had little, if any, prior public accounting assistance. Business coming from other public accounting firms is generally the least desirable if the other firm is a good one. It usually takes many years for the practitioner to obtain choice clients.

The individual who has the courage, energy, and ability to start in business for himself finds the most difficult problem the lack of clients during the initial period. The very energy which caused the decision to start in business becomes surplus energy when the accountant finds himself sitting at his desk without clients. This energy must be used to secure clients. Direct solicitation is in poor taste and must not be resorted to under any circumstances. This leaves only one approach open. We choose to call this approach indirect solicitation. The individual, during this initial period, should make much of his time available for community activities. He should offer to serve as auditor for charitable institutions without fees. He should accept the position of treasurer of church organizations, lodges, parent-teacher associations and other worthwhile community endeavors. He should participate in community fund drives, and Red Cross drives and other fund-raising activities. These suggested activities will do two things—first, they will provide a good use of the energy which is otherwise being wasted, and secondly, and probably more valuable, it will enable the individual to familiarize the community with his ability.

The beginning period is the hardest and usually presents the more perplexing problems. Losses, lack of adequate personnel, unsatisfactory clients, lack of sufficient work to occupy one's time and many similar problems present themselves daily. Many successful practitioners today could write a very interesting treatise on "how to be hungry and yet maintain a professional attitude."

Unless the accountant purchases a practice from some other accounting firm or leaves an accounting firm and takes some clients with him, he finds all of the better and more successful business firms already clients of another accounting firm. At the start one must be satisfied with part-time bookkeeping engagements, taking care of the disgruntled clients of other accounting firms (who will never be good clients for anyone) and doing accounting work for many who have a limited ability to pay. In most communities the beginning accountant will be considered a bookkeeper and this is probably a fair comparison since a number of his engagements will be in this category. It is at this point that the professional attitude asserts itself. As a bookkeeper, the accountant brings more than just record keeping—he becomes a comptroller, a business adviser, a tax expert, and renders services far beyond the ability of the bookkeeper. This bookkeeping provides an opportunity for the individual to impress his client that he is a professional man and that his opinion is valuable and necessary.

Every person who has given the question of solicitation an objective analysis is firmly convinced that it must not be done and is equally aware that the only satisfactory clients are those recommended by other satisfied clients. It is, therefore, very important during the first few months and years always to give the client more than he is paying for and better than he bargained for. In this manner, clients will start recommending the new practitioner and he is on his way. There is no intention to infer that the fee should be cut or that the beginner should let the business public "chisel" the payments for services; rather it is inferred that adequate charges should be made for the work contracted and that "plus" services should be added to the engagement for a very minimum charge.

The accountant should become acquainted with his community and the business interests in the community. The acquaintanceship of attorneys, bankers, brokers, insurance men, and government employees should be cultivated. All of these individuals can be of great assistance to the accountant by providing practical tips and advice. The accountant can better serve clients if he is known favorably wherever he goes. The opportunity to cultivate the friendship of the business people of the community on a professional basis should be sought at all times and is very important throughout the accountant's career.

The passage of a new tax law or other important business legislation will many times afford the accountant an opportunity to give a talk before a service club or civic group. If the accountant possesses some speaking ability and has sufficient experience to do the assignment well, he should seek these methods of letting the local community know of his ability and of the accounting profession.

The accountant will no doubt be tempted to take on some assignments that are undesirable. In every community there are businessmen of questionable standards who will be seeking an accountant who will keep records and prepare tax returns in an unethical manner. The discerning accountant should not be long in determining who these individuals are and proceed immediately to eliminate their work from his office. While the fee may be desperately needed at the time, the accountant who accepts engagements of this nature cannot expect to command the respect of the business public and will never be successful. There are so few of these unethical individuals that this should present no real problem at any time.

The development of an accounting practice requires the employment and training of a staff. The accountant should try to supplement his own ability and add staff members who are experienced and well trained. The growth of the practice will find staff men having more contact with the clients than the principal, and so it becomes absolutely necessary that all staff men be well qualified and of sufficient ability to serve the clients properly. Staff personnel must be compensated adequately and must maintain a good professional attitude. The better the staff personnel, the better chance the practitioner has of improving and expanding his firm. Eventually, the firm may employ specialists in the tax, cost, or systems department, but this is impossible in the beginning. The first staff men should be of well-rounded auditing and tax experience and should be equal in ability and accounting knowledge to the principal. The senior partner, or principal, will have to spend a tremendous amount of time in developing and maintaining good will for the firm, and therefore, must surround himself with a staff of well-qualified individuals who will be able to assist him in the more technical phases of the professional engagements as the firm develops. The principal cannot afford to gain the good will of the public and then lose that good will by having employed an incompetent staff. A qualified staff provides diversified viewpoints on the many controversial problems which arise. The individual who does not have well-qualified assistants is at a tremendous disadvantage to keep abreast of all the new phases of the accounting profession. Daily office conversation with staff men does more to keep one well aware of current developments than any other method.

Fees should always be measured by the services rendered—bookkeeping services at the bottom of the list and consultation services probably at the top. Clients should be advised that the accountant, as a professional man, is able to perform several different classes and types of service which have a different value to the client, and therefore, compensation would be at a different rate per diem. It is generally expedient and practical to charge the larger clients more for the same service than it is the smaller clients. As the accountant's prestige in the community increases, larger firms will seek his services and in this manner the accountant is able to increase his income.

The business world places a great deal of confidence in experience. As the accountant develops and gains a reputation in his community, it is very proper that his fees should increase since the client may place more reliance on his judgment and the accountant will probably spend less time in producing the same opinion. The accountant should avail himself of every opportunity to acquaint his clients with the values of his services. Selling accounting services is like selling any other commodity in that the buyer must feel that he is getting his money's worth. Generally speaking, the businessman has no basis of appraisement of an accountant's services and it is difficult to reduce these services to a dollar value. If the accountant is to be successful, he must constantly keep in mind that his clients must have a basic knowledge of the services he is rendering to them and their value. Most experienced accountants charge too little for the valuable services rendered to the business world.

The accountant should constantly review the problems of his clients for the purpose of improving records, providing budgets, cost systems, tax planning, and other services provided by the accounting firm. Many clients, coming in for the preparation of their tax returns are unaware that their bookkeeping systems need some attention or that the installation of a cost system would save them thousands of dollars. The accountant is remiss in his duties to a client if he does not suggest improvements where they are needed.

A successful practitioner must appreciate his client's viewpoint and limited knowledge of accounting techniques and government regulations. It is his duty to supplement the client's knowledge if he wishes to render the client adequate services. Many accountants fail to speak the businessman's language. That is to say, explanations of the client's problems are couched in accounting terminology that is not understandable by the client.

By way of summary, the well-qualified accountant who surrounds himself with a good staff and maintains a professional attitude should be able to develop a good accounting practice.

Accounting and auditing services to banks

by SAMUEL W. PRICE, CPA

THE BANK, as custodian of a large part of the money and other property of the community, is charged with the great responsibility of a public trust. Proper acceptance of this responsibility requires good bank management which carries with it an effective system of audit and control. The certified public accountant stands ready to help the banker to develop and operate a sound over-all auditing program and also has many special services to offer, such as periodic examinations for the directors, preparation of tax returns, advice on tax problems peculiar to banks, reporting on borrowers' affairs, advice on the mechanics of service charges, and budgetary control of earnings and expenses.

Banking laws and regulations have always recognized the necessity of providing every possible safeguard for banking activities. To this end, federal and state laws provide for periodic examinations by supervisory authorities. Many states further require periodic directors' examinations. While the National Bank Act does not require directors' examinations, the Comptroller of the Currency, following a long established policy, will not approve the by-laws of national banks unless they provide for an examining committee and periodic directors' examinations.

The duty of examining the affairs of the bank should not be treated lightly by the directors. Under the common law, they may be liable for losses sustained by the bank as a result of their neglect of this duty or failure to perform it properly.

In an early case on this subject (*Rankin* v. *Cooper*, 149 Fed. 1010) the court stated in part that "it is incumbent upon the directors of a national bank, in the exercise of ordinary prudence and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency." In a more recent case (*Federal Deposit Insurance Corporation* v. *Mason, et al.*, 115 Fed. 2nd 551), the court said in part that "ordinary prudence, in view of the almost universal practice among the national banks of the country, likewise should have persuaded the directors of the need of an independent audit of the bank's affairs by a competent outside accountant."

General supervision must be exercised by directors in all banks, and particularly in the community bank, where policy, with respect to both operations and examinations, is apt to be dominated by the chief executive officer of the bank. Even though the directors may have delegated active management to a senior officer, they can not transfer to him the responsibilities imposed upon them by law for the safe and prudent management of the bank. It is suggested that regular examinations by independent certified public accountants furnish a large measure of protection to the directors, and assist them in meeting their responsibilities, by providing disinterested reports on many phases of the stewardship of the active management of the bank.

The factors in over-all auditing program

Three main factors should be considered by the banker in developing this program:

1. The scope of examinations by supervisory authorities
2. The scope of directors' examinations
3. The proper perspective in order to attain adequate auditing coverage

Let us review quickly the purposes and limitations of the supervisory examina-

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tion. The purposes are three in number: first, to determine solvency and liquidity; second, to evaluate management and general policies; and third, to make certain that banking laws and regulations are conscientiously observed.

The limitations, as I see them, are likewise three in number. In the first place, the earnings and expenses are viewed from an over-all standpoint and the details of operations are not examined. The authorities are primarily concerned with a determination of financial condition. In the second place, the matter of internal control is approached on a question and answer basis. No real test of the effectiveness of the system can be accomplished in the short time allotted to each examination. In the third place, the supervisory authorities have not adopted, as a regular procedure, the direct verification of deposits and loans, to any great extent. Among the objections raised to the use of this procedure are first, the possibility of arousing doubts as to a bank's solvency; second, the cost and size of the operation; and third, that as a matter of policy, the supervisory authority should not inject himself into the relations between banks and their customers under ordinary conditions.

Turning now to directors' examinations, we find that three methods may be used:

1. A direct audit by a committee of directors
2. Delegation of the auditing function to an internal audit staff
3. Engaging certified public accountants to examine the affairs of the bank for the directors

It is not reasonable to expect that a committee of directors can make a direct audit which will be adequate. Auditing requires specialized training. Bank directors, in general, are attorneys, investment bankers, and chief executives in industry, finance, and many other types of enterprise. Their backgrounds and training are usually far afield from auditing. Their time, outside of attendance at board and committee meetings of the bank, is largely taken up with their own affairs. Usually, most of the directors have only a sketchy knowledge of the details of bank routines.

Careful planning is vital and the control necessary to an adequate bank examination cannot be subject to interruption. The directors just can't afford to divorce themselves from their own activities for a long enough period to perform an efficient examination by themselves.

One of the alternatives to a direct examination is to delegate the job to an internal auditing staff. However, the small bank can not afford the expense of an auditing department. It is true that many small banks have an auditor, but it is often a part-time task delegated to a person whose other duties are of an operating nature. It is difficult to see how such a person can take an objective viewpoint in performing his auditing function. Even in the large institution having a competent auditing department, day-after-day association of persons in this department with operating personnel always has the possibility of weakening the objective viewpoint. It is suggested, even though many bank auditors and comptrollers may not agree, that the internal auditing program should be reviewed and tested by disinterested outside parties in order to produce the best results.

The certified public accountant has a definite place in directors' examinations, either in review and testing performance of the auditing program of the large institution or in conducting the entire examination for the directors of the small bank.

The independent professional accountant has much to offer in this category, by furnishing personnel who are trained in auditing techniques, supervised by those specially trained in bank examinations. The outside accountant offers wide experience in accounting and auditing in many fields which can be of real service to the small bank, particularly in dealing with operating problems noted during the examination.

Surprise is vital to an effective bank examination. Who is better able to meet this objective than the certified public accountant? He is constantly reminded by training and experience of the importance of surprise in all financial examinations.

It follows that an outside professional accountant takes an objective viewpoint in a bank examination as in any other type of assignment. In this connection, the independence required of professional accountants by the Securities and Exchange Commission and by canons of professional ethics laid down by national and state societies of accountants can not be too strongly emphasized.

Bankers throughout the country are becoming more and more aware of the advantages of delegating directors' examinations to certified public accountants. In the June, 1950, issue of *Auditgram*, Glenn C. Simpson, president of the State Bank of St. Charles, St. Charles, Illinois, wrote an interesting article on "Audits for a Small Bank," recognizing the place of independent accountants in directors' examinations, particularly in the field of direct communication with borrowers and depositors. Jack W. Person, assistant cashier and auditor of the Frost National Bank, San Antonio, Texas, in an article on "Directors' Examinations" contained in *Auditgram*, in the June, 1948, issue, states in part, "Theoretically, it seems to me, the only perfect examination would be one in which the directors personally did all the counting, listing and checking. The next most perfect examination would be that made by an outside agency reporting direct to the committee.—It must be emphasized that an examination by directors which is inadequate and inconclusive is of little value."

The proper perspective, in order to attain adequate auditing coverage, is to complement the minimum requirements prescribed by supervisory authorities by covering areas not encompassed by state and federal examinations.

The first matter to be considered is the procedure of direct communication with borrowers and depositors which is a keystone in a sound auditing program. Some states have recognized the importance of this auditing procedure. The State Banking Commission of North Carolina adopted the policy of direct verification in selected banks several years ago and hopes to confirm these accounts in about 20 per cent of the banks each year. The reaction from the customers has been to ask the examiners not only for a verification of their commercial accounts but for all the business the customers have in the banks. The commissioner of banking and insurance of New Jersey issued regulations on October 18, 1948, relating to directors' examinations, requiring written confirmation of 5 per cent, in number, of demand deposits and of 10 per cent, in number, of loans and discounts, including mortgage loans. The position of the Pennsylvania department of banking appears to be to encourage, although it does not require, confirmation of such accounts. Instructions, issued by the Comptroller of the Currency for directors' examinations, state with respect to loans, that the genuineness of each note should be carefully determined, but do not indicate how this is to be accomplished. National bank examiners with whom this matter was discussed took the position that it was a responsibility of the directors themselves to determine the authenticity of loans. In view of such responsibility, it seems logical that national bank directors should welcome direct verification. There appears to be a considerable difference of opinion as to whether such verification should be performed by the bank's own staff or by outside accountants. However, consideration should be given to the objective viewpoint of the outside accountant in weighing this question.

Another area to be developed is that of earnings and expenses which appears to be unexplored in the supervisory examination. The possibility of defalcation in this area and the importance of proper control of operations appear to be sufficient reasons for including a verification of earnings and expenses in the directors' examination. Here again, the certified public accountant can render valuable service in many instances by making comparisons of operating efficiency among a number of banks. Even where he has only one bank client, his training leads him to draw proper comparisons between operating periods and to bring distortions to the attention of directors for prompt corrective action.

The suggestion is made that there is the possibility of accepting the report of the supervisory authority as a starting point for a complementary program. Using the controls of resources and liabilities shown in such report as the basis for accounting for earnings and expenses, the accountant may still be of great assistance to bank management in an examination limited to the operating accounts. Many accountants will no doubt take the position that any such partial examination is inadequate. Nevertheless, from a broad point of view, the desirability of supplementing or complementing supervisory examinations by CPA audits of earnings and expenses should be apparent to everyone who is interested in obtaining proper coverage in the over-all auditing program for banks.

The development of an adequate internal auditing program for a bank is another invaluable service to be rendered by the independent professional accountant. The accountant who inaugurates such a program is remiss in his duty, however, if he does not point out to the directors the need for regularly testing the efficiency of internal auditing by an outside party.

The over-all cost of auditing is a highly important consideration to the bank officers and directors. The foregoing suggestions for complementing rather than duplicating auditing functions are made from that standpoint. The independent professional accountant should be considered as having a necessary place in the program, but, in offering his services to banks, he must be prepared to show why and where his services are needed and that cost is not unreasonable in relation to results attained.

Accounting and other special services

Leaving the matter of auditing, let us consider accounting and other special services offered by the certified public accountant to banks.

Loans. In many country banks, loaning policy still appears to be based, to a large extent, on the banker's knowledge of the borrower's everyday activities, rather than on information contained in credit files. Even in these small communities, however, business is more complex than it was twenty or thirty years ago. Accordingly, the professional accountant should stress the need for regular and adequate credit reports from borrowers and the advantages of having such reports prepared by certified public accountants.

Regular inspection of collateral under floor plan and assigned account loans is in many cases made by bank personnel. Where such personnel is not available for this purpose, it appears in order for the certified public accountant to suggest his ability to perform this function. He would, of course, investigate each situation to determine that the accounts inspected were not audited by other accountants. He could still be of service by recommending in those particular situations that the bank should require the borrower to have its accountants supplement their annual or other periodic reports by monthly inspection of the collateral.

Control of operations. Budgetary control of earnings and expenses is now receiving attention even in the smaller banks. Declining interest rates on investments and rising costs of operations have had considerable influence in this respect. Daily accrual systems for earnings have been adopted and monthly or weekly budgets have been set for expenses in many institutions. The professional accountant, in making suggestions for controlling operations, must bear in mind the value of the results obtained in relation to the cost of operating these systems. Too often, a daily accrual system is adopted where monthly determinations of unearned discount, accrued interest on bonds and demand loans and monthly provisions for expenses would have furnished the necessary guidance for successful operation and at considerably less cost.

Service charges. The certified public accountant has a job to do in acquainting the country banker with the mechanics of cost analysis and proper development of service charges. There are still a large number of banks in smaller communities that use over-all methods which do not result in adequate earnings from this source and are not fair to all parties concerned.

The results of a recent survey of 2,406 banks, made by the commission on country bank operations of the American Bankers Association, showed that only 1,162 of them were using an analysis plan providing for charges on the basis of earnings and expenses per account. Various banking associations have recognized the need for wider acceptance by bankers of adequate service charges based on sound costing methods and have developed considerable material on the subject.

In this connection, the National Association of Bank Auditors and Comptrollers assigned a committee to prepare a manual on *Cost Accounting for Banks*, which was presented at the Denver conference of that association in 1948. The American Bankers Association, through its commission on country bank operations, has likewise published a manual entitled *Checking Account Service Charges for Country Banks.*

Along the same lines, several interesting articles have appeared in recent issues of *Banking*, the journal of the American Bankers Association. In the April, 1950, issue, Herbert E. Kirmmse wrote on the subject "The C.P.A. Looks at Bank Costs." In the May, 1950, issue, "Bank Earnings and Service Charges" was the subject of an article by Richard W. Trefz, chairman of the ABA commission on country bank operations. In the same issue, Thomas L. Nims discussed "Analysis of Activity and Costs in One City's Savings Banks."

The professional accountant should make a real effort to break down the country banker's reluctance to adopt sound service charges which appears to be caused by lack of knowledge of practical mechanics of determining them. Further, he should discuss with the banker the arguments to be furnished to bank customers in order to obtain their support of a service charge plan.

Income taxes. The preparation of federal income tax returns for banks involves a knowledge of the special treatment applicable to certain transactions, such as sales of real estate taken under foreclosure proceedings, net losses on sale or exchange of bonds, etc. In many of the small community banks, the officers and staff are too busy with operating matters to acquire such knowledge. The certified public accountant's training, of necessity, includes a study of taxes and he is well qualified to prepare the tax returns for these smaller institutions.

In the broader field of tax policy, as it affects both small and large banks, the professional accountant can render invaluable advice on many specific tax questions. As an illustration, the decision for tax purposes as to whether to take the election to amortize premiums on taxable bonds, or to defer the loss of premium until sale, call or maturity, requires careful consideration as to its effect on present and future earnings. Likewise, the determination to change from an actual charge-off basis to a reserve method for bad debts is a matter that is not finished when the change is made. Careful consideration must be given for tax purposes to proper treatment of future recoveries and to ceiling limitations on the amount of the reserve, set forth in income-tax regulations which give special treatment to banks as distinguished from other classes of taxpayers. A decision to change from a cash to an accrual basis for tax purposes is another matter that must be weighed carefully by a bank because the usual result is an increase in taxable earnings in the year of change.

Unemployment compensation taxes. The merit rating system, used by many states in connection with unemployment compensation taxes, involves a number of factors including timely payment of contributions to the insurance fund and payments from the fund charged to the taxpayer's account. A careful review of tax reports and notices of payments from the fund, helps to insure proper merit rating for taxpayers. It is true that this is a matter of general application to many different classes of taxpayers besides banks, but it is pointed out as a service to banks which should not be overlooked.

Systems and procedures. A careful study of systems and procedures is vital to effective bank management. Experience in other banks and in many fields of industry provides the certified public accountant with the proper background to determine adequate methods in this connection. Remarkable advances have been made in adapting machine methods to commercial and trust department operations in banks. Many certified public accountants have attended schools held by some of the companies which manufacture tabulating and other types of mechanical equipment in order to learn at first hand the adaptations that can be made to specific operations.

In conclusion:

The certified public accountant has a responsibility to acquaint the banker with the many types of service offered by the accounting profession. Several means are available to accomplish this purpose.

Personal contact with local bankers, either in a social or business relationship will, in the course of time, develop an awareness of the value of consulting with the accountant on many phases of bank operation.

Cooperation of groups of accountants with Robert Morris Associates and National Association of Bank Auditors and Comptrollers at the local level and with other state and local banking groups leads to an interchange of ideas and an appreciation of the part each is playing in accounting matters.

Every opportunity that is offered to the certified public accountant to speak before bankers' groups should be accepted in the spirit of public service.

The goal of close cooperation between the banker and the certified public accountant is better service to the community and the greatest possible protection to management, employees, stockholders and depositors of banking institutions.

Additional steps necessary to certify accounts where CPAs currently supervise record keeping

by ROBERT E. WITSCHEY, CPA

A PROPER DISCUSSION of the subject requires a brief review of the background out of which our topic has arisen because there have been many differences of opinion in that background—some of them not yet fully resolved. It was first necessary for the profession to find an answer to the question, "Does the legitimate field of the public accountant's work extend beyond the auditing of records, the certifying of financial statements and the preparation of tax returns?" That question has been affirmatively answered, not by a resolution adopted by a large segment of the profession, but rather by a gradual acceptance of the much wider service which progressive local CPAs were rendering to small businesses. Other questions have followed: "Should the accountant indicate in his report that he has been responsible for a part of the record keeping?"; "Should he indicate in his report that he has prepared the statement from the client's records?"; "Does keeping accounts preclude expressing an opinion on them?"; or, as the last question is now worded, "Does keeping accounts *always* preclude expressing an opinion on them?" The changing nature of the questions indicates that a substantial part of the profession is coming to realize the fact that local practitioners are rendering a multitude of services in which a thorough knowledge of accounts is helpful.

The questions of the tax gatherers have impressed upon management of small businesses the necessity of keeping adequate records. Bankers and other credit grantors are more and more stressing the importance of financial statements that have been independently examined. But the most definite impetus to the movement for better accounting for small business has been given by the American Institute of Accountants in its work with banking associations, insurance and bonding companies, trade associations, and by written material for public consumption. It is upon this *need* that a whole new area for service has been opened to CPAs. The profession has been substantially enlarged by a rapidly growing group usually referred to as local, or small growing practitioners, who seem to be best fitted to render this important accounting service to small businessmen. Here is the frontier of our profession where the ever-growing list of young men and women who are joining us can find an opportunity to serve their community well.

The importance to the profession of this type of work should not be underestimated, or treated as a type of service about which we should not talk too much, or as if the performing of it is something to be a little ashamed of. It is a type of work that serves the small businessman best. It is a type of work to which a third of the members of our profession are devoting a very substantial part of their time.

It is important that it be clearly understood here that there are not two separate and distinct accounting professions with different sets of standards for each. The accounting and auditing standards set forth from time to time in the bulletins of the American Institute of Accountants are just as applicable, just as appropriate, and just as important to the CPA in Crossroads, West Virginia, as they are to the

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CPA in New York with branches in all major cities. The only distinction between us is in the type of situation with which we are generally confronted. It is because of these different situations that the local accountant must, of necessity, emphasize one type of service, whereas the large firm emphasizes another. The large accounting firm generally is dealing with management who has long recognized the need for independent verification of accounts. It deals for the most part with businesses that have adequate internal controls, highly trained accounting and tax staffs, and other specialists as part of their permanent organizations. The local practitioner deals with businesses which enjoy none of these advantages except as they are provided by the local CPA.

In the former instance the CPA can rely, to a considerable extent, on internal control, tests, and review. The local CPA must rely more extensively on detailed examination of primary documents. The large firm of CPAs work with well-kept records. The local CPA more often works either with poorly-kept records, or with books which he himself is keeping. It is obvious that the type of service which we render is different, but it is just as obvious that the standards of performance are precisely the same. With this background then, we approach the matter of certifying of records which the accountant himself has kept.

Ideally, of course, supervisory record keeping fills a transition period for the client. It covers that period when the business has few, if any records, through the months of training a bookkeeping staff (and incidentally educating the client to the value of proper records), and finally to the time when the client will have a well-trained accountant or bookkeeping staff and the auditor will be called upon to make an independent audit, prepare tax returns, and consult periodically with management. This ideal development does not always come to pass, but even so, the alert accountant will attempt to verify, as far as possible, each account on which he works, within the practical limits of the job for which he is employed. Very frequently supervisory record-keeping jobs do develop to a point where the client will want the accountant to express an opinion as to the fairness of the accounts. It is with this particular situation that we are here concerned.

There are certain characteristics in most supervisory record-keeping jobs that should be noted here since they have a significant bearing on the work if the accountant intends to express an opinion on the accounts. (1) The CPA quite likely installed the accounting system now in use. He probably had to wade through cardboard boxes of rolled and wadded-up invoices and sales records well seasoned with cancelled checks. Out of this engagement he has established an accurate starting point and obtained a good background knowledge of the business. (2) Relatively small items may have important significance on the records of a small business. (3) The business will likely be owned by one, or by a very few individuals, one of whom may be manager, and in many instances may make the daily verifications of sales and cash, or even keep a part of the records. (4) The volume of many types of original papers is relatively small so that detailed inspections can be made in a short time. (5) The management will invariably insist on taking supposed income-tax advantages over proper accounting. (6) The accountant is usually familiar with the client's business, his suppliers and his customers. (7) The client and accountant are frequently close personal friends. (8) It is virtually impossible to establish any sort of satisfactory internal controls. With these factors in mind then, we can consider the specific additional procedures that should be carried out, in addition to the work performed during the record keeping, before the accounts should be certified.

Cash on hand and in bank. Frequently the accountant finds it necessary as a part of the routine write-up work to make occasional cash counts in order to reconcile actual cash with the ledger. In any case, a cash count should be made on or near the close of the fiscal period, and special attention given to checks held for redeposit, cash-paid vouchers, and I.O.U.'s. In many write-up jobs the accountant receives bank statements together with canceled checks directly from the bank, or from the client, unopened. The procedure then usually followed is to compare each check against its corresponding entry, inspecting amount, signature, and endorsement. Not infrequently the covering vouchers are kept in one folder so that they may be examined concurrently with the detailed entries. If cash receipt summaries were verified they are compared with deposit entries recorded on the bank statements. In this case the accountant need only to supplement his work by obtaining direct confirmation from the banks. The chief purpose of the latter is to disclose restrictions on cash, and liabilities, actual or contingent, of which the accountant may not be aware. If the monthly bank statements have not been received unopened, then the bank balances should be verified in the same manner as would be done in any annual examination. In those cases where no effort is made to deposit receipts intact, the bank balance should be reconciled as of the closing day of the fiscal period and at a cut-off day, and a reconciliation between the two should be prepared. In some instances, one employee may perform many of the procedures in the handling of cash including the signing of checks. In such cases, if the bank statements are not received unopened, then the cancelled checks should be compared with bank charges for at least four months.

It should be repeated here that among small businesses internal controls are a rarity. Cash frequently is loosely handled, and clerks are often so close to management that the idea of fidelity bonds will not be considered. The owner of the business may pocket an occasional twenty-dollar bill on the perfectly valid assumption that it is his. It is obvious, therefore, that in these situations cash transactions must be examined in much greater detail than would be otherwise necessary. It is just as obvious that such verification could be done much more satisfactorily along with the monthly write-up work, before the volume of detail becomes heavy. The CPA will perform a real service to his client if he can convince him that this additional verification should be a routine part of the supervisory record keeping.

Receivables. In some instances little additional verification of receivables need be obtained. Such cases are those where sales are made to a limited number of customers. Thus, a contractor's income will be based on architect's or engineer's estimates which are available for monthly inspection. Producers of natural gas and oil will usually sell their product to one or two refineries. Frequently small manufacturing and mining companies will sell their product to only a very few customers. In such cases a detailed examination of receivables can readily be made as part of the monthly record-keeping service. Even so the accountant should request direct confirmation of large accounts. Differences existing between the client and customer will thus be disclosed. In those cases where customers' accounts are voluminous, the accountant will probably be unable to do more each month than run an adding-machine tape of the customers' ledger to compare against the control figure. If frequent inspections of daily receipt summaries and sales records are made in connection with the monthly work, then the accountant will have substantially eliminated the blind spot of lack of internal control, but *rarely does he acquire a sufficient knowledge of the accounts so that he can forego the need for independent verification.*

Notes receivable should be verified by physical inspection at the close of the fiscal period, even though they may have been inspected during the course of record keeping, to determine whether they may have been sold, pledged, or hypothecated.

Of particular importance are the amounts shown as owing from officers or owners. Quite often these accounts represent nothing more than withdrawals which were never intended to be repaid. Such items have no place on the balance sheet.

In addition to ordinary means of determining probable losses, the accountant may have a first-hand knowledge of the credit rating of many of the customers, and this knowledge will help in determining the sufficiency of reserves for bad debts.

Inventories. Although many questions have been raised within the profession concerning inventories, in many of the record-keeping jobs they do not present a serious problem. As was previously noted, the business involved is generally small so that the taking of an inventory is a relatively simple matter. In this case, inventory records can be verified by physical count at times other than the last day of the fiscal period. One point should be made crystal clear—*seldom, if ever, should any type of verification be used as a substitute for a physical inspection.* The most serious problem facing the small practitioner concerning inventories is that of trying to make sufficient physical inventory tests for a large number of clients during peak load periods. This condition can be greatly alleviated if interim physical inventory tests can be arranged for those clients served in a record-keeping capacity.

Investments. It is a quite common practice for the small businessman to discuss the matter of investments with the accountant before acquiring them. In any case the securities should be again inspected at audit date. One serious problem that frequently presents itself is the valuation of unlisted securities. The client may have investments in numerous local businesses from whom reliable financial statements cannot be obtained. The accountant must use his best judgment in each situation.

Fixed assets and depreciation reserves. Of all the major accounts, the property accounts are probably the most completely verified in the process of keeping a client's records. Plant accounts, if maintained at all by the client, are usually sketchy affairs. As a consequence the accountant maintains his own schedules of depreciable property and the related reserves. Almost invariably the accountant must refer to original documents to determine the correct figures to be entered. An occasional plant review should be made to verify the existence and condition of the fixed assets. However, this review can be made during the periodic visits to the client's place of business. In view of the innate desire of many businessmen to reduce income taxes by charging off everything that can be written off, the accountant must be constantly alert for such items as labor expended on major improvements, freight on newly acquired equipment and similar charges. Frequently the small businessman operates on the theory that if his accountant does not catch the error then the income-tax examiner will miss it too. Fortunately the accountant frequently knows his client so well that he can readily place his finger on erroneously marked disbursements.

Generally, depreciation reserves and rates are left to the discretion of the accountant, and will be reflected on the records during the course of the periodic write-ups.

In those cases where fixed-asset accounts have not been verified periodically through the year, then the usual audit procedures should be followed through at audit date. Source documents should be inspected; material and labor costs of the client's own construction should be examined; retirements, cost of removal, and resale credits should be analyzed; repair and maintenance accounts should be carefully examined; and insurance policies covering fixed assets should be inspected, and, of course, a physical inspection of the property should be made to verify its existence and condition.

Deferred charges. The most substantial amounts will usually be made up of prepaid insurance, franchises, and leaseholds. If the insurance policies have not been examined upon their acquisition, then that examination should be made at audit date. Franchise and leasehold agreements should also be inspected. Usually the accountant himself will compute the amount of deferment.

Accounts payable. Many small businesses follow a practice of grouping invoices at the month end, clipping them with the creditor's statement and paying the total amount. As was previously stated, these paid items are often kept together in a folder until after the accountant has completed his record keeping. In such cases an examination of trade accounts payable is relatively simple. Particular attention should be given to charges that may appear near the end of the fiscal period for items which may not have been received and may not have been considered as an in-transit asset. If a close control of accounts payable has not been maintained in the bookkeeping process, then the accountant can verify the list of accounts payable by comparing the detailed amounts with creditor statements. Confirmations should be obtained in cases of differences and also from creditors whose accounts have not been paid on a basis of invoices or groups of invoices.

Notes payable. Usually the accountant will have a good knowledge of notes payable from his record-keeping work. However, requests for confirmation should be sent out and information concerning collateral should be called for.

Accrued expenses. Where the accountant is keeping the records the determination and computation of accruals will be left in his hands. The preparation of the federal income-tax returns is one of the major functions for which the accountant is employed by small business management. Ordinarily, the accountant will have become thoroughly familiar with commission agreements during the course of routine work. If he has not done so, then these agreements should be examined to determine that proper liabilities are recorded therefor. Accrued salaries and wages can be determined by scrutiny of the payrolls for the final period in the fiscal year.

Capital and surplus. These accounts are generally verified as the bookkeeping work is carried along. Ownership usually is confined to a few people so that an examination of stock records requires but a few minutes. Changes in surplus will be recorded by the accountant. Quite frequently the client is torn between two extremes—his desire to keep down income taxes and his desire to give the credit grantor the best possible financial statement. Income-tax considerations will nearly always win out when the client learns that he cannot have two sets of certified statements. Thus those items that could reflect in decreased surplus and still not be plainly spread in the records are the accounts that usually need the accountant's chief attention.

Income accounts. In many of the supervisory record-keeping jobs a detailed examination of sales and receipts can be made a part of the record-keeping work. Lack of internal controls is to some extent offset by the accountant's close personal knowledge of his client's business. However, if the supervisory record keeping has been a matter of copying from the client's summaries, then the accountant should make the same examination that would be called for if he had been called in to audit the records of the business.

Expense accounts. If the accountant has inspected cancelled checks and substantial numbers of paid invoices, little additional work need be done on the expense accounts. Otherwise the usual audit procedures should be followed. Special attention should be given to repair and maintenance accounts and any other of those accounts which might easily contain elements of both asset and cost. Particular attention needs to be given to payrolls in smaller concerns. The payrolls should be extensively checked to determine that the names contained thereon are those of actual employees. Total hours and gross earnings should be tested against timekeepers' records multiplied by an average pay rate.

General considerations. It is quite obvious that the limitation of time permits only a brief listing of the more important of additional steps that should be taken before accounts can be certified where the accountant performs a substantial part of the record-keeping service. The keeping of records does give the accountant an opportunity to make a much more detailed examination of primary documents than would be possible in an ordinary audit engagement. He uses every opportunity to point out to his client how much additional service can be rendered if permitted the opportunity of extending his examination. Very frequently only a very little additional time will be required to make these additional examinations if they are carried out in conjunction with the record-keeping work.

In concluding, I should like to sound a few words of caution in connection with the certification of accounts where record-keeping work is performed. (1) The mere act of writing up the books, of itself, does not give the accountant enough information concerning the accounts to justify the omission of any of the generally accepted auditing procedures as set out in publications of the American Institute of Accountants. If the accountant has, however, made independent verifications concurrently with the record keeping, then to this extent the work need not be repeated at the end of the fiscal period. Just as in any audit, the accountant should have prepared and kept on file sufficient working papers covering the items that were verified. (2) The accountant must never forget that he is equipped by training and experience to render a much greater service to his client than the keeping of records alone. He should therefore strive to impress on the client that the record keeping provides a base from which these greater services can be rendered. The more accurate the record keeping has been, the greater will be the assistance that the accountant can give, and accuracy of accounts can be obtained only by sufficient examination of primary information. (3) The profession must never underestimate the importance of record-keeping service. It is through this work that the need for the CPA's services in attaining proper record keeping is being impressed on small businessmen. It is in this type of work that a large new area for service is opening up to the profession. Perhaps most important of all, it is in this type of service that many of the newer members of the profession are acquiring skills in their work and developing their practices. The profession can do no less than to give to those in this field of endeavor as much of assistance and help as is practicable.

Gentlemen: The question of certifying accounts which we have ourselves kept has not been resolved. I have, in my remarks, implied that I do believe that it is proper. I must do more. With a keen sense of obligation to conscientious local practitioners everywhere, I express to you the firm conviction that it is entirely proper to certify accounts that have been verified in accordance with the highest standards of published auditing procedures. Let us not waste our efforts theorizing whether or not a qualified accountant can both supervise record keeping and review accounts. But rather let us give full devotion to the task of educating businessmen to the importance of proper records and independently verified accounts. We shall have failed in that task if we do not lend all needed assistance to the maintaining of those records, and if we refuse a clearly stated opinion concerning accounts which have been properly verified.

Experiences with Auditing Statement No. 23

by LINCOLN G. KELLY, CPA

WITHIN A SHORT PERIOD of one year, it is altogether too much to expect complete and universal compliance with the requirements of professional responsibility and performance set forth in Statement No. 23, issued by the committee on auditing procedure and adopted by the membership at the annual meeting of the American Institute of Accountants held in Los Angeles in November, 1949. That there has been a widespread endeavor throughout the profession to comply with both the letter and spirit of Statement No. 23, I think there can be no doubt. Progress and advancement toward the attainment of higher standards of professional performance throughout the profession is an educational process, and it necessarily takes time to bring about changes in practice which appear to be new and constitute a deviation from what was previously considered established and acceptable practice. It is both natural and desirable that such a departure from former practice should be widely and thoroughly discussed. To stimulate this constructive and helpful discussion the Institute followed the right course in postponing action with respect to final adoption of Statement No. 23 for a full year when the matter was presented to council at the 1947–1948 annual meeting. During the year prior to its adoption, the statement received widespread attention so that the membership of the Institute had an opportunity to gain a fair understanding of its objectives and the primary reasons for its adoption.

The limited investigation I have been able to make has convinced me that experiences with Statement No. 23 during the past year have demonstrated the need for its adoption in order to maintain the high standards of the profession and to fix the limitations of the responsibility of the certified public accountant within the bounds intended to be assumed and to so clarify the written word in reports that no misunderstanding could possibly arise with respect to the degree of responsibility assumed by the certified public accountant. Experiences have also, I believe, conclusively demonstrated the fact that the arguments against the adoption of Statement No. 23 and the fears which some members had with respect to its constructive value were not well founded. These arguments were ably answered in an article by Marquis G. Eaton, CPA, in the October, 1949, issue of the *Journal*, and experiences have well confirmed his position. My own firm's experience with Statement No. 23 has been most satisfactory. So far we have had no serious trouble whatsoever with any of our clients as a result of changes in report presentation required under the provisions of this statement, and we have lost no clients as a result of any such changes. I think it is well to remember that the adoption of this Statement and first its promulgation by the committee on accounting procedure simply fixes a point in the development of auditing procedures as the time when it appears such a procedure has attained acceptance by many leaders in the profession, and I think this is a significant factor to stress in an educational program designed to bring about general conformance with Statement No. 23 by certified public accountants throughout the country. In other words, it is not something that appears upon the scene all at once, nor is it something that has not been well tried out in practice. It marks another important step forward in a program for report presentation that will convey to all interested parties the significance of the auditor's

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opinion where will be found in clear and unmistakable language the extent of the reliance that may safely be attributed to financial statements because of the auditor's association with them. Having been adopted by the Institute, compliance on the part of Institute members is mandatory.

Leading accountants throughout the country for many years prior to the adoption of the bulletins on extensions of auditing procedures in many cases confirmed accounts receivable by direct communication with the debtors and made extensive test checks of quantities and price in connection with the verification of inventories, and the importance of a system of internal control effectively applied was fully recognized. Auditing standards were also generally high. It is therefore more a matter of maintaining the standards and high ideals set by the leaders of the profession and well established years ago that becomes our solemn duty and direct obligation. The profession has grown and increased so rapidly during the past twenty-five years, not only in numbers, but more important, in the responsibilities which must be assumed along with the greatly increased recognition the certified public accountant has attained. In such a situation, we are bound to have differences of opinion which, of course, are wholesome, and we must expect to encounter hazards and hurdles in our forward advance. I think the small, or what I might term the medium-sized accounting firm, has taken this forward step with a stride founded upon a firm conviction gained from experience thus far that the adoption of Statement No. 23 has done more than any other one thing to identify the certified public accountant in a professional capacity and to emphasize the importance of his opinion in the presentation of financial statements.

Before dealing with specific experiences, it might be well to briefly review Statement on Auditing Procedure No. 23 as finally adopted at the 1949 annual meeting, which reads as follows:

The independent Certified Public Accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent Certified Public Accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

Whenever the accountant permits his name to be associated with financial statements, he should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative this opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as "Prepared from the Books Without Audit," appearing prominently on each page of the financial statements is considered sufficient.

It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole.

It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements.

Council, in recommending its adoption, stated:

In considering this recommendation, it should be remembered that Extensions of Auditing Procedure for ten years has precluded the expression of any opinion on the financial statements taken as a whole when the accountant's exceptions or qualifications were such as to negative the opinion. This provision is continued under the committee's recommendations. The proposed change is concerned solely with improving current reporting practices by providing that, in such cases, the accountant should henceforth clearly indicate that he is not in a position to express an opinion on the financial statements taken as a whole, and give his reasons why.

It will be clearly observed that the improvement sought to be brought about by the adoption of Bulletin No. 23 had to do solely with improving current reporting practices by specifying that whenever an accountant permits his name to be associated with financial statements, he should determine whether in the particular circumstances it is proper for him to: (1) Express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion may be given. If they are such as to negative an opinion on the statements taken as a whole, he should clearly disclaim such an opinion and give his reasons why.

In order to obtain a cross section of the experiences of representative concerns in the Mountain States and West Coast area with respect to the application in practice of Statement No. 23, I communicated with a relatively large number of what I considered representative concerns in the small and middle-sized class. I quote from replies received as a result of my inquiries as follows:

Over all, it seems that the procedures followed under this Bulletin have been well received by all of our clients. It is true that a clear understanding must precede each engagement. However, we have had no difficulty in this regard. Businessmen are very quick to understand that accountants cannot take responsibility for accounts which have not been examined to their satisfaction.

Adhering strictly to the wording of Auditing Statement No. 23 has had very little effect on our practice. If anything, the clients have become more appreciative of our services, and creditors are especially happy with the responsibility taken. (C. W. Gaymon, CPA, of the firm of Cordle and Associates, Cheyenne, Wyoming)

Prior to the adoption of Auditing Statement No. 23, we rendered very few reports in which we gave no opinion. Our clients were always informed of this fact and they understood the limited scope of our services. After the adoption of Auditing Statement No. 23, we merely advised them that it was necessary for us not only to not render an opinion but to place a disclaimer in the comments and set forth our reasons for not rendering an opinion. In all instances this was satisfactory with our clients and as far as we know at the present time it has not changed our clients' attitudes in any respect. (L. D. Wilch, CPA, of Wilch & Roelofs, Denver, Colorado)

The application of the principles of Statement No. 23 has affected our practice to a relatively limited degree principally because of the attitude of credit grantors in this state and the fact management and capital are the same individuals in the great majority of Wyoming's businesses. Consequently, we have relatively little demand for audits with opinion.

The principal difficulty we have had, both before and after the adoption of Statement No. 23, is the matter of the wording of the disclaimer. As I brought out at the conference in Denver during Carman Blough's discussion period, we find it very easy, on the one hand, to make the disclaimer so negative that it places an undeserved stigma on the statements, or, on the other hand, to make that portion of the disclaimer wherein opinion is expressed on certain items so positive that the reader may give unwarranted weight to the statements. I presume all practitioners have encountered the same difficulty. It appears to me that this problem may well be one of the greatest in relation to Statement No. 23. It would be very helpful if one or more uniform disclaimers could be developed, or, if this is not practicable, if a large number of sample disclaimers could be suggested. (Gordon J. Raab, CPA, of Raab, Roush & Company, Casper, Wyoming)

We make a number of annual audits for small businesses, medium-sized businesses, and for two or three rather large businesses. With the exception of approximately three or four of these clients, we make a complete annual audit, that is, we follow the auditing program set forth by the American Institute. For example, we insist on circularizing the accounts receivable and make test checks of inventories where they appear to be a material item on the balance sheet.

In two or three of the above cases, we do not give an opinion for the reason that perhaps the client does not wish to incur the expense. For example, he may not want a detailed examination of the capital stock account, or perhaps, for personal reasons, he does not want the accounts receivable circularized. In those cases, we make a complete audit of all other accounts. We then make a report, setting forth what accounts we have verified and what accounts we have not verified and the reason or reasons this was not done.

We have not made any particular change in our professional practice subsequent to November, 1949, when the revised Statement No. 23 was formally adopted. It has always been our practice to follow the procedure which is outlined above. We would welcome any criticism you might have. (L. J. Randall, CPA, of Randall & Magnuson, Wallace, Idaho)

I am pleased to reply to your request regarding our experiences with Statement No. 23. In this connection, let me state that we believe the concept of this Statement to be one of the greatest steps that the profession has taken, and are therefore doing our utmost to comply with both the spirit and the letter of its provisions.

Our office has given a choice of three possible audits to the clients, and upon this choice depends whether we submit an unqualified opinion, a qualified opinion, a disclaimer of an opinion, including the reason therefor, or a "prepared from books and records without audit." A principal of our firm has been careful to explain in advance to the clients our requirements for the presentation of each type of report, and the nature and implications of a disclaimer. In most cases the clients have recognized our point of view and have, regretfully sometimes, agreed either to an extension of our work, or to the disclaimer. Fortunately, in the majority of cases in the past we made it our business to do a good job of analysis and checking at year-ends. Consequently, the additional time and fee required for compliance with standard auditing procedures is not always great. Any changes made in the scope of work authorized by clients have been in the direction of more verification toward either a certificate or a minimum of qualifications.

The banks and other credit agencies have been of help in educating businessmen as to the value of a certified report at least once a year. Many bankers are now familiar with "No. 23" and have evolved certain standards within their organizations for audit reports submitted in the case of substantial loans. The publications on the subject issued by the Institute have been of great value in promoting understanding on the part of credit agencies and others. (Herbert G. Shane, CPA, of Meyer Pritkin & Company, Los Angeles, California)

With one possible exception, we have had very little difficulty in adhering to Auditing Statement No. 23. Of course, there have been times when we have had to "sell" a report to some of our clients, containing a positive disclaimer, but such "selling" has been done without the loss of the client.

The exception referred to above occurred during the past week. A bank loan of a sizable amount was contemplated by one of our clients. One of the provisions of the loan was certified financial statements. However, when it was explained to the client that certified financial statements included, among other things, our being present at the inventory taking and also a confirmation of the receivables, the client objected, principally because of the additional time involved, which, of course, meant an increased expenditure for accounting fees. At this writing we have not been authorized to proceed with the engagement. (Stanley V. Davies, CPA, of Davies, Zarini & Company, Denver, Colorado)

It has always been our opinion that financial statements issued over the name of a Certified Public Accountant should be presented in such manner that the reader thereof would not be misled as to the kind or type of report he was reading.

It has been our practice to always make a formal disclaimer statement in reports where no audit has been made, or the examination is so brief or casual that it could hardly be called an audit.

It seems to us that the average audit

requires the accountant to report on what he finds. This can seldom be done in a short-form report. The auditor will occasionally have a case where numerous distortions of the accounts exist. He may find physical assets written up by the proprietor himself, or find that the writeup is based on nothing more than the expressed opinion of the corporation's directors. He may find that adequate reserves for losses of receivables have not been set up, that inventories are overstated, and that liabilities have been understated. If the accountant cannot persuade his client to make the proper adjustments so that the truth can be shown, then I think he had better withdraw altogether and not issue any report even though he loses the fee in so doing. This has happened to us and no doubt to you.

On the other hand, suppose the work is being done for a bank as a basis for a loan or for creditors already involved. In either case, should not the accountant set out the facts in a formal report, each item on the balance sheet being appropriately commented on in such manner that the reader will know exactly what the existing condition is? In a case of this kind, why should a formal disclaimer be made when the accountant has already stated clearly and unequivocally the facts bearing upon each item on the balance sheet? In other words, a detailed opinion has been expressed on the accounts purporting to represent the financial condition.

While we have no particular objections to the formal disclaimer, we feel in the circumstances above recited it would be superfluous.

We do not feel that Auditing Statement No. 23 has in any way affected our practice for the reason that we have with a few exceptions followed, in principle, the pronouncements of Auditing Statement No. 23. (Douglas N. Wilson, CPA, of Douglas Wilson, Ferris & Company, Great Falls, Montana)

Our experience with Auditing Statement No. 23 has not been especially difficult. We began modifying our reports when the first draft of No. 23 was published about two years ago. To those of our clients who did not really require an opinion report, we have been able to explain the need for the disclaimer. For other clients, with but one exception, we were able to expand our audit program so that we could render an opinion.

I believe our greatest problem was the proper wording of the disclaimer. Our search there was for an expression that would not be misinterpreted and would not give the report less significance than that to which it was entitled. We found that a number of clients gave the word "opinion" its usual meaning of "belief," and some few of the clients were offended by the disclaimer that "we cannot express an opinion on the statements taken as a whole" because they interpreted the disclaimer to mean "we do not personally believe the statements to be true." We have attempted to give the word "opinion" a technical meaning by using wording as follows: "We cannot express an independent auditor's opinion on the statements taken as a whole."

In the one exception noted above, the client has for years insisted on keeping only cash receipts and disbursements records. For income tax purposes the company reported on a completed contract basis, while its own financial reports were prepared on an accrual basis. As the company employs us to assemble the necessary data, we do a very considerable amount of work as accountants but only incidental work as auditors, and are in no position to render an opinion. This past year they took exception to our disclaimer, stating that we had handled the firm's work for years, knew them to be honest, and consequently should be willing to express an opinion. Our explanation that we had no personal doubts as to their honesty and integrity but could not express an informed opinion without doing additional work was unsatisfactory to them. They were unwilling to spend a sufficient additional sum to enable us to express an opinion and stated that they thought we were being unduly technical. We have probably lost the account. (Carl M. Esenoff, CPA, of Everts and Esenoff, San Diego, California)

We have had no special experience with the application of Auditing Statement No. 23. We have made a positive disclaimer in a number of our reports and have had no criticism from any of our clients. I think in each case the facts have been clearly stated so that the client had no reason to question the purpose of the disclaimer. In most instances where our examination has not been made in accordance with generally accepted auditing standards we have so stated in our report and advised the client in the report that because we had not made certain verifications or satisfied ourselves with respect to certain items that we were unable to express an opinion as to the financial position of the company as of a given date or as to the results of operations for the year or period ended that date. We know of no instance where the use of the disclaimer has had any effect upon our practice. (M. T. Deaton, CPA, of M. T. Deaton and Company, Pocatello, Idaho)

We have had no important repercussions as a result of our conforming to Auditing Statement No. 23. In fact, we had followed it to a considerable extent before the statement was promulgated by the committee. In cases where we previously put at the top of the balance sheet and operating statement "Prepared without complete audit," we now say "Prepared without complete audit; therefore, no opinion is expressed." This, of course, is in the cases of so-called "tax audits" where the examination is only sufficient to enable us to make out the tax returns. We have had very few cases where we make up statements when we have made no examination of any kind. In those few instances, we would put at the top of the statement merely "Prepared without audit; therefore, no opinion is expressed." The only difference between the two statements is the elimination of the word "complete."

As to the reaction of clients, we have had little comment (other than some friendly kidding) as a result of our adding to our former statement: "Prepared without complete audit," the further words "therefore, no opinion is expressed." Some of our friends handed us a jab to the effect that we must have acquired a poor opinion of the intelligence of our clients and others in assuming that if we did not say we had not made a complete audit, they would not know that an opinion could not be expressed. Our general reply to that has been that everyone is not quite as smart as they are.

We have lost no clients that I know of as a result of the adoption of No. 23, and I think in some instances it has helped us sell the idea to some of our clients that they should have a broader examination than that to which they have been accustomed. (Clem W. Collins, CPA, of Collins, Peabody and Schmitz, Denver, Colorado)

We find in some cases where the client does not want a certified report we do not put the balance sheet on our letterhead and do not even sign the balance sheet. In other cases where the client does not desire a certificate, but we do feel that the figures are correct, we give him a letter of transmittal on our letterhead but do not say just what has been done. I believe this procedure is being corrected somewhat now as we have discovered in a few cases the supposition was that the figures would be correct regardless of whether we said so or not. In other cases where certificates are desired by the clients and the scope of our activities has been limited or the information in some cases being not available, which happens for various reasons, we are careful to make such statements in our reports. (Edwin Mathieson, CPA, Great Falls, Montana)

In general, we can state that our experience has been satisfactory from the standpoint of cooperation by clients and our general relations with them. We have enforced the rule without exception and have lost no clients on account of it. In some cases when the matter was explained, the client elected to have us expand the audit program to include procedures which would avoid the "disclaimer," but there are still a few cases of audits where it is impossible to state an opinion and so we must "disclaim." (Ralph B. Mayo, CPA, of the firm of Ralph B. Mayo and Company, Denver, Colorado)

As a result of all of my inquiries, I received no replies which indicated an attitude of willful noncompliance with Statement No. 23 or any remarks by the accountants questioned indicating a disapproval of its adoption. As stated before herein, my investigation was necessarily very limited. When the total number of firms and the total number of Institute members and the total number of certified public accountants practicing are considered, an investigation to determine the application of Statement No. 23 throughout the entire country would be a gigantic task.

In his very scholarly article covering "An Analysis of Current Developments in Auditing Procedures and Standards," Mr. Alvin R. Jennings, CPA chairman of the committee on auditing procedure, in dealing with the problem of the nonconformist reports on an investigation conducted in Detroit by Harry Prevo of the firm of White, Bower & Prevo, another member of the committee on auditing procedure, in cooperation with four of the leading banks in that city, from which I quote as follows:

Mr. Prevo decided that he would like to determine the extent to which it was customary for accountants in his area to observe the taking of inventories and to confirm accounts receivable. Almost 300 reports were reviewed by the four banks. For the most part the audit reports reviewed were restricted to those which related to companies the securities of which were not listed on any stock exchange. It was believed that generally where listed companies were concerned there would be few departures from prescribed procedures. From their study the banks presented to Mr. Prevo a tabulation of the number of instances in which the reports indicated that the accountant in question had not followed the procedures required by "Extensions of Auditing Procedure" classifying the departures as between those relating to inventories and those relating to confirmation of accounts receivable. The banks did not, of course, disclose either the name of the company audited or the name of the auditor. The study showed that only 54 per cent of the reporting accountants had followed required procedures with regard to inventories. With regard to confirmation of accounts receivable, only about 45 per cent of the accountants followed prescribed procedures. How many of the accountants involved were members of the American Institute of Accountants was not determined. Without going into further detail, I might add that the study also disclosed serious deficiencies in the reporting practices of the accountants.

Mr. Jennings further states in his article that Statement No. 23 having been adopted by the membership, his committee feels that an auditor may not in good faith hereafter consider an engagement to have been completed in accordance with generally accepted auditing standards if he has ignored Statement No. 23 in drafting his report. Mr. Jennings feels, as I think most of us do, that the nonconformist can be best dealt with by stepping up our educational efforts, obtaining the help of credit grantors by properly informing them of our objectives and persuading them to insist, where proper, that their borrowers authorize all of the procedures required to conduct a satisfactory audit. He also states that it is the hope of his committee that they can enlist the cooperation of every state society in a campaign to deal with this problem. Mr. Jennings' article deserves very careful study by every practicing public accountant in the country. He points out particularly that the small practitioner who is concerned with examining statements of smaller business units may possibly enjoy an advantage insofar as this problem is concerned.

A periodic review of the *Tentative Statements on Auditing Standards* issued by the committee on auditing procedure should be a great help to every practicing certified public accountant. He should understand the generally accepted significance of these standards and exactly what it means when he reports above his signature that the examination has been conducted in accordance with generally accepted auditing standards.

As one of the speakers here before this afternoon has told you, we can have no double standards. We can have only one standard for accountants throughout the entire profession and for all members of the American Institute of Accountants, and we must unitedly attempt to conform strictly to those standards.

I believe we have every right to be encouraged by the progress which has been made in the limited time since Statement No. 23 has been adopted, and that eventually we can obtain general compliance in report presentation with the requirements of Statement No. 23 by united effort to obtain the objectives sought. This can be done without interfering with the two fundamental pillars upon which professional accounting services must always rest. These are "independence" and "judgment."

Mr. Ira N. Frisbee, CPA, partner of Ira N. Frisbee & Company, Beverly Hills, California, has an illuminating article in the March, 1950, *Journal of Accountancy* on "How Exercise of Judgment Affects Application of Standards in Auditing Field Work," dealing with good judgment as a critical factor, appraising materiality and risk, alternate procedures, difficulties in testing, and the effect of Statement No. 23. He also suggests that where control is lacking, a qualified report may be needed and that it is the solemn duty of the certified public accountant to qualify the report in all cases where the circumstances seem to justify or require a qualification.

Last year the committee on ethics had before it in a certain particular case whether keeping books should preclude the rendering of an opinion by independent public accountants. The committee took the position in that case that so long as the facts were disclosed with respect to the keeping of the books, it was proper for the accountant to render an opinion with respect to his findings. This matter has recently been under study by the committee on auditing procedure, and the majority of that committee are apparently of the opinion that as a general rule if the accountant is in fact independent and has performed all of the auditing procedures necessary he should be entitled to express any opinion he may have formed, and further, that keeping of the books does not have sufficient bearing on the accountant's independence to require disclosure in his report. The committee on ethics is again considering the matter. I am firmly of the opinion that it should be left to the judgment of the accountant as to whether disclosure in such a case is necessary.

One of the most difficult problems encountered by an accountant is that of explaining clearly to the reader of the report just what representations he is making with respect to the financial statements when he cannot express an unqualified opinion. Various contributors to *The Journal of Accountancy* indicate that this difficulty is being encountered by a large number of the accountants throughout the country, and it appears to me that the committee on auditing procedure might well devote some time in an effort to develop satisfactory expressions of disclaimer when the circumstances are such that an over-all opinion cannot be rendered as well as in those cases where qualifications are required to be used as a guide in report presentation, somewhat as a supplement to the short-form report. We must all remember that these can only be given to you as guides, and after all, it is up to the man who makes the examination and makes the audit to make up his own mind as to what he is going to say in the report and how he is going to say it. The main thing is to be sure that he reports the facts and tells the truth about them.

As a matter of information and with the objective of stimulating further discussion and consideration of the matter, I am presenting as an appendix to this paper suggestive paragraphs submitted by a number of certified public accountants either as contributions to *The Journal of Accountancy* or in reply to my inquiries, a study of which should be helpful in developing clear-cut and concise exceptions and disclaimers, pertaining to both the scope of the work undertaken and the auditor's opinion. As a matter of preference, I am inclined to believe that rather concise and clear-cut statements should be used whenever possible, and I can see no necessity for using separate captions for each paragraph. It seems to me this might in some cases create some confusion on the part of the reader and make a somewhat awkward presentation.

There are still some accountants who seem to feel that disclaimers are likely to prove confusing to the reader of the report and in some cases are offensive to the client and therefore objectionable on his part. I am sure that through proper cooperation and educational work clients can be brought to understand and appreciate the forward position taken by the professional accountant, and if by this effort we can bring about an appreciation of improved report presentation among corporation executives, credit grantors, and all other parties interested in developing a more effective and understandable presentation of financial statements with greater emphasis on the phrase "In our opinion," we will have accomplished a very great forward step in the development of higher standards for professional performance and service, and will establish for the certified public accountant a place in the professions which will be universally recognized as equal in importance and rank as the older established professions of law and medicine.

In the October, 1949, issue of *The Journal of Accountancy* (page 319), you will find a list of discussions which appeared in *The Journal of Accountancy* up to that time with respect to Statement No. 23 and which will be helpful to those who desire to review the subject in more detail. Some accountants have strenuously objected to what might be termed "piece-meal" opinions. This matter was ably discussed by Mr. Alvin R. Jennings at the Ann Arbor conference in June, 1949.

To give you a banker's viewpoint, here is what Kenneth K. DuVall, vice president of the First National Bank, Appleton, Wisconsin, has to say with respect to accountants' reports:

Bankers would like to have accountants (1) make clear the scope of their assignment, (2) express an opinion as to the adequacy of the evidence examined, (3) delineate the steps taken to ascertain the facts behind the figures, (4) set forth an opinion as to the qualifications to be attached to the conclusions reached, and (5) offer interpretive addenda based on an intelligent grasp of the facts.

The standardized forms of the accountant's certificates have the weakness—to banker and accountant alike—of becoming "rubber stamps" because of stereotyped wording which lulls both user and producer into a false sense of mutual understanding.

Let me suggest that many bankers are prone to expect more than is possible. They need to be warned that all compilations of figures are expressions of opinion made by human beings of varying qualifications as a result of applying widely varying techniques to evidence which may itself be either reasonably adequate or (oftentimes) inadequate.

In teaching mature bankers at the School of Banking at Madison, Wisconsin, I have gained the impression that many bankers seem to believe that figures prepared by accountants are statements of incontrovertible facts made by an expert of unvarying perfection after applying a standardized, infallible technique to evidence of undeniable finality.

So we have not only to educate our own accountants to the necessity and significance of this bulletin and the fine thing that it can do for the profession, but we probably must take it up also with the bankers, and if we will conform, I am sure, to the Statement in spirit and letter, we will help to advance our profession so that when a man gets an auditor's report, the first important thing he will look for is the accountant's opinion. That is the thing we should continuously strive for.

In closing, I am again reminded of the fine words of Colonel Montgomery many years ago when he was president of the Institute when he told us that the primary obligation of a certified public accountant was to delve into and find the facts and tell the truth about them, no matter where or in whatever quarter the chips might fall. If we do that, we will maintain our independence and at the same time improve our status and recognition throughout the world as a professional organization and as professional men.

Appendix

The following are suggestions for the expression of qualifications and disclaimers of opinion in audit reports, some of which have already appeared in articles in *The Journal of Accountancy.*

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Examples submitted by Lincoln G. Kelly, of Lincoln G. Kelly and Company, Salt Lake City, Utah:

Example of Disclosure in Scope Paragraph Involving No Qualification in Opinion

We have examined the balance sheet of ____________________at__________________, 19__, and the statement of income for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. Upon instructions from the company, we did not verify inventories by count of physical quantities, and receivables and payables were not confirmed by communication with debtors or creditors; however, we were able to satisfy ourselves with respect to those items by other methods and procedures.

In our opinion, the accompanying balance sheet and related statement of income present fairly the financial position of the____________ __________at______________________, 19__, and the results of its operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Statements Prepared—No Audit

The accompanying balance sheet of the ______________________Company, at______ __________________________, 19__, and related statement of income for the fiscal year then ended were prepared by us from the financial records of the company and are in agreement therewith. However, as we did not audit the accounts, we are precluded from expressing an independent accountant's opinion on the representations contained in the statements.

Example of Auditor's Report
Qualified as to Scope of Examination

We have examined the accounts and records of____________________, for the fiscal year ended__________, 19__. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.

Auditing tests and checks of accounts and records concerning accounts receivable and inventories have been made, but, upon instructions of the company, we have not applied the generally accepted auditing procedures of direct communication with debtors or attendance at the physical count of inventories, nor have physical tests of inventories been made under our observation.

In our opinion, subject to the exceptions stated in the foregoing paragraph relating to the limitations of the scope of our examination, the accompanying balance sheet, designated exhibit __, and the related statement of income, designated exhibit __, together with supporting exhibit __ and schedules __, __, and __, present fairly the financial condition of________________at ________________, 19__, and the results of its operations for the year then ended, in conformity with accepted accounting principles applied on a basis consistent with that of the preceding year.

Auditor's Report Indicating Inability to Express an Opinion Because of Limitations on Scope

We have examined the balance sheet of the ________________Company at__________, 19__, and the related statement of income for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, but it did not include all of the tests of the accounting records and other auditing procedures which we considered necessary, in that, under the terms of our engagement, we did not confirm the customers' accounts by direct correspondence, nor did we test the physical existence or the pricing of inventories.

Because of the materiality of the investment in inventories and accounts receivable in relation to total assets, and, as we did not apply generally accepted auditing procedures with respect to the verification thereof nor satisfy ourselves in regard thereto by other means, we are unable to express an independent accountant's opinion on the fairness of the over-all representations in the accompanying financial statements. However, nothing came to our attention during the examination which would indicate that these items are not correctly stated.

Example of Disclaimer
Pertaining to Income Statement Only

In our opinion, the accompanying balance sheet fairly presents the financial position of the________________Company at______ ____________, 19__, in conformity with generally accepted accounting principles. The ineffectiveness of accountability controls precludes us from expressing an opinion as to whether the accompanying statements of income present fairly the income, costs, and expenses for the six months' period ended ________________, 19__.

*

Examples submitted by Ira B. McGladrey, CPA, partner in the firm of McGladrey, Hansen, Dunn and Company, appear in the July, 1949, issue of *The Journal of Accountancy* in four exhibits, as follows:

Exhibit I:

Scope of Examination: Our examination of the financial records of the Company was made mainly for the purpose of furnishing a report for the use of the management on the financial condition of the Company at November __, 19__, and the results of its operations for the fiscal year ended on that date. A secondary purpose was the preparation of tax returns.

Our examination was made in accordance with generally accepted auditing standards, but it did not include all of the tests of the accounting records and other auditing procedures which we considered necessary to express an opinion on the statements taken as a whole, in that we did not confirm the customers' accounts by direct correspondence, nor did we test the physical existence or the pricing of the inventories.

(Here follows a general description of the auditing procedures performed. It should contain all the comments which are believed to be desirable in connection with compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion.)

Statement of Accountant's Responsibility: The terms of our engagement did not include the verification of accounts receivable by direct correspondence, nor did it include the physical verification or price tests of inventories, and we did not satisfy ourselves in regard to these accounts by other means. Nothing came to our attention during the examination which would indicate that these items are not correctly stated. However, in view of the materiality of these assets, we are unable to express an independent accountant's opinion on the overall representations in the attached statements.

Exhibit II:

Scope of Examination: The primary purpose of our examination was to obtain the information necessary to prepare the income tax returns of____________________, a co-partnership, for the year ended December 31, 19__. In this connection, we briefly reviewed the company's accounting records, but we did not audit them.

(Here follows a general description of such auditing procedures as were performed. It should contain all the comments which are believed to be desirable in connection with compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion.)

Statement of Accountant's Responsibility: The attached balance sheet as at December 31, 19__, of____________________, a co-partnership, and the related statement of profit and loss for the year then ended were prepared from the Company's accounting records which, however, were not audited by us.

In view of the fact that our function was largely limited to assembling the information necessary for the preparation of tax returns, and the arranging of such information in statement form, and therefore we did not make independent verification, except as noted, of the assets, liabilities, income or expense, we are not in a position to express an independent accountant's opinion on the fairness of the representations contained in the statements submitted in this report.

Exhibit III:

Scope of Examination: Our service in connection with this report was limited to preparing a balance sheet and profit and loss statement of the____________________for the fiscal year ended August 31, 1900, from the books of account, without audit verification of any kind.

Statement of Accountant's Responsibility: The attached balance sheet as at December 31, 19__, of____________________, and the related statement of profit and loss for the year then ended were prepared from the company's accounting records which, however, were not audited by us.

In view of the fact that our function was largely limited to assembling into statement form the information appearing on the financial records furnished us, and we did not make any independent verification of the company's assets, liabilities, income or expense, it is evident that we are not in a position to assume responsibility for or to express an independent accountant's opinion on the fairness of the representations contained in the statements submitted in this report.

When financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as "Prepared from the Books Without Audit," appearing prominently on each page of the financial statements, is considered sufficient.

Exhibit IV:

Scope of Examination: Our examination ot the financial records of the____________________ __________was made mainly for the purpose of furnishing a report for the use of the management on the financial position of the company at January 31, 19__, and the results of its operations for the month then ended, as shown by the books of account.

Once each year at the close of the company's fiscal year on December 31, we make an examination sufficient in scope to express an opinion. At the close of each month during the remainder of the year we make partial examinations and prepare interim reports. It is apparent that it is not practicable to make all of the verifications necessary for the expression of an opinion at such frequent intervals during the year. Our work in these monthly examinations is, accordingly, confined to such tests of accounting transactions as will fit into the over-all annual audit program.

Statement of Accountant's Responsibility: The scope of our work on this interim examination did not include normal audit verification of assets and liabilities. Nothing came to our attention which would indicate that such accounts are not correctly reflected on the attached statement, and so far as was revealed during our observation of the records in the course of our examination the amounts appeared to be normal. However, in view of the materiality of the items with respect to which normal auditing procedures were omitted at this time, it is obvious that we are unable to express an independent accountant's opinion on the fairness of the overall representations contained in the attached statement.

*

In *The Journal of Accountancy* for the month of August, 1949, page 159, the following quotations are made from two accountants' reports which accompanied the annual financial statements of two large manufacturing companies for the fiscal year ending September 30, 1948:

I. During the year physical inventories were taken of approximately 52% of the value of the companies' inventories, but all other inventories are based on book records; therefore, our observation of the taking of the inventories and the test-check of quantities was confined to those departments where physical inventories were taken. We employed supplemental and extended procedures in checking the book inventories and satisfied ourselves that they are reasonably stated at September 30, 1948.

In our opinion, the accompanying consolidated balance-sheet and related consolidated statements of profit and loss and surplus, taken in conjunction with the comments in notes to the consolidated financial statements, present fairly the consolidated position of . . . and its wholly owned subsidiaries at September 30, 1948, and the results of their operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent, except as explained in the preceding paragraph, with that of the preceding year.

II. To avoid suspension of operations and the consequent interruption of production and delivery schedules for important customers in the . . . industry, the company omitted its customary practice of taking a physical inventory during the year. The inventory at September 30, 1948, is stated in accordance with ledger balances, not supported by physical counts at that date, which balances are based on the last previous physical inventory, taken June 30, 1947, plus the cost of materials purchased and labor and manufacturing expenses incurred in the interim, and minus the cost of products sold as determined through operation of the cost records. We reviewed the cost accounting procedures and records and made tests of the transactions reflected thereby for the year; we also took note of the substantial correctness of ledger inventory balances over a period of seven preceding years, demonstrated by comparison with annual physical inventories. Based on such review and tests, we have no reason to believe that the ledger balances at September 30, 1948, should not be considered a fair representation of the inventory valuation at that date.

In our opinion, subject to the foregoing explanations regarding the method of determination of the inventories and our examination pertaining thereto, the accompanying balance-sheet and related statements of income and surplus, present fairly the position of . . . at September 30, 1948, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent in all material respects with that of the preceding year.

Journal comment:

While it seems to us that both accountants' reports fully explain the procedures followed, we feel that many readers of the reports may understandably be confused as to the significance of the qualifying remarks. For example, the reference in the opinion paragraph of the first certificate to an inconsistency in the application of generally accepted accounting principles does not seem to be substantiated in the paragraph which preceded it. It was necessary to mention the limited nature of the auditing procedures followed, but it seems to us that there was no change in the application of accounting principles.

We are also inclined to question the necessity of any qualification in the opinion paragraph when, as in the first example, the auditor has employed other procedures which satisfied him that the inventories are reasonably stated. When that is the case, it seems to us that the accountant is in a position to express an unqualified opinion and that he should do so, limiting his remarks regarding the procedures employed to the "scope" paragraphs of the report.

It is difficult to say whether the situation in the second example is similar to that of the first. In the second example, the auditor did not make an affirmative assertion that the procedures described were adequate to satisfy him as to the inventories. However, in view of the fact that the inventories were material items an exception to which would presumably negative the opinion, and since he refers to the descriptions of the procedures as explanations, it appears that the two cases are similar. In any case, the auditor's position might well have been stated with greater clarity.

In commenting on these particular reports we do not intend to be unduly critical of the accountants. The questions have been puzzling to many auditors who were striving to give the most useful information they could. However, we believe these cases illustrate very aptly certain of the problems involved in expressing qualified opinions and we hope that our comments will lead to further discussion of this difficult question by our readers.

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From *The Journal of Accountancy* for September, 1949, page 253, the following is quoted as a sample form of report used in disclaiming opinions on financial statements:

We have examined the consolidated balance sheet of____________________and its wholly owned subsidiaries as of December 31, 1948, and the related consolidated statement of profit and loss and earned surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The inventories include substantial amounts in respect of slow-moving and possibly obsolete items, and equipment requiring further engineering and development. The management, assisted by a firm of outside engineers, is presently engaged in a survey of the company's products and potential markets, and pending completion of this survey we are unable to determine the amount of inventories which might be classified as noncurrent and also to form an opinion as to the marketability of the inventories at the values at which they are carried in the balance sheet.

During the year 1948 expenditures approximating $1,200,000 were made in connection with unusual servicing of products in the field. Further expenditures in this respect will be incurred in 1949 but in the opinion of the management in lesser amount. It is not possible to estimate the liability for servicing existing at December 31, 1948, and no provision has been made therefor in the accounts.

We believe that the materiality of the matters dealt with in the two preceding paragraphs precludes our expressing an opinion on the financial position of the companies as at December 31, 1948, and on the results of their operations for the year then ended. Except for the effect of the foregoing, the consolidated balance sheet and related consolidated statement of profit and loss and earned surplus have been prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

*

From *The Journal of Accountancy* for November, 1949, page 441:

Auditor's Disclaimer of Opinion Need Not Discredit Statements:

In commenting on the revision of Statement on Auditing Procedure No. 23, a correspondent mentioned that he sometimes adds to his report the statement that he found nothing in the course of his examination to indicate that the accounts which were not fully verified were not correct. He was of the opinion that there is nothing in the revised statement which would preclude such an assertion as long as the expression of an over-all opinion was denied and the reasons therefor clearly stated.

We agree that there is nothing in Statement No. 23, as revised, which should interfere with adding such a statement in appropriate cases. Moreover, we can see that it might in some instances be very helpful in preventing what might otherwise be interpreted as an undue reflection on the fairness of some of the items. We believe that it would have to be used with considerable care, or it might be taken to mean more than it is intended to mean. However, when it is carefully worded in connection with a clear-cut denial of an over-all opinion and a clear-cut statement of the reasons for that denial, we doubt very much whether one would need to be greatly concerned about its being misunderstood.

*

From *The Journal of Accountancy* for March, 1950, page 217, is quoted a limitation paragraph suggested by the late Myron J. Boedeker at the annual meeting of the California Society of Certified Public Accountants in 1948:

By reason of the small number of persons engaged in recording transactions and receiving and disbursing funds and other assets of the corporation, it is not feasible or economical to establish the diversification of duties which would provide the desired degree of internal control practicable with a larger organization. Our examination did not, and could not within reasonably economical limits, provide a completely adequate substitute therefor, but it disclosed nothing warranting extension of the auditing procedures employed.

For the opinion paragraph, Myron Boedeker suggested the following wording:

In our opinion, except for the possibilities inherent in the conditions outlined in the preceding paragraph, the accompanying balance sheet and related statements of income and surplus present . . .

*

From *The Journal of Accountancy* for December, 1949, page 522:

More on Difficulties in Writing Qualified Reports:

In an effort to stimulate further consideration of the means by which accountants may more clearly explain to readers of their reports just what representations they are making, we recently discussed two reports illustrating some of the problems involved in writing qualified reports (J of A, Aug. 49). The following excerpt from another accountant's report illustrates a different type of statement which we believe leads to misunderstanding:

> We did not verify the inventories by count of physical quantities, and the receivables and payables were not confirmed by communication with the debtors or creditors. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures we considered necessary.

Although the auditor responsible for this report feels that the second sentence clearly indicates that he has satisfied himself with respect to all material items, we believe that many users of financial statements are not sufficiently well informed as to auditing procedures to understand the significance of his assertions. For example, one interpretation placed upon the report was that the accountant did not consider verification of inventories and confirmation of receivables to be necessary procedures generally.

We believe that, where the accountant has omitted the procedures recommended in "Extensions of Auditing Procedure" but is able to employ alternative procedures which he considers satisfactory, good practice requires him to affirm that he has satisfied himself by other means. In some cases, he should perhaps go even further and indicate by what methods he has satisfied himself. It seems to us he owes a clear explanation of the matter not only to possible users of the financial statements but also to his client as well.

Several of the Statements on Auditing Procedure issued by the Committee on Auditing Procedure of the American Institute of Accountants have implied strongly that there may be circumstances in which alternative procedures can be effectively employed as substitutes for the procedures set forth in "Extensions of Auditing Procedure." For example, Statement No. 12 requires disclosure of the omission of those procedures 'even though the independent accountant may have satisfied himself by other methods.' However, the only discussion in the Statements with respect to disclosing the results of employing alternative procedures appears in Statement No. 12, dealing with confirmation of receivables from the government. In that Statement the committee says, in part:

> In many, and perhaps most, cases the independent public accountant may be able by reference to shipping records, contracts, correspondence, or other documentary evidence, or the subsequent payment of the accounts, to satisfy himself on a test basis as to the validity of such receivables. In such cases, his disclosure of inability to secure confirmation of government receivables by communication with the debtor may well be accompanied by a statement that he has satisfied himself by other means.

That Statement dealt with a limited situation and does not provide conclusive support for our views. It does suggest, however, that the committee was inclined to look with favor upon the type of disclosure we propose.

A number of firms have adopted a policy of using wording which indicates their position much more clearly than does the report quoted above. For example, in the case in question they might say:

> We did not verify the inventories by count of physical quantities, and receivables and payables were not confirmed by communication with the debtors or creditors, but we were able to satisfy ourselves with respect to those items by other methods.

We believe that it would be a very worthwhile step in the right direction if accountants generally adopted the policy of including such a statement in their reports whenever appropriate.

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From *The Journal of Accountancy* for June, 1950, page 533:

Another Example of Non-Opinion Report:

The following disclaimer of opinion was used by an accountant in submitting financial statements requested by a client some months after the date of an interim examination, but before the close of the calendar year.

> In accordance with your recent request we have prepared the following statements from our working papers for the six months' period ended June 30, 1949:
>
> Exhibit A—Balance Sheet, as at June 30, 1949.
>
> Exhibit B—Analysis of Surplus, for the six months' period ended June 30, 1949.
>
> Heretofore we have made a report as at December thirty-first each year containing a certified balance sheet. It has not been our custom to make a report and prepare a balance sheet as at June thirtieth. Therefore, we did not make the verifications as at June thirtieth which we do when a certified balance sheet is prepared. Bank balances on that date were not confirmed. Inventories were not verified.
>
> Since the interim examination did not include all normal verifications and the statements herewith were made from our working papers without such verifications, we are not expressing an opinion and these statements are subject to our regular report when the examination for the year ended December 31, 1949, is completed. However, nothing was brought out in our examination to that date which would indicate that the information presented herein is incorrectly stated.

We believe this report complies completely with Statement No. 23. Our only criticism is with respect to the reference to June 30 in the last sentence of the report, in which it is stated that nothing was brought out in the examination "to that date" which would indicate that the information presented therein is incorrectly stated. We believe the accountant is responsible for disclosing any important information having a bearing on the statements, of which he has knowledge, regardless of whether it came to his attention at the time of the audit work or subsequently. We are, therefore, of the opinion that the report would be improved if the words "to that date" were omitted.

From *The Journal of Accountancy* for August, 1950, page A-14:

Accountant Seeks Some Advice on the Use of Disclaimer in Signing Tax Returns:

Now that income tax return period is over, I am going to undertake something that I have been putting off for several years and that is to try and find out what other accountants are doing with reference to any disclaimers in connection with the preparation of income tax returns. I will appreciate it if you will publish this letter in *The Journal of Accountancy* with the view of having various accountants write in and explain the procedure that they follow.

The Federal Income Tax Return requires the accountant sign the following statement:

> I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

I have no particular objection to signing this statement provided the Treasury Department understands the type of examination which I have made, and consequently I have had three rubber stamps made. I use whichever stamp is applicable for stamping on each sheet or statement included with the return. The stamps which I use are as follows:

This return prepared
after audit of client's records.
L. B. Maddison, C. P. A.,
Scotland Neck, N. C.

This return prepared based on a review,
but not an audit, of client's records.
L. B. Maddison, C. P. A.,
Scotland Neck, N. C.

This return prepared from information
furnished by client and not from
an audit of the books.
L. B. Maddison, C. P. A.,
Scotland Neck, N. C.

This procedure satisfies me but I am not too sure that all clients are satisfied with it. However, in all fairness to myself and to the Treasury Department, it seems that some disclaimers should be made when an audit of the client's records has not been performed.

I will appreciate it if you can get some discussion started on this subject so that by next year I can at least tell my clients who may complain that I am only following the generally accepted procedure in connection with disclaimers on tax returns.

From *The Journal of Accountancy* for

March, 1948, page 229, in which was included an article by Charles B. Hellerson, CPA, of Zimmermann and Company, from which the following "Auditor's Report" is quoted:

Scope of Examination:

We have examined the balance sheet of the ABC Company at December 31, 1947, and the related statement of income and earned surplus for the year ended on that date. In connection with our examination, we have reviewed the system of internal control and the accounting procedures of the company and have examined their accounting records and other evidence in support of the financial statements. Our examination was made in accordance with generally accepted auditing standards and included all auditing procedures which we considered applicable and necessary in the circumstances. These procedures were applied by tests to the extent we deemed appropriate in view of the system of internal control.

Exception:

For the past ten years it has been the company's practice to compute depreciation on its plant and equipment on the straight-line method. That is, the useful life in years of each class or kind of plant and equipment is estimated. Annually, income is charged with its proportionate share of the cost based on those estimates.

During the year ended December 31, 1947, the company's plants have been closed for three months because of a changeover from wartime to peacetime operations and because of a strike. No depreciation has been taken for that period. In our opinion depreciation should have been taken during the time that the plants were shut down. If depreciation had been recorded for the entire year, net income would have been reduced by $1,823,641.90, and the net depreciated value of plant and equipment shown on the balance sheet would have been reduced by a like amount.

Opinion:

In our opinion, except for the qualification with respect to depreciation commented upon above, the accompanying balance sheet and related statement of income and earned surplus present fairly the financial position of the ABC Company on December 31, 1947, and the results of its operations for the year ended on that date. The statements have been prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The following quotation was included in the letter received from Gordon J. Raab, CPA, with respect to his experience with Statement No. 23:

We have had an interesting experience in the application of Statement No. 23 to statements of cash receipts and disbursements in instances where the internal control of cash receipts was, in our opinion, inadequate. The language we adopted was as follows:

Because of the unavoidable lack of internal control in connection with cash receipts, we cannot, as you will appreciate, express an opinion as to the fairness of the accompanying statement taken as a whole. However, in our opinion, the statement reflects the fact that all recorded receipts were deposited, cash disbursements were proper, and the cash in bank at December 31, 1949, is correctly stated.

*

From Carl M. Esenoff, CPA, of the firm of Everts and Esenoff, San Diego, California:

We have reviewed the records of your company at the close of business January 31, 1950, and have prepared the statements presented herein from the data shown on your financial records and from other information furnished by you. In the preparation of these statements we made such adjustments as were necessary to reflect prepaid and accrued expenses and income, our services being essentially of an accounting nature. The statement of financial position and the statement of income and surplus have been accurately prepared from the books of the corporation without independent confirmations. However, the statements reflect generally accepted accounting principles applied on a basis consistent with that of the preceding year.

We have examined the financial records of XYZ Company for the period ended March 31, 1950, and have prepared the accompanying statements from those records. As our examination did not include essential auditing procedures as related to inventories, receivables, fixed assets, and certain liabilities, we are not in a position to express an independent accountant's opinion on the statements of income and financial position taken as a whole. However, in connection with the work done, we have indicated our findings and recommendations in the following paragraphs of this report.

We have examined the financial records of the XYZ Company for the period ended May 31, 1950, and have prepared the accompanying statements from these records. Since we have not independently verified the inventories nor circularized the accounts receivable, we are not expressing an independent accountant's opinion on the financial statements taken as a whole. However, during the audit we found nothing which would indicate any material error or omission in the accounts not fully examined and we are satisfied that the records are maintained in accordance with generally accepted accounting principles on a basis consistent with prior periods.

The accompanying statements are presented without opinion, since our service to date is a portion of the work to be done on a continuous audit throughout the year. For this interim report we used such auditing procedures as would fit into a program extending to December 31, 1950, which will enable us, at that date, to express an opinion on the financial position of the XYZ Company and the results of its operations for the year then ending.

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From Ralph B. Mayo, CPA, of the firm of Ralph B. Mayo and Company, Denver, Colorado:

We have examined the balance sheet of The Doe Steel Company as of June 30, 1949, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, except that it did not include all of the tests of the accounting records and other auditing procedures which we considered necessary in the circumstances, in that we did not confirm the customers' accounts by direct correspondence, nor did we test the physical existence or the pricing of the inventories, and we did not satisfy ourselves in regard to these accounts by other means. Nothing came to our attention during the examination which would indicate that the customers' accounts and inventories are not correctly stated. However, in view of the materiality of these assets, we are unable to express an independent accountant's opinion on the over-all representations in the attached statements.

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From Ira N. Frisbee, CPA, of the firm of Ira N. Frisbee and Company, Beverly Hills, California:

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Frankly, I do not think we have had any experiences except that it has been necessary to spend a little time in determining whether a qualified opinion or a disclaimer is required under the circumstances. No client has raised any objection to the action which we deem desirable to conform to the rule, and actually, I believe my surprise has been that usually the client did not object to a qualified opinion.

Opportunities for serving business in small communities

by MARQUIS G. EATON, CPA

At first glance it might be thought that the only difference between practice in small communities, as compared with large, is that only little businesses are found in little places, and big business more or less dominates the big places. This is one of the two main differences but there is another.

In this country public accountancy began around the mid-Eighties on the eastern seaboard. It spread from east to west in the principal cities until now the certified public accountant enjoys a considerable degree of acceptance in all of the large centers of population. During these same years accountancy has spread from the large city to the small, but more slowly. It is only recently, in fact, that there is a major tendency for accountants to establish themselves in the small communities. Small communities, as a class, are years behind in their acceptance of the work done by the certified public accountant.

While accountancy has gradually blanketed the country in a geographical way, it has at the same time attained a broader degree of acceptance in regard to the kind of services performed. Beginning as only auditors and experts in accounts, certified public accountants are now called upon for assistance in tax reporting, tax planning, and tax controversy; for special reports to management and others; for advice in connection with dividend policies, compliance with government regulations, pricing, public utility rate making, budgeting (both public and private), financing, labor relations, and many other things; and are asked to serve as arbitrator, referee, receiver, director, executor, trustee, and in numerous other capacities.

Characteristically the small community is far behind in its acceptance of the professional accountant in any capacity, and particularly is it far behind in its acceptance of him in all of his various capacities. The first accountant to establish himself in a small community may find conditions reminiscent of those prevailing in large eastern cities thirty to fifty years ago. The problem of serving business in these small places is as much concerned with gaining acceptance of accountancy as with the size of the business units served, though each of these presents difficulties.

The smallest community in which an accountant can practice, then, is one that would sustain him professionally if he performed all of the services he could for everyone in the community. Because this complete acceptance can never be attained in practice we must enlarge the community to allow for the unwillingness of some people to employ the accountant even where he can be of value. This would leave it still a quite small place. The greater the degree in which the accountant fails to secure employment where he is needed, the larger the community he will need to support him.

If we give our consideration to practice conditions in this quite small town it is probable that some of our conclusions will have application in larger places affording opportunity for several accountants but which themselves would still be small by usual standards.

Having considered in a general way some

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of the limitations of our small community it is now necessary to consider some of the limitations within which accountancy must be practiced in any community, whether it be large or small.

Four things must be harmonized. As a first consideration, and before any service can be performed for a client, the accountant must maintain an office that is financially successful. This is to say that he must receive a professional rate of compensation for his time, a rate high enough to attract the high type of mind necessary in the work. Only an office that is financially healthy can hold itself ready to serve the public. Financial health probably contributes something to the accountant's physical health. Accountants make a mistake when they accept a low hourly return, and then by long hours at the desk attempt to convert this into a decent annual average. It is not flattering to the individual, or to the profession, to have it thought that the product is of so little value that a professional living can be earned only from long grinding hours, hours far longer than those commonly considered as enough to gain an acceptable living in other professions.

Second, there is a dollar limit to what any small business unit can pay for professional assistance, and this limit must not be exceeded, no matter what the value of the services rendered. Little businesses have to get along with something less than the best in many respects. This may have to do with location, advertising, machinery or equipment, or anything else. They also have to get along with something less than the best in accounting services. This is not to say that the quality of the work should, or can, be lowered, but that the quantity must be restricted. For example, an audit is a thing with a certain minimum cost, because there are certain minimum standards that must be observed. Not all small businesses can afford an audit, though far smaller ones can support this work than is commonly thought. A long-form report for management, and another for the banker, may be the ideal, but the business may be able to afford only one, which must serve both purposes.

Third, and accepting the client's ability to pay, the services performed must have a value commensurate with the cost. A successful practice must, in the final analysis, be based upon giving value for value received, and the client must understand the value of the thing for which he pays. This, of course, is a platitude, but it has practical application in our practices.

Fourth, any services performed by the accountant, at any price, must be of high-level quality or he must not perform them. The profession has its standards—of auditing procedure, of accounting principle, of ethical conduct, of independence, of professional competence, and others that could be mentioned. These have as much application to small clients as to large, and must not be compromised.

Within these limitations, that sometimes pull against each other, of professional compensation, the client's ability to pay, value to the client, and the standards of the profession, something can be done by the accountant for even the smallest business units, even if this consists only of a few minutes of oral advice. Harmony in these various elements is attained by careful and intelligent diagnosis of the client's problems. The sophisticated client of the large city knows why he wants to employ us. The small client in the small community oftentimes does not. He knows only that he needs help of some kind and feels that we may be able to furnish it. It is for us, then, to select the things we can do for him that will relieve his distress as best we can, while maintaining proper balance in the things we have just discussed.

Before we go further we should give some attention to the accountant who is to practice in this small community—to the individual himself. The ability to practice accountancy on an acceptable level is gained through education and experience. Experience is largely a process of learning from others, i.e., from the performance of others within the field. As soon as the individual accountant associates himself with the small community he has in a measure, sometimes a large measure, removed himself from association with other members of the profession. He quite often practices alone, or with employees who are inexperienced, and he may not be able to meet conveniently with other accountants in the usual professional organizations.

These circumstances necessitate that he take with him an adequate stock of experience. There is evidence that in specific instances accountants are not doing this. Overanxiety to begin a career of his own, or too much reliance upon the CPA designation (which itself can in many states be obtained with little or no experience) sometimes leads the accountant to embark prematurely upon the small community adventure. For the reasons we have just considered this is especially to be avoided where he becomes isolated from future opportunity to learn from more experienced men within the profession. The mistake once made is difficult, if not impossible, of correction. If not corrected the individual may have the unhappy prospect of suffering all of his life, not only in the financial return from his work, but in the regard in which the community holds him, and in his opinion of himself. The profession itself must suffer, too, from any inadequacies displayed by its members in practice. If the accountant is ever to decide prematurely to practice for his own account he should, by all means, avoid coupling this with a decision to begin in a small community.

Having given some outline to the place in which we practice, to the financial and professional boundaries of practice in any place, and to the accountant who is to conduct the practice, where in this small community do we find our opportunity to serve business?

At the outset it is obvious that we must seek to do all of the things, of all kinds, for which we are qualified, and we must qualify ourselves to do as many as possible. It is only in this way that the small city can be made to yield a large enough volume of demand to support our office. In a larger place, and with larger clients, a practice may be built upon auditing alone, but in the small communities this is not so. It is worth notice in passing that the audit leading to an unqualified opinion is one of the last of our services to expect many small communities to accept.

At the risk of being accused of romancing our subject, it is perhaps true that in the small community, more even than in other places, the accountant is beneficiary of the vitality of his science. (I am aware that some years ago the committee on terminology said accounting is not a science, but an art. Let us forgive them on the ground that this was long ago, before our other committees had done so much to systematize the basic truths of accounting through "bulletins" on this and "statements" on that. At any rate, and for the sake of the point that here needs to be made, let us say that accounting is a science, of which accountancy is the art.)

Accounting is, beyond question, a vital science. Not every profession is so fortunate as to deal with one so vital. Profit, for instance, is not a thing you can hold in your hand, or weigh on scales or measure with a yardstick. It is a thing of the mind—a thought that can be expressed only in terms of accounts, and one that in many of its business meanings is best understood by an accountant.

There have now been created an economic system and a political system, in which much of the very substance of affairs exists only as a concept of the accountant. In point are the public revenues, the relationships of capital, labor, management, consumers, and regulatory bodies, and the rights of various groups in property or income. Not only does much of the substance of affairs in these areas exist only in accounts, but the ability to manage affairs is closely interwoven with the understanding of accounts.

So far has this gone that it is becoming fashionable to refer to accounting as "the language of business," as "economic shorthand," and by other terms which acknowledge that for many vital purposes accounts are the only means of communication and the only media of understanding. Accounting may, in fact, come to be regarded as a normal part of the culture of the individual, as fundamental as history, geography, or mathematics, and accounting courses are being introduced into the curricula of law schools, engineering schools, and others. In time, it is not unreasonable to expect, all educated persons may have some knowledge of accounting.

In the small community the accountant will not limit himself to work with accounts, in which his product is only accounting statements and his advice is sought only on problems concerned with accounting methods and accounting results. He will, instead, perform much at the policy level, where the symbols of thought and expression are accounts, but the conclusions sought are concerned with affairs rather than with the symbols themselves, the accounts.

What has been said of accounting may also be said with some justification of taxation. So heavy a share of business profit is taken by the public revenues that many of the problems of business can be considered only in intimate association with the income tax and taxes of other kinds. Is it not true that some understanding, perhaps a searching understanding, of our intricate system of taxation must come to be accepted as a part of the normal culture of the individual, at least of the individual engaged in some phases of management?

At any rate the accountant brings to the small community one of its few minds equipped in this way, perhaps the only one, and in this he should find much opportunity.

But this is not enough.

He will find in the small community that not only has acceptance of professional accountancy not penetrated, but neither has modern management. And, as another thing, small business units can seldom have balance in management personnel. The large staffs needed for this are not possible.

In what is now to be said about the accountant's opportunity it should not be understood that he is being urged to become everything to everbody. It is only that he brings a mind equipped as we have just discussed, and may go on to furnish it with other information that will enable him to serve business, with justified confidence, in areas well beyond formal accounting. He will recognize first the other established professions. He will not practice law, engineering, architecture, or medicine, nor will he preach the gospel. But many other things are his, limited only by his ability to perform. Because he cannot expect to learn everything, he should restrict himself to tasks that may be implemented by his knowledge of accounts and taxation. This presents a wide field.

The talent he will most often find lacking in his clients is the ability to manage money. He should, therefore, acquaint himself with the subject of financial management as it can be applied in small business. Particularly does he need to know the sources of capital and credit in use in the community and available from it. He will pursue this inquiry into the other parts of his area, the large cities of the state, and elsewhere throughout the country, until he knows where and how money can be obtained for the enterprises of his town.

He should learn what businesses are common to the place, the transportation systems, the labor supply and labor problems, the natural resources, the market for various commodities, the value of local property. He must become a specialist in the accounting and tax problems that are typical of the industries in the community. If, for example, farming or ranching are prominent occupations of his probable clients, he should inform himself on the best accounting methods for use here and the peculiarities of tax law application. He must carry this to the point of knowing all the tax-saving devices having usefulness in this industry. He should learn, too, a good deal about the technicalities of the industries of his area.

He must, of course, have an adequate accounting and tax library. At some additional cost this can become also the best business library in the town, not only in permanent reference material, but in current publications of a news character. It will become the best without much difficulty, because it will have little or no competition. The possession of such a library, besides furnishing the accountant with some information that he needs, soon becomes known around town and carries considerable prestige.

The accountant should also search out and become acquainted with the complementary technicians he will require in his work. This may take him outside the community. Clients will be coming to him with problems that are far removed from accountancy, some in fact falling within the scope of the other recognized professions. He should know where to get this assistance and either join these specialists with him, in proper instances, or refer the clients to them. The clients should feel that no matter what their problems the accountant will either solve them or get them solved. The more the accountant can habituate them to coming to him with everything, the more invulnerable is his position. A common example of this kind of complementary assistance is the lawyer who can draw a will with informed regard to the estate tax, the gift tax, and the income tax. The town may not possess such a lawyer, and finding one nearby may require something of a search. But the results repay the effort. The lawyers of the town will themselves sometimes appreciate the opportunity to join this specialist with them in these matters.

A knowledge of the accounting and financial business of the local political subdivisions is necessary—the county, the town, the school district. Not only are these possible clients, but leadership in the local thinking on their affairs is easy to attain.

Having equipped himself to serve his community, how does the accountant go about gaining the community's acceptance of these services? One day the solution of this problem may be reduced to formula but that day is not yet here. A few things having possible application here and there and, based upon experience, are perhaps worth mentioning.

The process is, of course, one of education. And here we encounter another old copybook maxim. Nothing will contribute so much to the educational process as excellent performance when the opportunity offers. But this excellent performance must be known, which dictates that the work must be so done that the client knows its difficulties, the time involved, and the value of the result to him. And this, in turn, must be brought off without undue emphasis, emphasis that may be received as in bad taste.

One thing that cannot be overstressed in the small community is the rigid necessity to respect the confidential nature of the client's business. While accountants observe this universally, it requires special emphasis in the small community. Large corporate clients are accustomed to having their affairs given considerable publicity, but the small-town businessman is most jealous of this type of information about himself, sometimes almost to the point of mania. It is well to cultivate the habit of never discussing local business situations, whether they are clients or not, else it be thought that distribution is being given to information confidentally obtained. Every small-town accountant, whether he is aware of this or not, has had business withheld from him by his close friends because, in view of the intimate relationship, they did not want him in possession of information about their incomes. They would more gladly have approached him professionally as a stranger.

Much good use can be made of material prepared from time to time by the American Institute. This material includes radio recordings, pamphlets for distribution on various subjects such as the natural business year, audits by certified public accountants, and various others; and guidance on public relations. The Institute only prepares these things, and it is the responsibility of the local accountant to arrange for their local use.

The accountant should become identified with his community. In doing this he can best serve the community, and his own purposes, if he performs always in his professional capacity. If, for example, he is asked to take part in a Community Chest drive, he should offer to deal with the accounting, or auditing, of the campaign rather than engage in solicitation. His participation as accountant, auditor, trustee, treasurer, etc., in these things calls attention to his professional classification and enables him at the same time to perform the most valuable service of which he is capable. Making some small audits of charitable organizations without charge is a good way to call attention to the function of auditing. After the accountant has gained the acceptance of his community, what kind of work will he be doing?

A complete answer, based upon experience, might be received by accountants from the larger places (as most accountants are) as only indifferent humour. Omitting, then, all reference to requests from clients that the accountant take part in family arguments regarding the wife's weekly allowance, the more common things he does are well known in the large cities. The difference is in the place the small town puts the emphasis.

Work with some part of the bookkeeping process is prominent in the practice. This may occasionally entail all of the bookkeeping, but more often only part of it, the part that the client's less expert staff it unable to do. This is an entirely justifiable way of getting the work done. In small business units it is not feasible to keep expert accountants on the pay roll the year round just so they can exercise their expertness for a few days each year. Clients will often want the accountant to hire their bookkeepers, instruct and supervise them, fix their compensations, and fire them if that is necessary.

A few audits leading to unqualified opinion will be made, but far more will be partial audits, leading to disclaimer of opinion in a long-form report. The usual tax reporting will be expanded to include some routine reports on minor taxes that public accountants are not called upon to deal with for clients with more than minimum staffs.

A considerable volume of special reports and opinions will be written on various subjects. These will often have to do with management problems that have been dealt with by the accountant, or mutually by the client and the accountant, and sometimes serve as check lists for getting the policies carried out. Reports and opinions are resorted to freely by the accountant to make a record of what advice has been given, the facts upon which it was based, and to enable the collection of an appropriate fee. There is some tendency for clients to expect oral advice to cost less than written.

The accountant will come to expect it as the usual thing, rather than the reverse, to be asked to serve as executor or as co-executor under clients' wills, and as trustee under *inter vivos* and testamentary trusts. He will engage prominently in work having to do with estate plans, but not much of this will be in regard to disposing of estates in being. Most of it will be with clients who have little estate, helping plan to acquire one and then to dispose of it. He will have a hand in most of the divorce settlements where property is involved. He will sit with his clients in nearly all transactions of a nonroutine nature, coaching the parties on what business points they should agree to, preparing a memorandum from which the lawyers will draft the contracts and other documents, advising on the tax effect of what is being done. He will serve (usually informally) as arbiter of disputes, and formally as stakeholder in various business transactions, especially those in which there is some incidental task of accountability to perform. He will play a prominent part in most matters having to do with the financing of his clients' businesses and will often represent them in the negotiations. He will buy and sell business properties and properties of other kinds for his clients and members of their families, not as broker but as representative of his principals. He will find himself in peculiar positions of informal responsibility, as where the banker appears to be making the loan not so much on the client's note as on the fact that the accountant has the situation under scrutiny and has a reputation for working things out. Under these and similar circumstances he gradually drifts toward the point where he cannot afford to have a business failure among his clients if he can help it, and if he sees it coming because of bad management will usually disassociate himself well in advance. In many of his special reports he will not only present the facts, as is the custom of the profession, but will also draw the conclusions, and point out the indicated courses of action. He will spend a very substantial part of his time in conference with his clients. In all of his reports and other products he will take into consideration the fact that his clients are not skilled in accounts, probably have little or no acquaintance with them, and will temper his reports and other communication with them to suit the ability of the individual, in each instance, to receive the information.

The established accountant of the small community has a very satisfactory relationship with his clients. He does not know, for instance, what it is to be resented by them, as might be the case if the services had been enforced by some SEC requirement or other outside influence. His clients have all sought him out for their own reasons, and of their own will. In his dealings with them he is the expert on the topic under discussion. He is not confronted with preconceived notions of the limitations of accountancy, as in some other places where the accountant is so prominently identified with the audit as to have led many to believe that is his only function. It is, instead, his opportunity and his responsibility to make of accountancy very much what he wishes. He begins with a small place that has given little if any acceptance to accountancy—a community that may resemble in this respect the large cities of thirty to fifty years ago. But because his influence and example may be felt easily throughout the community, he may induce acceptance of accountancy in that place on a scale that may not be matched by the country as a whole for a long time to come.

The view we have just taken, of opportunity for practice in the small community, while sometimes discouraging, is perhaps more cheering on the whole than has been the experience of some. Nevertheless, it is not visionary. It has been done, and is being done, in this way.

The little place has its limitations but it also has its compensations.

Report writing in the accountant's office

by LEWIS LILLY, CPA

MATTHEW ARNOLD has given us a succinct and yet all-embracing formula for good report writing when he remarked "have something to say and say it."

Report material is susceptible of three classifications, the essential, the important and the interesting; but it is the essential and the important with which the accountant primarily must be concerned. The interesting well may serve to illuminate the other elements and in some instances act as a leaven, if the basic material is heavily factual.

Reports for the purposes of this discussion will be identified as short form and long form, with the emphasis upon the long form. Reports for special purposes are too numerous for general definition and the conditions to which they relate are so various that only the most general reference will be made to them in the closing paragraphs.

The long-form audit report presents the most serious challenge to the accountant's ability to produce an informative, well-rounded presentation of a company's financial statements and of the salient facts reflected by the statements. With this should be coupled a skilled interpretation of the conclusions to be drawn from these facts. Therein lies the real value of the report to the client; an abundance of working papers is of no interest to him, for only the carefully distilled essence of the accountant's most significant findings will have merit in the client's eyes. Accountants must recognize that their professional stature will be measured by the quality of the output and in the usual accounting engagement that output is the long-form report.

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Report writing falls into the following definite categories:

(a) Preparation for the report during the examination.
(b) Writing of the report.
(c) Review and rewriting of the report before issuance.

At the outset of an engagement the accountant in charge should be fairly well aware, at least in a general way, of the product he eventually will have to produce upon completion of the engagement. The audit program outlines the procedures to be followed in the examination and with these in mind the accountant can begin to shape the form in which the facts to be established by the examination will lend themselves to the most effective report presentation. It is suggested that when any section of the examination is finished, the accountant review the working papers, prepare his illustrative summaries and write his findings in report form. There are several reasons to recommend this course, the primary one being that the material is fresh in his mind and that he can set forth his findings in a quiet orderly manner and in the absence of the pressure attendant upon report writing in the home office after the completion of the examination. It also must be pointed out that the review of the working papers in this manner and the concurrent preparation of the report material serves as a check on the adequacy of the examination of this particular section of the accounts. Preparation of report summaries and the accompanying text material should disclose any procedural or other deficiencies and allow of their correction before closing the engagement in the client's office. Nothing need be left to memory or to fragmentary notes, the facts are set forth and their cogency determined while the material is currently in mind.

Adoption of this piece-meal method of report writing should equip the accountant for the preparation in final form of the exhibits and any supporting schedules with a thorough and comprehensive understanding of the content of each account or group of accounts; and enable him to determine in his own mind, by reference to the summaries and comments, if necessary, the precise treatment to be afforded to the individual accounts or groups of accounts in the financial statements.

The principal purpose of an audit report is to present a convincing and well-founded conclusion or series of conclusions based on the facts established by the examination. To attain this purpose three primary characteristics must be observed; the report must have clarity, it must have proper emphasis, and equally important, it must have the requisite factual persuasiveness to convince the client reader of the soundness of the findings. This presupposes that the report writer is able to use good English and that he has developed an individual and mature style of expression, for no one element can destroy the appeal of a report as quickly as a stilted style or the use of awkward or lax expressions. Except in comparatively rare instances, where the opportunity for misunderstanding practically is non-existent, the use of colloquialisms should be avoided. Some colloquialisms are inherent in certain activities and in these instances their use is permissible and probably unavoidable. Trade parlance when established through long use and familiarity is to be considered the exception and not the rule.

Clarity is a prime essential of any report and in the attainment of this end short summaries illustrative of salient facts and those best suited to the type of report that is being written have been found to be most useful. The use and position of summaries in a report may follow any one of several courses. For example, the conclusion followed by supporting summaries may be stated at the opening of a report paragraph, thus presenting the factual findings initially and enabling the reader to visualize and understand them without having to read the entire section; or the conclusions may be placed at the close of the comments, which forces the reader to study the summaries without predisclosed knowledge of the accountant's findings. Still another and probably a more useful and logical presentation of report material is to use a series of integrated summaries (depending upon the required extent of the individual group comments) with the conclusion at the end. The method to be employed is dependent largely upon the accountant's individual judgment as to which will produce the most effective presentation in clear and trenchant form. Great care must be exercised to attain continuity, with special consideration being given to the opening sentence which should orient the reader in what to expect from the material that follows. Reader interest must be sustained if the comments are to accomplish their desired purpose.

Emphasis, likewise, is of primary importance for the major and minor points must be carefully distinguished. This simply is a recognition of the distinction between the essential, the important and the interesting. The length of a paragraph is not a sure indication of proper emphasis nor is the presentation of the most salient points first necessarily the best method of handling the report material. The judgment and skill of the report writer here meet their severest test in the choice and arrangement of the material in such a manner as to give the proper emphasis to his findings. Clarity and emphasis, and an orderly marshalling of the essential facts, accompanied by soundly reasoned and logical assumptions where required, will create a report structure of the desired persuasiveness.

In furtherance of both the interests of clarity and emphasis and with due regard for the reader's welfare it is recommended that in the preparation of financial statements and in the summaries cents be omitted from all report material. The statements are just as meaningful, the typing work is reduced and the statements obtain a degree of compactness which adds to appearance; and, incidentally, dispels the impression of penny accuracy in the accounts. This does not imply the abandonment of cents in the working papers where arithmetical accuracy is most useful for balancing purposes. Many accountants advocate the omission of dollar signs except for the first and last figures in financial statements. This is a moot question but it is submitted that dollar signs to indicate subtotals are highly useful and to many perhaps are aesthetically appealing as lending a certain degree of form and finish to the statements.

Next in order is the office review and the rewriting of such sections of the report as in the judgment of the reviewer may be required. It is assumed that all arithmetical errors have been eliminated prior to presentation for review so that the task of the reviewer resolves itself into a cold, impartial and, it is to be hoped, an entirely objective approach to the subject matter. It is for the reviewer to determine whether the report develops the essential facts established by the examination, whether these facts have been stated so clearly as to eliminate any misunderstandings or incoherencies, and lastly whether the treatment is consistent with sound and accepted accounting practices. Particular emphasis must be placed upon the form of the financial statements to establish their compliance with the rules for display of these facts as dictated by custom or other and statutory requirements and to see that they carry out the firm's particular rules for the presentation of financial statements.

The reviewer's task is not an easy one, for granting the correctness of the findings, it is incumbent upon him to accept responsibility for the quality of the finished product. It is his duty to review the working papers, to question the conclusions reached, and from his presumed wider experience pass final judgment on the report as a whole. While the accountant who made the examination may make mistakes either as to facts or as to judgments, the reviewer is charged with the ultimate responsibility of finding and correcting them. Quite apart from this responsibility, there rests upon the reviewer the further and perhaps more far-reaching duty of instructing the report writer in the best methods of presentation and report structure. Sympathetic and helpful reviews by an experienced reviewer can be the means by which competent staffs are trained and developed.

The content and arrangement of a long-form report now will be considered and the proposals and suggestions that follow are illustrative of a type of report that it is felt has merit, both from the standpoint of the client and of the accountant preparing the report.

This report would have the customary introductory page, addressed to the client, indicating the period covered by the examination and setting forth the exhibits with supporting schedules and closing with the opinion paragraph (of which more later) and the signature. On the following pages would appear, in whatever order the accountant chose, comparative balance sheet summaries of the current and preceding year or years and similar comparative statements of income, followed by a statement of sources and application of funds and assets. The respective comparative balance sheet and income statement summaries would be followed by comments relative to the significant changes indicated in and by the statements. To make these comparative statements self-contained and to draw from them the compelling and essential facts is a most serious challenge to the report writer. This treatment should develop a compact and informative group of the material facts, and should apprise the client of the current financial position, of the results of operation, of the changes in financial position during the period and the reasons for these changes. Here, in a few pages at the start of the report is a concise over-all presentation of essential facts; further and more specific information will be found in the comments on such of the individual balance sheet and income statement items as may be warranted.

There is a vogue current to eliminate the standard form of balance sheet and income account, brought about, no doubt, by the tendency to "streamline" reports, which are published for the information of stockholders. This movement raises a serious question as to whether the standard forms of statements are, in fact, obsolete and serve no useful purpose. The profession well may ponder whether the shorter summarized statements will convey the same essential information to the management, to the informed reader, to the regulatory authorities, to financial analysts and to interested bankers. The standard statements may be orthodox, but nevertheless, it is felt that they can and should be sufficiently informative to be of definite value for many purposes.

One requisite must be observed whether the financial statements or principal exhibits are submitted in either summarized or standard form, and that is the inclusion of informative footnotes that explain and illuminate the statement figures where and when necessary. These footnotes should be explanatory of the specific account or group of accounts to which they refer, or, if general in nature as in the case of contingent liabilities, possible future excess profits or other potential tax liabilities and like matters, they should define briefly but with accuracy the subject matter they seek to explain. Footnotes should not embrace qualifications or exceptions which properly belong in the opinion or certificate.

The growing importance attaching to the income statement would seem to require special comment to develop the salient information which it is expected to reveal. The bulk of this information must be sought in the corporation's operating records and is as good or as inadequate as the records themselves. Again, the nature of the enterprise will determine the extent and degree of these comments; e.g., in some cases it may be practicable to analyze sales by dollars as related to quantities of specific products, particularly may this be true in certain extractive industries such as several kinds of mining and the production of salt. Costs of goods manufactured and sold, with attendant costs of production, lend themselves to comparative summarization and thus serve to indicate the changes in production costs by categories such as material, labor, depreciation, maintenance, supervision, etc. Comments on individual categories must depend on relative importance.

Report comment on elements or divisions of the income statement becomes a matter of judgment and lays a heavy responsibility on the accountant writing the report and on the reviewing accountant. The usual tests of essentiality and importance must be employed with sufficient imagination to make the ensuing comments of real value to the reader. Many corporations prepare such thoroughly informative reports that the question of where and when repetition is warranted or desirable is not easy to resolve. On the other hand, where the material is available and the corporation has not used it to the best advantage the accountant has a fertile field for the preparation of a sound and persuasive report.

Comments on the individual items appearing in the balance sheet can be as brief or lengthy as the particular subject matter warrants. A fine line of distinction exists in the determination of facts to be included. Essential and important matters warrant comment, but how much and in what form is, first, the responsibility of the accountant preparing the report and, second, of the reviewing accountant. Here, judgment and skill again must be employed to devise and articulate informative summaries. Good examples are the summaries of accounts receivable which can be shown by descriptive age groupings with the related provision for doubtful accounts. To make this summary more informative the comments may include the terms on which sales normally are made, that the reader may judge the condition of the accounts with greater accuracy and understanding. Notes receivable summaries with dates and maturities and collateral pledged, if any, should indicate whether an attempt has been made to establish independently the value of the collateral. A mere listing of collateral without reference to the steps that have been taken to determine its worth may be construed to mean acceptance by the accountant of the values set forth in the pledge, and a credit grantor may seek redress if the collateral does not materialize its stated amount upon liquidation, if that be necessary.

Inventories constitute a special problem, and the report summaries must be assembled not only to reflect the customary classifications of raw material, work in process and finished goods, but should, if desirable to adequate disclosure, be developed to show significant amounts by age groupings. Obsolete, partially outmoded or slow moving items or groups of items thus can be identified and will permit the reader or credit grantor to appraise and determine whether the inventory bears a proper relation to the needs and requirement of the business. In merchandising operations statistical data on turn-over are of first rate importance. The inventory comments should be specific as to methods used to arrive at the substantial accuracy of the physical count, of the bases of pricing of all classifications, and for good measure give an indication of whether the finished goods will liquidate at a price sufficient to return selling and other expenses and still yield a representative profit margin. This may not seem so significant in an era of expanding markets, rising prices and shortages of supplies, but it is well to be mindful of the fact that inflationary eras with the accompanying large credit extensions often are the forerunners of periods of decline. The accountant will be buying useful professional insurance if his report comments develop essential facts on which sound judgments of conditions could have been based.

Security holdings where material in amount and number should be set forth in a schedule, which in the comments may be reduced to summaries indicating the several types of securities, with interest or dividend rates, and a column for the interest and dividends received during the period. Cost or other acquisition price and market value at the date of the examination by individual groups of securities can be important information for the reader. If any of the securities are pledged or otherwise encumbered this should be noted and in more detail than the indication thereof in the balance sheet.

Fixed assets require the customary classifications, i.e., land, buildings and structures, machinery and equipment, furniture and fixtures, etc., and with depreciation accumulations lend themselves to effective summarization. These summaries should be assembled to show changes during the period both in the assets and the depreciation accumulations. Bases of valuation should be stated where possible and the rates of depreciation applicable to each classification set forth. Descriptive identifications of land holdings and of principal structures, where not too extensive for concise summarization, frequently are most informative. Fixed assets that remain on the books but which presently are not in use or are of no further use in the conduct of the business should be summarized to show their present status as to book value, accumulated depreciation and residual value.

The liabilities as a rule present fewer opportunities for summarization, except in instances where notes payable are numerous or substantial in amount and the maturities are of special interest. Bond issues or other funded indebtedness may require detailed classification and merit special comment. In other instances, where liabilities are indeterminate and estimates are required, the bases upon which the estimates were arrived at should be set forth in the comments.

The capital structure furnishes another instance in which summaries may be used to advantage to show any changes during the period under review. The situation with reference to retained earnings (or surplus in its several recognized classifications) must be resolved by the extent and importance of the subject matter. Commonly, the surplus statement starts with the balance at the beginning of the period, followed by any adjustments that have been made, plus the net profit for the period then ended; and from this total are subtracted any dividends declared during the period. The extent of the disclosure pretty well rests with the accountant preparing the report and largely is dependent upon his opinion of what is required and desirable.

A most interesting and, perhaps, highly provocative viewpoint as to the extent of surplus disclosure has appeared recently in the publication of an eminent state society in which the authors contend that full disclosure of the surplus account should comprehend historical information and analysis. Their argument is that the conventional form of surplus statement does not reflect pertinent information as to the corporation's past and they propose to set forth in statement form the financial history of the corporation as reflected by an analysis, in broad groupings, of the changes in surplus. The summary would be divided into two sections—the first—Prior to Current Period—and the second—Current Period. The Prior Period would show in one figure the total earnings from the corporations' inception (less federal income taxes with the amount thereof shown) to which would be added any increments such as reductions in capital stock or from donations or other sources. From this total would be deducted any write-offs of intangibles and dividends of whatever nature that have been declared. Having thus analyzed the surplus at the beginning of the period, the second section would include changes in surplus for the current period.

The authors envisage many objections from many sources but argue and with some conviction that management should have no valid objections as the information would supply agencies, exchanges and regulatory bodies with facts helpful in the performance of their tasks and at the same time furnish investors with information not otherwise readily available. Our premier industrial corporation, for example, furnishes this information and more besides in its annual report and one of our great transcontinental railroads accomplishes practically the same end in its annual report. The proposal is submitted as a matter which should be of interest to practicing accountants.

Opinions vary as to whether comments relating to adequacies or inadequacies of internal control and other accounting procedures have a place in a long-form report or whether they properly belong in a separate report. Where the deficiencies are not sufficient to obviate the issuance of a certificate, it would seem that the preferable practice would be to make them the subject of a separate report which would be of informative use to the management and enable it to remedy the defects.

The opinion paragraph of the accountant's certificate, because of its transcendant importance, has warranted and has been given intense and mature consideration by the Institute's Committee.

The issuance of Revised Bulletin No. 23, in December, 1949, by the Committee on Auditing Procedure has served to clarify the position to be taken and the responsibilities to be assumed by the accountant issuing the certificate. This bulletin, having in mind the lack of control over financial statements once the report has been issued and to avoid uncertainties and misinterpretations by third parties, recommended that there should be a clear-cut indication of the character of the examination and an expression of opinion regarding the statements taken as a whole or an assertion that an opinion could not be expressed and the reasons why.

The accountant in the preparation of his certificate must weigh with great care and with due regard for all of the circumstances surrounding the engagement: (1) whether he can express an unqualified opinion; (2) express a qualified opinion; or (3) disclaim an opinion on the statements taken as a whole. If the exceptions are so significant as to prevent the issuance of a certificate the question is answered quite readily, but where the exceptions are not so serious and a qualified opinion can be expressed the accountant must state clearly why an unqualified opinion has been withheld and his reasons for so doing; a mere statement of omissions and departures is not sufficient, and must be accompanied by an explanation of their effect upon the financial statements taken as a whole. It is the province of the accountant to determine whether qualifications are justified, or whether alternative and equally effective procedures could have been adopted which would have made the qualifications unnecessary. Third parties are not in a position to pass an informed judgment on these matters. Statements issued on an accountant's letterhead with such captions as "For Management Purposes Only" or "Prepared from the Books Without Audit or Verification," despite the warning caption, have inherent in them certain elements of danger and while the disclaimers may be deemed sufficient, they should be avoided.

The recommended revised form of certificate is familiar enough not to warrant repetition here and has been improved by the omission of references to internal control, and to omission of the detailed audit, and by the correction of the inconsistent expression relating to auditing standards applicable in the circumstances. A further change in the arrangement of the certificate recently has made its appearance in published reports. This change transposes the position of the opinion paragraph from the last paragraph to the first, beginning the certificate with "In our opinion, the accompanying statements fairly present—financial position—results of operation, etc., in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Our examination was made in accordance, etc." This reversion to the opening paragraph formerly in common use leads one to the conclusion that "the thing that hath been, it is that which shall be; and that which is done is that which shall be done." Eccles. 1:9; and that nothing concerned with accountants' certificates is more striking than their repetitive character and that all efforts to change or vary their pattern materially have failed in the long run.

Reports for special purposes, earlier referred to, furnish the accountant with a prime opportunity to use his originality in the presentation of material in its most effective aspects. As a rule several points must be covered to lay the foundation for the final report:

(1) The basic problem: The issue may stand out clearly or it may be complex and obscure to the point that its determination is difficult. Whatever the circumstances, a decision must be reached after all the facts and conditions have been reviewed and the problem approached with this objective firmly in mind.

(2) The elements underlying the basic problem: Where the problem when viewed as a whole seems to defy solution, a recommended procedure is to analyze the component parts separately, always with the main objective in mind, and with the consciousness that hitherto hidden relationships may reveal the essential facts.

(3) The question to be answered: A check list of all important questions should be prepared and all facts and evidence should be assembled and their bearing on the main question determined by objective analysis. After this a final conclusion must be reached by assigning to each element its proper and proportionate weight; and it is at this point that the skill and ingenuity of the accountant meet their severest test.

A recent writer in the Journal of Accountancy said that he had gained the impression from teaching mature bankers that many of them believed that "figures prepared by accountants are statements of incontrovertible facts made by an expert of unvarying perfection after applying a standardized infallible technique to evidence of undeniable finality." Substitute "most third party readers" for "bankers," and the necessity for the accountant to make clear the extent and degree of responsibility he assumes in connection with the report becomes alarmingly apparent.

Problems of an accountant's office operation

by A. STANLEY HARMON, CPA

RATHER THAN immediately get into a factual discussion of the problems involved in the organization of a public accountant's office, I felt that a review of background material would aid in the preparation of a few choice introductory remarks. Accordingly, I requested Miss Miriam W. Donnelly, librarian of the American Institute, to supply me with all articles written along these lines published since 1940. The selection of 1940 had no implications other than to provide a limit on the amount of material to be sent through the mail and to limit the expenditure of my own energies.

At any rate, there arrived at my office the following morning a large package of such publications as: "New Developments in Accounting—1946," "Papers Presented at the 59th Annual Meeting of Accountants," numerous copies of the *New York Certified Public Accountant*, a publication put out by the La Salle Extension University called *A Public Accountant's Office*, one copy of *The Bulletin of the Massachusetts Society*, a copy of the *Accounting Review*, etc. As a result of my reading, I recommend that those interested in further information refer to these publications as a source of general information covering the subject. It was noted, however, that articles of the "case-study" type were rather infrequent.

I was particularly impressed by the author of one article (Greenberg) who suggested that a CPA might well engage another CPA to review his office procedure on the same theory that gave rise to the quip that "a lawyer who acts as his own counsel has a fool for a client.*" Undoubtedly I am now in a similar position, having worked intimately for some ten years with the procedures I am about to outline. On the other hand, experience has shown that our system has served us well and continues to function adequately.

The system

Our accounting system might be described as a current standard cost system. We develop three rate classifications: for partners, staff and typists. These rates are reviewed from time to time, usually once a year but as many as three or four times a year if circumstances warrant, to develop a rate which, based upon 2000 hours per year per employee, will absorb the total payroll cost within each classification. For instance, if we had a typing payroll of say $20,000 per year for ten typists, our standard cost would be $1 per hour per typist. The same procedure is applied to staff men.

In many partnerships the rate for partners bears some relationship to anticipated profits for the year—in our case we have always used an arbitrary rate.

1. Assignment Sheet

As soon as we have been engaged by the client, partner dictates an Assignment Sheet (Exhibit I) which is typed in triplicate; the original being white, the duplicate blue and the triplicate yellow. At this time the name and address of the client, the party to see, the assignment number, and the date of memorandum are filled in. When an accountant is assigned to the work, the

* *The New York Certified Public Accountant*, Volume II, November, 1949, No. 2, Benjamin Greenberg, CPA, page 88, conclusion:
"There is a common saying in the legal profession, that a lawyer who acts as his own counsel has a fool for a client. That saying might apply to an accountant. It might be well for an accountant to occasionally engage another practicing accountant to review his internal organization and system and obtain recommendations as to accounting methods and procedures. In any case, the time and thought given by an accountant to his own organization should be well rewarded."

A. STANLEY HARMON, CPA, is a partner of Hadfield, Rothwell, Soule & Coates in Stamford, Connecticut. He is a member of the Connecticut Society's board of governors.

EXHIBIT I

HADFIELD, ROTHWELL, SOULE & COATES

ASSIGNMENT MEMORANDUM

ACCOUNTANT IN CHARGE ____________ NUMBER ____________
THIS NUMBER MUST BE NOTED ON TIME REPORT

NAME OF CLIENT ____________ DATE OF MEMO. ____________

ADDRESS ____________ WORK STARTED ____________

PARTY TO SEE ____________ WORK FINISHED ____________

____________ READY TO BILL WHEN TYPED ____________

ATTACH THIS MEMO. TO WORKING PAPERS SUBMITTED TO PARTNER AT COMPLETION OF WORK
(SEE OVER)

INSTRUCTIONS:

ASSIGNMENT SHEET - FACE

partner in charge fills in his name in the space provided on this form. Spaces for Work Started, Work Finished, and Ready to Bill When Typed are filled in when these dates are available.

The original of the Assignment Sheet is handed to the accountant in charge when the work is started, and is returned to the partner in charge after completion of interim work or after the job is finished. The reverse side of the original is used by the accountant in charge for indicating progress on the job. This is particularly important in the case of interim work and is

EXHIBIT I

THE FOLLOWING MUST BE OBSERVED

Notify the office as soon as possible after starting an assignment as to what date you expect to finish and will be available for another assignment. This will facilitate making arrangements for your next assignment and will also enable this office to intelligently indicate to a client when a new assignment will be started.

Discuss all unusual features with partner and obtain permission to discuss such matters with client.

Discuss any changes in program with partner.

Working papers must include complete program of audit or examination, name of accountant and time spent on each operation; also report on methods of internal check and control.

Depreciation schedules must be maintained. These should be brought forward from prior years working papers, if any, and completed for the current year. Depreciation schedule required for tax returns is inadequate for working papers.

Make use of tax and other services in this office and be sure that tax returns are prepared and tax liabilities are determined in light of current regulations, rulings and decisions.

Progress reports must be made to a partner at least once each week, either by telephone, or on the printed form provided for this purpose.

Note hereunder period covered and date of completion of interim work and any peculiar features, results of partners' conferences, etc.

ASSIGNMENT SHEET - REVERSE

Date........................ Signed........................

ACCOUNTANT IN CHARGE

chiefly for the guidance of the partner in charge. When the accountant completes interim work, the original of the Assignment Sheet is returned to the partner in charge, together with the working papers, and any important matters are discussed at that time.

If the engagement is being completed, the original is attached to the draft report immediately under the typing instruction

EXHIBIT II

L-9

HADFIELD, ROTHWELL, SOULE & COATES

Report of Services and Expenses for the period ended..........19...... Hourly Rate.......... No..........

Must reach office the 1st, 8th, 15th and 22nd of month, to and including the day preceding.

T I M E S H E E T - F A C E

NAME OF CLIENT	NUMBER OF HOURS AND DATES										For filling in at Office	Assignment Number
										Total		
Total Chargeable Time												
Unassigned Time												
Lost Time (Report Here: Sickness, Holidays, Vacation)												
Overtime (For Office Use Only)												
Net												

EXPENSES

Date	DESCRIPTION	Transportation		Train Meals	HOTEL		Miscellaneous		TOTALS
		Train	Auto		Room	Restaurant	Description	Amount	
	Totals								

DISTRIBUTION OF EXPENSE CHARGES

Name of Client	Amount	Assign. No.
TOTAL		

Sign here ....

Address ....

EXAMINED AND APPROVED:

....

Assignment number must appear against Client's Charges.

All Accountants are to observe Client's Office Hours up to 8 hours per day.

sheet (no sample). After the Report Review Department has completed its work and a partner has passed the work for typing, the original Assignment Sheet is given to the bookkeeper as a notification that the client is to be billed when the report has been typed. The bookkeeper keeps these sheets until the office copy of the typed report reaches his desk, whereupon he prepares a pencil draft of invoice to client. This, in turn, is reviewed with a partner before being typed and mailed.

The duplicate (blue copy) of the Assignment Sheet is retained in a looseleaf book on the desk of a partner from the beginning until the completion of the engagement.

EXHIBIT II

Date	Time of Arrival	Time of Departure	Work Done at Office of	Assign. No.	CLIENT AND DESCRIPTION OF SERVICES

TIME SHEET - REVERSE

The partner makes his notes, if any, on this copy and it serves as a reminder of work to be done or the status of work in progress. When work has been completed, this copy is forwarded to the file room and is filed numerically, thereby providing an index to assignments by assignment number.

The triplicate, or yellow copy, of our Assignments is retained in the typing department until a Cost Card is typed, as hereinafter discussed. This copy is then circulated to each partner, following which, it is sent to the file room and filed alphabetically by client. The practice of circulating a copy of each assignment to all partners, we have found, serves the purpose of letting the left hand know what the right hand is doing.

From the above it may be seen that we have provided the scope of the engagement for the staff man, the detail for preparation of a Cost Card, and numerical and alphabetical cross-indices to all assignments.

We have found it important that each assignment be as explicit as possible as to the nature and scope of an engagement and, generally, the full space provided for such information is used on an assignment. There are, of course, exceptions. The two extremes being that on a few occasions an assignment may fill three or four pages and on others, a single line such as "Prepare Federal Corporation Income Tax Return for Calendar Year 1950."

2. *Time sheet*

Our Time Sheet (Exhibit II) may not differ much from the form generally used. We require each employee to record his chargeable time, unassigned time, and lost time, while the office enters overtime. The net time on every time sheet must be eight hours a day. This might be made up as follows: total chargeable time of seven hours plus unassigned time of three hours, or a total of ten hours, minus the two hours of overtime resulting in a net of eight hours.

On the right-hand side of the top portion of the sheet it will be noted that there is a column ruled for dollars and cents to be filled in at the office. The figures in this column would be the rate of say $2.50 per hour times the total hours for the related assignments; so that if the A. B. Company had twenty hours on line one, representing total hours for the period, $50 would be posted in the column provided therefor.

The information under expenses appears to be self-explanatory except that meals other than train meals are included under "Hotel-restaurant" even though the restaurant may not be affiliated with the hotel.

Transportation charges for automobiles in our organization are computed at seven cents a mile, plus one cent for each passenger carried, with a total rate not to exceed nine cents a mile. Expense charges are summarized at the bottom of the sheet for bookkeeping purposes and posting to the Cost Accumulation Card is made from the summarization.

The reverse of the Time Sheet contains substantially the same data as is found on any accountant's time sheet. The description of services in our office is simplified as much as possible for it merely serves the purpose of enabling reference to working papers (audit program) for details.

It will be noted that Time Sheets are required to reach our office on the 1st, 8th, 15th and 22nd of the month, covering the periods respectively from the 22nd to the end of the month, from the 1st through the 7th, from the 8th through the 14th, and from the 15th through the 21st. This procedure is followed by all staff personnel except the typing, switchboard, and bookkeeping departments who report on a calendar week basis and are paid weekly. Staff men are paid twice each month on the 1st and the 15th.

EXHIBIT III

COST ACCUMULATION CARD

PERIOD ________________

ASSIGN NO. ________________

CLIENT ________________

NAME	HRS.	COST	EXP.

3. *Cost accumulation card*

A small card, which for this purpose I have titled Cost Accumulation Card, is probably the key to the efficiency of the procedure we follow. You will note that each card provides for a date, the names of the staff members and two amount columns, one for services and the other for expenses. One card is made out each period for each assignment and each staff member's time is posted in dollars to one or more of these cards. A staff man working on ten engagements during the pay period would have his time and expenses posted to ten of these cards and if six men worked on the engagement, the names of six men would appear on one card. At the end of each month, upon analysis of our telephone bill, toll charges attributable to clients are summarized on the same type of card (Exhibit III).

These cards, when completed and proved in total, are posted to the Cost Cards of the respective clients, as discussed later on. It will be seen that the Cost Accumulation Card provides a direct reference between the Cost Card and the Time Sheet (or the original documents of other expenses).

4. *Cost card*

As hereinbefore stated, a Cost Card is typed, at the time an Assignment is typed, at the beginning of each engagement (second cards being prepared if and when necessary). The Cost Card contains a bare minimum description of the engagement which is helpful in the case of one or more assignments for a single client (Exhibit IV).

Cost Cards are posted each period from Cost Accumulation Cards, the posting in our organization being made in ink, with pencil totals being carried down monthly. It will be noted that the Cost Card provides for analysis of time and expenses for each of our three classifications; namely: partners, staff and typists. The name of the partner in charge should also appear on the card. As a matter of practice, Cost Cards are reviewed each month by the partners to determine whether or not the engagement is ready to be billed. Where clients desire monthly or quarterly billings, notations are made in red ink at the top of the Cost Card to insure billing on the desired dates.

It will be noted, at the bottom of the face of the Cost Card, that cost and billing detail of the previous year are recorded, together with the same information for the current year. This has been helpful in providing comparison from one year to the next, particularly where the engagement for one year was practically identical to that of the preceding year.

5. *Accounting controls*

Personnel of our organization are required to report time in units of not less than one-quarter of an hour. As previously stated, chargeable time on each engagement is multiplied by the applicable rate in the space provided on the Time Sheet. The total hours for the reporting period are multiplied by the rate to check the total dollar amount on each Time Sheet. Similarly lost time, overtime, etc., are computed on the separate lines provided and the net time of forty hours per week computed to prove the mathematical accuracy of each Time Sheet. The total dollar value of time in each category is then accumulated by machine tape for the entire personnel for a given period, resulting in an entry thus:

Debit—Work in process	xxx.	
Debit—Unassigned time	xxx.	
Debit—Lost time	xxx.	
Credit—Overtime		xxx.
Credit—Services		xxx.

After the above has been completed all Time Sheets for a particular pay period are posted to the Cost Accumulation Cards in both hours and dollars. Machine tapes are then taken of these cards and checked against the totals in the above entry as to chargeable time. When the Cost Accumulation Cards are in proof they are, in turn, posted to the Cost Cards and a trial balance is then taken of the Cost Cards to see that they are in agreement with the Work in Process control account. Time costs are carried separate from reimbursable expenses in the Work in Process record.

When a job is billed in full, the Cost Card is removed from the Work in Process file, a charge is made to Accounts Receivable and a credit to Fees for Services with an offsetting credit to Work in Process and charge to Cost of Services Billed.

On interim billing we have found it practicable to debit Accounts Receivable and credit Fees Billed in Advance, treating the latter account at all times as a liability and allowing the accumulated costs to remain in Work in Process.

As might be expected, we run an Accounts Receivable ledger and each month a listing of all open balances is prepared, showing the name of the client and the amount unpaid. This ties in with our balance sheet and is in support thereof. Also, each month we prepare an analysis of all billings during the month (Exhibit V). Here we itemize the invoice number for each client, services billed,

EXHIBIT IV

(COST CARD - FACE)

CLIENT	ASSIGN. NO.
DESCRIPTION	DATE
OF SERVICES	STAFF

PERIOD		PARTNERS			STAFF			TYPISTS			TOTAL		
		HRS	COST	EXP.	HRS	COST	EXP.	HRS.	COST	EXP.	HRS.	COST	EXP.

PREVIOUS YEAR				CURRENT YEAR			
COST			BILLING	COST			BILLING
	DAYS	COST	DATE		DAYS	COST	DATE
PART			SERVICES $	PART			SERVICES $
STAFF			EXPENSES	STAFF			EXPENSES
TYPE			TOTAL	TYPE			TOTAL
TOTAL				TOTAL			
EXPENSES				EXPENSES			

(COST CARD - REVERSE)

CLIENT	ASSIGN. NO.
DESCRIPTION	DATE
OF SERVICES	STAFF

PERIOD		PARTNERS			STAFF			TYPISTS			TOTAL		
		HRS.	COST	EXP.	HRS	COST	EXP	HRS	COST	EXP	HRS.	COST	EXP.

EXHIBIT V

MONTH OF

	INVOICE NO.	CLIENT	SERVICES BILLED	EXPENSES BILLED	COST OF SERVICES	UNRECOV'D EXPENSES	DAYS		PER DAY	
							STAFF	TYPE	BILLED	COST

ANALYSIS OF MONTHLY BILLINGS

expenses billed and cost of services and any unrecovered expenses. The last four columns are not presently used but would provide one means of developing a standard rate.

The column "Unrecovered Expenses" may require some explanation. Generally, unrecovered expenses are insignificant in amount, such as a single telephone call or other incidental expense which, for policy reasons, we think is too trivial to justify inclusion on a client's invoice.

In the case of advance billing, such bills are included in the listing with the amount of the bill being inserted in the column "Services Billed" and in parentheses immediately thereafter the legend "Advance Billing on Incomplete Work."

The list of monthly billings is totaled each month and the last page contains an analysis of each category which is, in itself, the Journal Entry as follows:

Debit—Accounts Receivable	xxx.	
Debit—Cost of Services	xxx.	
Debit—Unrecovered Expenses	xxx.	
Credit—Work in Process		xxx.
Credit—Advanced Billing on Incomplete Work		xxx.
Credit—Services Billed		xxx.

6. *Payroll and expense analysis*

Our payroll and expense analysis sheet (Exhibit VI) is prepared each pay period from Time Sheets. Services, as used here, refers to our actual payroll costs and expenses which are in turn allocated across the sheet in accordance with the various headings: Work in Process, Unassigned Time, Lost Time, Office Time, and Overtime, being charged at the standard rates previously referred to. The difference between the total of these columns and the services column is either over-absorbed or under-absorbed payroll. Expenses are also analyzed as between chargeable expenses (carried, as aforesaid, as a separate element of Work in Process) and non-chargeable expenses (previously referred to as Unrecovered Expenses). The allocation of time and expenses to work in process should be readily understandable. However, allocation of time to unassigned time, lost time, office time and overtime may require some explanation.

(a) Unassigned Time represents time of staff personnel when they are in our office available for work but not assigned to any engagement.

(b) Lost Time "General" and "Girls" represents vacations, holidays and absences because of sickness.

(c) Office Time of "Typists" and "Others" represents time spent on regular office work as in the case of typists working on general correspondence and in the case of others, for the time of the switch-board operator, file clerk, bookkeeper, and

EXHIBIT VI

Hadfield, Rothwell, Soule & Coates

(Date)

PAYROLL and EXPENSE ANALYSIS

	Name	Services	Expenses	Work in Process	Chargeable Expenses

time of staff men spent re-arranging files or other nonroutine work.

(d) Overtime, as the title indicates, represents the overtime of any employee whether or not compensated.

The schedule is totaled at the end of each pay period and becomes the source of a journal entry wherein the general ledger accounts are debited and credited in accordance with the titles. It has been our practice to allow any credit balance in the over- and under-absorbed services account to remain as a balance-sheet item during the year and to absorb it at the end of the year. Any debit balance created in a given period is absorbed as an expense element.

It does not seem necessary to dwell at any length on our payroll records, there being so many completely adequate records, all quite similar to each other. However, we have found it practicable to maintain a list of all personnel on a monthly basis and to insert the compensation of each employee in a separate column for each payroll period, adding the four columns across at the end of each month to obtain totals for our payroll entries. While this appears efficient for our use, any regular payroll procedure may be applied which would best suit the particular circumstances.

As a matter of practice, the Payroll and Expense Analysis has been filed with the corresponding Time Sheets each pay period although these could be filed separately or be entered in a looseleaf or bound book.

7. *Instructions to report department*

There is one other form which we use and is probably used in every public accountant's office, namely, a 5 × 7 slip entitled "Instructions To Report Department." No sample of this sheet has been provided as any simple form would be adequate for this purpose. Our particular form contains space for the following:

Name of Client
Assignment Number
Deliver: Mail: Will Call:
Number of copies to client
Name and address (person to whom report, tax return, etc., are to be delivered)
Date on which required
Binding instructions: Paper, Brief Form, None

EXHIBIT VI

Unassigned	Lost	Time	Non-	Office	Time	Over
Times			Chargeable			Time
	General	Girls	Expenses	Typists	Others	

Remarks—(Usually would refer to whether the report was letter size or legal size or whether additional "printers copies" or "Stamford Office Copy," etc., are required.)

8. *Modifications*

The design of our accounting system is such that certain modifications may be made if desired or if they become necessary.

You have seen that our Time Sheets are prepared on what is practically a weekly basis. And therefore, our Cost Cards develop cost information for managerial purposes each week.

We have found that the more often the progress of work on any engagement is brought to the attention of a partner the better the results. While in theory each partner always has before him at least one copy of the assignment memorandum and may be talking with the man in charge regarding the assignment one or two times each week, there is, nevertheless, a tendency to overlook the accumulation of costs on a job and a frequent review of Cost Cards has proved invaluable in providing control over each engagement.

Probably the majority of accounting firms require time sheets prepared semimonthly. It will be obvious that the fewer time sheets, the fewer postings would be required. In this case, the amount of bookkeeping required should be weighed against the control effected. In my opinion, any posting period longer than semimonthly would result in cost information with respect to each assignment coming to a partner's attention much too late to enable effective control.

In a very small organization the Cost Accumulation Card could be eliminated and posting made directly from the Time Sheet to the Cost Card. Contrariwise, in a larger organization, and particularly where the engagement involves a larger organization, and particularly where the engagement involves a larger number of men in a single pay period, a larger Cost Accumulation Card might be desirable. However, even in a small organization it would be necessary to make an analysis of telephone bills on a work sheet or other piece of paper and we have found that the Cost Accumulation Card serves this purpose and provides a record for future reference which otherwise might be lost.

Accounting for cooperatives

by WALTER L. BRADLEY, CPA

In recent years the public accounting profession has become more acutely aware of and developed a keener interest in the matters of accounting for business done by cooperative enterprises. Yet withal, there has not been the general recognition within the profession of the specialized procedures and problems involved in the accounting and auditing requirements of this rapidly expanding segment of American business enterprise. It might be reasoned that our appearance to discuss the problems of accounting for cooperatives in this special seminar, devoted to institutional accounting, indicates to a certain extent the degree of misunderstanding or lack of understanding of the real nature of cooperatives as business enterprises as distinguished from nonprofit institutions which fall in the category of educational or eleemosynary institutions. True, the cooperatives are nonprofit insofar as making profit for themselves is concerned, but by and large they are utilized to conduct profit-making enterprises, but for the profit of their patrons rather than for profit to the cooperative corporation itself.

That is the cardinal distinction between the cooperative form of doing business and the proprietary form and furnishes the key to the distinctive features involved in accounting for cooperatives. Since the cooperative may be utilized to conduct almost any and every type of commercial enterprise, the accounting involves all of the features of accounting coincident to the conduct of that enterprise irrespective of the type of organization. For example, the accounting for operation of a feed mill would be substantially the same whether the operation of that mill is conducted by a cooperative organization or a private owner. Therefore it must be realized that the discussion of accounting requirements for cooperatives, to be presented here today, will be limited to those specialized requirements which are in addition to the normal accounting procedures coincident to the proper accounting for transactions normally required in the conduct of a business enterprise in any commercial field of endeavor.

Let me again stress that the cooperative corporation reflects a method of doing business for profit as a part of the American private-enterprise system, the sole distinction being that it operates for the profit and economic benefit of its patrons as such, rather than for its owners as such. The cooperative does not represent a particular ideology or a venture in sociology. The cooperative form of doing business has long been used in conducting joint purchasing or selling operations by almost every segment of American business. We are inclined to think of the cooperative form of business as being applicable almost exclusively to agricultural enterprises. As a matter of fact, its use in general commercial fields in this country is of as long standing as its use by agriculture, and the volume of business transacted by the cooperatives in nonagricultural commercial fields probably exceeds, in the aggregate, the annual volume of business done by all agricultural cooperatives.

It is true that accounting for agricultural cooperatives involves certain problems which may not always be present in the instance of the commercial type of cooperative. These will be discussed later, but essentially the basic problems are the same for both types. I might mention as examples of the utilization of the co-

WALTER L. BRADLEY, CPA, is chairman of the American Institute committee on cooperatives. He is president of the American Institute of Cooperation and chairman of its committee on education in accounting.

operative form in commercial business that the Railway Express Agency is a cooperative which operates on a nonprofit basis for the economic benefit of the railroads which are its members and patrons. The Associated Press is a cooperative. Doubtless many of you are familiar with the workings of the large number of purchasing associations utilized by merchants and other businessmen throughout the country, which operate on a nonprofit basis and which are utilized by their member patrons as a means for effecting economy in costs. These are cooperatives.

The principal distinction between agricultural cooperatives and the commercial-type cooperative involves the right given to certain types of agricultural cooperatives, which can qualify, to exemption from federal corporation income taxes. This exemption is applicable only in instances where the particular cooperative has been so organized, and operates in such manner, as to conform to the rigid requirements upon which the exemption depends. It is significant that out of approximately 10,500 agricultural cooperatives operating in the United States today, only 50 per cent of them have qualified for the exemption, and many of those which had qualified are voluntarily surrendering it because of their inability to meet or police the rigid conditions precedent to exemption.

Although only certain types of agricultural cooperatives are exempt from federal income tax, those which are nonexempt and the commercial type cooperatives, which are properly organized and operated, are able to limit the amount of their liability for federal income tax by exclusion from gross income of amounts refunded to patrons, pursuant to a valid obligation to make such refunds, which was in existence at the time of the transaction with the patron. This is in keeping with the nonprofit character of the enterprise, which permits it to have no income of its own account, which is subject to tax, other than perhaps the amounts which its by-laws may permit it to utilize for the payment of dividends on outstanding capital shares. These, of course, constitute taxable income and that income is taxed.

Let us briefly discuss those accounting procedures which a cooperative must follow and which are in addition to those coincident to the recording of transactions normally required in the conduct of the commercial business involved. Cooperatives obtain their cooperative status and form either by virtue of being organized pursuant to the terms of a special statute, as in the instance of most agricultural cooperatives, or by virtue of provisions in the articles of incorporation or by-laws or other contractual obligations such as in a marketing agreement or other special agreement outside of the by-laws and articles, which set up obligations to refund margins realized to the patrons in proportion to the relative volume of business done with each patron. It is evident, therefore, that the special accounting procedures involved must be so designed as to reflect in the records of the enterprise, conformance to the special provisions applicable to the circumstances in each case.

Limitations of time in the present instance prevent a full detailed discussion of the distinctive procedures in accounting and auditing of cooperatives. Additional light on the subject may be had by reference to an article which appeared in *The Journal of Accountancy* for July, 1940, entitled "Audits of Agricultural Cooperatives."

A summary discussion of the principal distinctive requirements is given briefly as follows:

Membership records. In many instances, especially those involving agricultural cooperatives, the statutes or the by-laws, or both, may impose limitations of the amount of business which the cooperative association may do with nonmembers. It is, therefore, highly important that the institution maintain adequate records of membership as a basis for subsequent analysis of the volume of business done to differentiate between that done with members and with nonmembers.

Patronage records. Since the refund to the patron of the margins realized is on a patronage basis, there must be maintained accurate records of patronage, which must be kept in reconciliation or balance with the total volume figures. They may be maintained either in units of volume or in dollar volume, or both, according to the circumstances and requirements in each instance. An accurate record of the patronage of each patron is a fundamental requirement in accounting for cooperatives.

Record of patrons' equities. Certain types of cooperatives are permitted to accumulate certain types of reserves. In fact, with respect to agricultural cooperatives, the cooperative statutes of the several states under which they are organized almost uniformly require the accumulation of a statutory reserve through the appropriation of a modest amount of each year's margins until the reserve has reached a varying percentage of the outstanding capital. The Commissioner of Internal Revenue requires, with respect to exempt cooperatives, that the interest of each patron in such reserve shall either be definitely allocated, or, as an alternative, that permanent records be maintained in the association from which such allocation could be made at any future time. Therefore, records reflecting the allocation of patrons' equities in this type of reserve are essential. In other instances, with respect to taxable cooperatives, it is the practice in many instances to effect the distribution of margins back to the patron in forms other than cash, such as in capital stock, certificates of indebtedness, or other evidence of equity, including in some cases a mere letter of advice. The Commissioner of Internal Revenue has ruled, and the courts have confirmed his ruling in numerous instances, that such distributions in forms other than cash constitute a valid distribution, which the cooperative association may exclude in determining its own taxable income, but which in turn is taxable to the patron, in the year in which it is received, as income constructively received by such patron and reinvested in the securities of his cooperative. It is, therefore, essential that proper records of each patron's equity in these accumulated reserves or capital accounts be maintained.

Utilization of cost accounting. The cardinal principle under which a nonprofit cooperative association operates is that it shall return to the patrons all or a certain part of the margins realized by it on business done with that patron. In ARR 6967 (C/B June 1924, P. 287) the Commissioner of Internal Revenue has prescribed a formula for determining the taxable income of a cooperative association which may be under obligation to make refunds to its members or a specified class of patrons only and does not make refunds to its other patrons, but rather pays income tax on the margins realized on their business. The substance of this ruling is that in absence of evidence to the contrary it will be assumed that margins realized on the entire volume of business are ratably equal, although such volume may be in different categories, and if such margins are substantially equal in all categories the taxable income is determined by applying to the tentative amount of all margins realized by the cooperative a percentage representing the ratio of the volume of business done with patrons not entitled to refund to the entire volume of business. This emphasizes the importance of cost accounting in manufacturing operations and the accounting for margins according to commodities which may be handled. The Commissioner's rule applies only in the absence of evidence to the contrary as to the ratable equality of margins.

As you will know from your own experience with other lines of business, there frequently are wide variations in both the gross and net margins realized in the handling of different commodities. Therefore, it is essential, in a true cooperative, that the accounts reflect as nearly as possible the actual margins realized, according to classified commodities handled in order that the equity of each patron in the margins realized may be accurately determined and to implement the true purpose of the nonprofit cooperative, which is to return to each patron the proportionate share that he has contributed to the entire margins of the association.

It is in keeping with the fundamental concept of cooperative accounting that insofar as practical, the margins realized on business done with each patron *within a certain fiscal period* be reflected in the accounts. This sometimes calls for accounting treatment which will differ materially and basically from procedures which would apply in the ordinary commercial institution. For example, in ordinary commercial accounting it is common practice, and a requirement for federal tax purposes, for a firm engaged in the grain business, which may have open commitments at the close of its year—commitments involving either a long or a short position in a futures market which are balanced off against open sales or purchase contracts with customers—to balance off its contracts at the close of the year and determine the gain or loss then realized, although the actual fulfillment of those contracts will fall in the following fiscal year. To follow this procedure in the instance of the cooperative might distort the picture with respect to the margins realized on the business done with a particular patron. For example, with the fiscal year of the cooperative ending June 30, the year-end closing records might indicate an open order from a patron for a hundred tons of mill feed to be delivered in September. The cooperative in turn had, prior to the close of its fiscal year, made a commitment to purchase this hundred tons of mill feed at a stated price, to be delivered in September. If those particular purchase and sales contracts were offset against each other in closing for the fiscal year and prior to the fulfillment thereof, the accounting for the margins would fall in that fiscal year, although the actual realization and the invoicing of the sale to the patron would occur in the following fiscal year, for the transaction would not be billed to the patron and enter into the volume figures of the cooperative until the shipment had been made. The patron would, therefore, be deprived of the margin on his actual transaction with the association and the patrons of the previous year would benefit by margins realized on transactions not represented by their own transactions with the association. Of course, in the instance of a taxable cooperative, the accounting would have to follow the applicable regulations to determine the taxable net income. However, the corporate records could reflect this distinction in respect to accounting for patrons' equities in the margins as actually realized.

Terminology and forms of statements. Since a true cooperative is, in fact, a nonprofit institution, proper accounting for the transactions of these enterprises involves the use of especially descriptive terms in some instances and advises utilization of special forms of operating statements in order that the clear intent may be properly expressed. This is of particular importance in view of the nature of the relation of the cooperative to its patrons, which in many instances involves that of agency and in others that of trusteeship. Limitations of time prevent the detailed exploration of this field in this paper. However, reference is made to an article which appeared in the April, 1945, issue of *The Journal of Accountancy*, in which this matter of terminology is fully discussed and specimen forms of statements are submitted. It may be said, in summary, that few of the proposed changes apply to the balance sheet other than in the net-worth section, wherein the distinction between proprietary capital and reserve liabilities must be clearly reflected and the terminology thus employed must be appropriately descriptive. The principal necessity for specialized terminology applies to operating accounts and in the forms of the operating statement.

Accounting for losses. In a true cooperative, just as there are no profits there should be no losses. It has sometimes happened, however, that due to the hazards which attend the conduct of any business enterprise, the margins which are retained to cover expenses may be insufficient, for some reason or other, to cover those expenses or to cover casual losses from other causes. The disposition of these losses sometimes presents a problem the answers to which will vary according to whether the cooperative is an exempt cooperative or one having income subject to taxation.

It rarely happens that the amount of the loss can be charged back ratably to the patrons. There have been instances where marketing cooperatives have overadvanced patrons for produce prior to sale and have been able to recover the amount of such overadvances by assessment against the respective patrons. But these instances are few and far between. Usually the handling of losses involves resort to other methods of accounting. In the instance of an exempt cooperative it is quite possible that patrons have, of record, an allocated equity in the statutory or contingent reserve and the loss can be charged against such reserve, allocated ratably in accordance with patronage to each patron. It may be that the loss exceeds the amounts in the reserve, but even under such circumstances the loss could be charged to the reserve in its entirety, allocated to patrons, and compensated in later years by additions to such reserves taken out of margins of later years. Where an exempt cooperative may not have such patrons'-equity reserve against which to charge the loss, it is the customary practice to hold the loss in a deferred account and amortize it against permitted accruals to a contingent reserve in such subsequent years. In instances where this cannot be done, and those are rare, and where the amount of the loss cannot be recovered from the patrons, then the only alternative is to recover it out of membership capital, whether that be represented by capital shares outstanding or membership fees paid in. The loss then is in the same category as a corporate deficit, which results in the impairment of the capital of the organization, and it would have to be so reflected.

In the instance of the taxable cooperative it frequently happens that the cooperative is taxable because it does business with other than members and with respect to those patrons it does not pay a patronage refund. Therefore, it pays a tax on the margins realized on the nonmember business and the remainder of such margins after paying the tax is usually available in a tax-paid or free-surplus account. Under such circumstances this provides a surplus against which such losses can properly be charged and in the instance of such tax-paying cooperatives the loss carry-back and carry-forward provision of the Revenue Act will apply. There is a moot question as to whether the entire loss can apply as a carry-back or carry-forward against taxable income of preceding or future years or whether only such portion of it as accrues with respect to nonmember business would be subject to the carry-back or carry-forward provisions. This is a question upon which the Internal Revenue Bureau has not as yet had occasion to issue a definitive ruling.

In the instance of taxable cooperatives or any cooperative where under the provisions of by-laws or operating contracts losses are chargeable back to the patrons pro-rata, of course, amounts of such losses are offset by the patronage assessments as distinguished from patronage refunds and the loss becomes compensated and solves the problem.

Taxation of cooperatives

Any discussion of this phase of the subject should be sufficiently comprehensive to cover both the rules of taxation of income, as they have been developed, and the exemption from such taxation of certain types of agricultural cooperatives which can qualify therefor. The problems involved are numerous, complex, and of sufficient importance to the practitioner handling cooperative accounts to warrant involved and special study. In the circumstances here present, limitations of time will permit only brief mention of the fundamentals involved. However, this presentation would be utterly incomplete unless this subject were covered at least in summary.

Exempt cooperatives. Section 101 (12) of the Federal Internal Revenue Code provides that certain agricultural cooperatives which meet prescribed conditions precedent, shall be exempted from filing annual income tax returns.

The conditions precedent involve requirements which may be briefly summarized as follows:

1. They must be organized as a cooperative.

2. They must market the *produce of producers*, turning back the proceeds thereof, less expenses in proportion to volume of produce marketed by each patron; or, if a purchasing cooperative, they must purchase supplies for patrons at cost—turning back to such patrons any amounts received from such patrons

in excess of cost and expenses (including in such expenses provisions for permitted reserves). An exempt marketing cooperative must do at least 50 per cent of its business with members. An exempt purchasing cooperative may do up to 50 per cent of its business with nonmembers, but may not do more than 15 per cent of its total volume with those who are *neither members nor producers.* Business done for the U. S. Government or any of its agencies may be disregarded in computing such ratios.

3. In doing business with its patrons, both members and nonmembers must be treated ratably alike.

4. Substantially all of the voting control of the association must be in the hands of members currently patronizing the association.

5. Dividends on capital shares cannot exceed 8 per cent of the value of the consideration for which the stock was issued.

6. Permanent records of patronage must be maintained with respect to business done with both members and nonmembers, as a basis for demonstrating the ratable treatment of all patrons in the distribution of patronage refunds.

7. Exemption will not be denied because the association accumulates any reserve required by law, or a reasonable reserve for any necessary business purpose. Where such reserves are accumulated the relative equity of each patron in such reserve must be subject to definite allocation, ratable to patronage.

8. Exemption is not automatic. It must be applied for, and, in each instance, the right to qualification as an exempt cooperation must be proven.

9. Exempt agricultural cooperatives must file an annual report on form 990, which is so designed to reflect data on which the Bureau of Internal Revenue can pass judgment as to continued adherence to the conditions precedent to exemption. The Commissioner has ruled, in this respect, that the timely filing of such annual report, completely filled in where pertinent, will serve as the filing of an annual return of income required by Section 275 of the Code to start the tolling of the Statute of Limitations.

The best available published summary discussion of these qualifications and conditions precedent to exemption may be found in an article written by L. K. Sunderlin, then chief of the taxpayers' ruling section in the Bureau of Internal Revenue, and published by the American Institute of Cooperation, Washington, D. C., in April, 1947, entitled "Exemption from Income Tax of Farmers' Cooperative Association."

Taxable Cooperatives. Any cooperative organization which has not qualified for exemption is taxable on its income. Through the years the Commissioner of Internal Revenue has recognized that patronage refunds paid to patrons pursuant to an obligation so to do in existence at the time of the transaction with such patrons are a proper item of exclusion from gross income in determining the taxable net income of the cooperative. The courts have repeatedly confirmed this position, by recognizing that since liability for such payments accrues by virtue of a legal obligation to refund, the margins represented by such refund payments are a liability of the association and, therefore, cannot become the income or property of the association. It should be noted that these refunds fall in the category of "exclusions" from gross income, and are not classed as items of expense properly deductible under Section 23 of the Internal Revenue Code.

The effect of this practice is to reduce the taxable income of the cooperative to amounts *available to pay dividends* on capital shares, and amounts appropriated to reserves (or surplus) other than valuation reserves. It is significant that taxable income includes amounts available to pay dividends, irrespective of whether such income was used for that purpose. (See *United Cooperatives* v. *Commissioner*, 4 TC 93.)

The Commissioner's rulings and the courts' decisions have generally held that patronage refunds paid are excludable by the cooperative whether they are distributed in cash, shares of stock, or other evidence of equity, including a letter of advice. The rulings also provide that where such distributions are made to patrons in media other than cash, they shall be taken into account by the patrons at their face value in the year of distribution, in determining the taxable income of the patron for such year. The rulings generally indicate a purpose to implement the principle that items excludable by the cooperative are taxable to the patron receiving them, the only exception being with respect to refunds pertaining to items of purchases, the cost of which did not involve a deductible expense of the patron when purchased.

The principles applying to the taxation of income of taxable cooperatives, which have been briefly summarized herein, have evolved from a long succession of rulings and court decisions. These involve many variations and diversifications applicable in the respective circumstances in each instance. A complete bibliography would be most extensive. A practical knowledge thereof may be gained by reference to the following sources of data:

Uniform Printing Co. v. *Commissioner of Internal Revenue* (Cit. 88F. 2nd 75, 109ALR 966,19 AFTR85)

United Cooperative v. *Commissioner of Internal Revenue* (US TC 4–93)

Farmers' Cooperative Company v. *Birmingham* (86F. Supp. 201)

U. S. Treasury Department, Press Release No. S-520, dated October 31, 1947. (This document embraces a most complete and revealing statement of the position and policy of the Treasury on this subject.)

Due consideration of the complexities involved, both as to the exemption and taxation of cooperative associations, serves to emphasize the responsibility of the accountant and, in his place, the auditor, to make certain that the accounting records and procedures properly meet the specialized requirements.

Hospital accounting

by C. RUFUS ROREM, PH.D., CPA

THE HOSPITAL has become as much a part of American life as a school or university. The 6,500 hospitals in the United States represent a capital investment of more than $8 billion and involve annual operating expenses of approximately $3 billion. Most of the beds are located in government institutions, but most of the patients are admitted to nongovernment hospitals for the care of acute medical and surgical conditions.

This paper will discuss certain operating problems of the nongovernment hospitals, particularly those organized as nonprofit associations conducted by churches, religious orders, and specially formed independent organizations. As a preface to the accounting problems, several characteristics of hospital income, expense, and capital will be described.

A voluntary hospital typically relies for its current income upon four major categories within the population: *the patients* who receive care and who pay in full from their private resources or through an insurance corporation, particularly a nonprofit Blue Cross Plan; *government agencies* which make block-grants or payments for specific services for the care of indigents or other individuals, such as veterans, dependents of the armed forces, etc.; *contributors*, individually or through community funds; *philanthropists* who have created endowment funds, the income of which is available for service or research. Patient income is the primary source of revenue for voluntary hospitals, but ranges widely, from less than 50 per cent in some old, well-established hospitals, particularly for the care of children, to 100 per cent for some institutions where community support has not been developed.

Hospital care involves a high proportion of salaries and wages, which represent about 60 per cent of the total expenditures. The ratio may be higher or lower, depending upon whether certain medical services are provided as part of the hospital program and whether any substantial portion of the employees' earnings are provided as perquisites (such as board and room), rather than cash salaries.

The capital investment in hospitals has been provided on a public basis. Less than 5 per cent of the total capital in American hospitals has been furnished by private investors who expect return of, or interest on, their investment. The remainder is about evenly divided between tax funds and private philanthropy, with tax funds rapidly going ahead in total amount and proportion. On the average, a hospital's annual operating costs are about one-third of the replacement value of the capital investment. Variations from this percentage frequently, but not always, indicate that the hospital management and professional staff are attempting to furnish unduly specialized and expensive services in an inadequate plant, or vice versa.

Hospital operating expenses include a high percentage of readiness-to-serve charges. Much of the current expenses for administration, plant operation, and professional services, are stand-by costs which must be incurred, regardless of the number of individuals who occupy hospital beds or receive out-patient services at the institution.

Hospital accounting has not received the attention which it deserves. It has been common for public accountants to audit the hospital's books during off-seasons on

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a cut-rate basis, either to please a client who is a member of the board of a hospital, or to find work for members of the permanent staff of the accounting firm. This policy has not always been a true economy for hospital trustees and management. There is convincing evidence that more careful attention to accounting records and reports, and the application of these data to hospital management, could achieve at least a 5 per cent increase in hospital service without additional expenditures. This would represent, for all types of hospitals combined, an annual saving to the American people of $150 million per year.

For this paper there have been selected four specific phases of hospital accounting, with the full realization that many others might equally well have been chosen for attention. They are: (1) Uniform classification; (2) Accrual basis for hospital earnings; (3) Direct-cost analysis; and (4) Depreciation as an expense.

The importance of uniform definitions and accounting classification has been recognized by hospitals for more than twenty-five years. Attention to this problem began when hospitals became more generally used by the public and there was a need for establishing charges based upon the costs of the services. Increased payments by governments and Community Chest to hospitals were also being developed and these agencies required a more formal accounting of the hospitals' activities than had been required when the institutions were conducted as private charities for the sick poor.

One of the first basic classifications of accounts was established by the Commonwealth of Pennsylvania as the basis of quarterly payments to state-aided voluntary hospitals. Later, various private fund-granting agencies, such as the United Hospital Fund, the Duke Endowment, and the Cleveland Hospital Council, established uniform charts of accounts for their member-institutions. They were similar

QUESTIONS ON HOSPITAL ACCOUNTING

Some of which are discussed in this paper

1. What is a hospital's operating deficit? The difference between patient income and operating expenses, or between *total* income and total expenses?
2. What type of accountant's certificate or opinion should be prepared when investment funds are not audited by a public accountant?
3. Have public bodies or private agencies established special rules concerning the treatment of legacies, unrestricted gifts, etc., as capital or income?
4. Are special current records necessary to sub-classify earnings in terms of type of patient, e.g.: private, semi-private, ward; *or* medical, surgical, obstetrical?
5. Do many hospitals accrue *all* earnings from patient services at the established rates (retail prices)?
6. When a hospital patient or contracting agency pays less than the established charges, are the receipts pro-rated to all services or are some given priority as to earnings?
7. Why bother to enter credits to income from services rendered to free patients?
8. What are some of the special uses of the departmental direct expense report?
9. Occasionally per-diem costs are calculated by assuming that an out-patient visit or a new-born-infant day is equal to an agreed fraction (such as one-fourth) of patient day. Is this desirable? If yes, for what purposes?
10. Why are hospital charges not more generally based upon unit costs?
11. Is the by-product theory a sound basis for estimating costs of special services, such as radiology, operating room, pathology, etc.?
12. Do any public bodies recognize depreciation as a reimbursable cost?

in most respects. In 1935, the American Hospital Association issued formal recommendations through a committee on which the writer served as chairman. A 1950 revision of the American Hospital Association's recommendations has been issued, and the exhibits accompanying this paper are based upon formal recommendations of the American Hospital Association.

A few characteristics of the American Hospital Association recommendations may be mentioned. The form of the balance sheet is significant mainly for its presentation in several portions: current (or operating) funds; investment funds; and plant funds. The assets, liabilities, and surplus of each fund are set forward in separate sections, as illustrated in Exhibit I. It should be remembered that the account titles are condensed to show the types of balance-sheet items, which would have many subdivisions in the balance sheet and ledgers of a large hospital.

The justification for the separation of balance-sheet data into "funds" is the variation in the practical administrative handling of the funds. The operation of the institution is the special responsibility of the administrator or executive director, and is frequently separated from the problems of investment of endowment funds or other income-bearing assets. The handling of investment funds for hospitals is identical with the problem facing educational institutions or other nonprofit organizations.

The plant funds include hospital buildings and permanent equipment which are usually obtained through public subscription, rather than commercial borrowing or investment. The replacement of plant and

EXHIBIT I

EREHWON GENERAL HOSPITAL

Condensed Balance Sheet

May 31, 1950

CURRENT FUND

ASSETS			LIABILITIES, PRINCIPAL AND SURPLUS		
Cash on hand and in bank		$ 98,423	Accounts payable		$ 170,000
Accounts receivable:			Accrued expenses		4,700
Patients	$ 150,124		Taxes, etc., withheld		5,418
Others	1,250		Current liabilities		180,118
	151,374				
Less: Reserve	50,000	101,374	Special purpose funds principal		8,500
Inventories		40,000	Current fund surplus:		
Prepaid accounts		5,700	Balance June 1, 1949	$54,379	
Special purpose funds—cash		8,500	Gain for year	11,000	65,379
		$ 253,997			$ 253,997

INVESTMENT FUND

Cash in bank	$ 23,481	Investment fund principal	$1,503,506
Investments	1,480,025		
	$1,503,506		$1,503,506

PLANT FUND

Land		$ 125,000	Mortgage due 10/1/57	$ 350,000
Buildings & equipment	$3,000,000		Net investment in plant	2,183,000
Less: Depreciation	592,000	2,408,000		
		$2,533,000		$2,533,000
GRAND TOTAL		$4,290,503	GRAND TOTAL	$4,290,503

EXHIBIT II

EREHWON GENERAL HOSPITAL

Condensed Statement of Income and Expense
General Fund

Year Ended May 31, 1950

Gross earnings from patient services (Schedule I)		$1,140,000
Less: Allowances:		
Contract allowances	$ 54,000	
Free service—in-patients	166,500	
Free service—out-patients	27,600	
Courtesy allowances	7,500	
Bad-debt allowances	23,000	278,600
Net earnings from patient services		$ 861,400
Other operating income		8,600
Total operating income		$ 870,000
Operating expense (Schedule II)		1,060,000
Operating gain or (loss)		($190,000)
Other income:		
Donations, contributions, etc.	$ 22,000	
Community Chest grant	20,000	
Endowment income	47,000	
City appropriation	12,000	
State appropriation	40,000	141,000
Gain or (loss) for year		($49,000)
Transfer of depreciation provision to plant fund		60,000
Gain or (loss) current fund		$ 11,000

equipment is seldom a direct administrative duty of the hospital superintendent, but rather a public responsibility to be borne by the entire board of trustees of the institution.

The income is grouped in two major categories: *earnings from services* to patients; and *other income,* such as receipts from investment earnings, voluntary contributions, taxation, nonhospital activities, etc. (These are summarized in Exhibit II.) Earnings from hospital services are classified by the various revenue-producing services, such as board and room care, operating room, delivery room, X-ray, and laboratories, as presented in Schedule I.

The expenses are also grouped in two major categories, namely: the *operating expenses;* and *other expenses,* not directly connected with hospital operation.

The operating expenses are classified by administrative functions (Schedule II) in order to give maximum opportunity for budgetary control. These functions or departments (administration, housekeeping, operation of plant, professional services, etc.) are typically not physically concentrated within the hospital, but they represent administrative responsibilites ordinarily delegated to individual department heads. Within each department, two basic object classifications are presented: *salaries and wages;* and *supplies and other expenses.*

The recommendations are minimal in their character and may be subdivided in as much detail as suits the needs of an institution. In general, the classification of accounts is adequate for an institution with 150 beds or less. Much more detail of financial accounts is required for some of the larger hospitals, particularly those which carry on special activities of education and research.

Accrual basis for hospital earnings

For many years, hospital receipts from patients were secondary to the other sources

SCHEDULE I

EREHWON GENERAL HOSPITAL

Gross Earnings from Patient Services

Year Ended May 31, 1950

ACCOUNT GROUP	TOTAL	SERVICES TO IN-PATIENTS	SERVICES TO OUT-PATIENTS
Room, board, and general care	$ 778,900	$ 778,900	...
Special services:			
Operating rooms	40,000	40,000	...
Delivery rooms	20,000	20,000	...
Anesthesiology	35,000	35,000	...
Radiology	83,000	60,000	$23,000
Laboratory	82,000	65,000	17,000
Pharmacy	58,000	52,000	6,000
Basal metabolism	4,000	3,000	1,000
Electrocardiology	4,600	3,500	1,100
Physiotherapy	10,000	7,000	3,000
Subtotal	$ 336,600	$ 285,500	$51,100
Clinic & emergency visits	24,500	...	24,500
TOTAL	$1,140,000	$1,064,400	$75,600

of revenue, namely, private philanthropy or taxation. Collections from patients were regarded more as windfalls than as rightful earnings. It was at one time very uncommon to use the accrual basis of earnings for hospital income from services to patients, inasmuch as the ultimate cash collections would have been such a small proportion of the values assigned to the services.

During the past twenty years, and upon the recommendation of the American Hospital Association, the accrual basis of earnings has become more widely accepted among hospitals. The number of paying patients has increased, as well as the percentage of hospital earnings from patients.

In a hospital, the problem of "accruing" the income is not one primarily of "timing" the entry in the accounts. It is rather a problem of determining the "prices" at which the earnings are to be recorded. Hospital services of the same character and quantity are regularly sold to the public at different prices by the same hospital. There are three basic types of prices charged for hospital services rendered to individual patients served in a hospital. They have no exact counterparts in private industry, but certain terms may be ascribed to them.

First, there are the published charges, or *retail prices*, which are made to individual patients who are expected to pay in full for the items which appear on their hospital bills. Charges for board and room services are related to the different costs or values of the accommodations occupied, such as private rooms, semiprivate rooms, or wards. The special services (radiology, pathology, etc.) are usually priced according to the public's willingness to pay the charges rather than the costs of such procedures.

The second type of price is that applied for composite services to groups of "contract patients." Special rates are offered to a contracting agency, such as a Blue Cross Plan, industrial firm, insurance company, or a local or state or national government. The rates correspond somewhat to a *wholesale price*, although there can be no bulk delivery of service. The contract rate will have its foundation in an estimate of average costs or charges per day of inclusive hospital care of the type furnished in the agreement.

The third price basis is that applied to part-pay and free patients, that is, low-

SCHEDULE II

EREHWON GENERAL HOSPITAL
Schedule of Operating Expenses
Year Ended May 31, 1950

ACCOUNT GROUP	SALARIES AND WAGES	SUPPLIES AND EXPENSES	TOTAL
Administration	$ 59,420	$ 21,380	$ 80,800
Dietary	$ 61,070	$ 25,450	$ 232,900
Raw Food		146,380	
Household:			
Housekeeping	$ 41,510	$ 17,790	$ 59,300
Laundry	20,200	10,200	30,400
Operation of plant	30,200	35,800	66,000
Repair & maintenance	12,300	15,700	28,000
Maintenance of personnel	16,050	10,650	26,700
Motor service	1,800	3,200	5,000
TOTAL	$122,060	$ 93,340	$ 215,400
Professional—General:			
Nursing (general)	$175,150	$ 10,200	$ 185,350
Nursing school	4,610	3,240	7,850
Medical & surgical service	12,600	15,100	27,700
Medical records	7,750	3,450	11,200
Social service	9,200	800	10,000
Ambulance			
TOTAL	$209,310	$ 32,790	$ 242,100
Professional—Special:			
Operating room	$ 18,400	$ 3,900	$ 22,300
Delivery room	9,700	2,200	11,900
Anesthesiology	16,200	8,200	24,400
Radiology	39,600	15,800	55,400
Laboratory	40,600	17,800	58,400
Pharmacy	6,200	27,800	34,000
Electrocardiography	1,840	160	2,000
Basal metabolism	1,800	200	2,000
Physiotherapy	4,750	650	5,400
TOTAL	$139,090	$ 76,710	$ 215,800
Out-patient department	$ 6,080	$ 6,920	$ 13,000
TOTAL OPERATING EXPENSES	$597,030	$402,970	$1,000,000
Depreciation on plant			60,000
TOTAL EXPENSES			$1,060,000

income or unemployed persons who are granted discounts as a matter of public policy. Hospital service is provided without regard to a patient's ability to purchase the care he needs at retail prices. The hospital collects as much as possible in the light of its own program of public service and the patient's ability to pay. The final collection from such a patient is something like a *"forced sale" price,* in reverse. A special type of part-pay patient is one who receives a discount regardless of his ability to pay. This class includes hospital employees, members of the medical profession, members of the clergy, and, in some governmental hospitals, members of political parties.

The American Hospital Association recommends that all earnings from services to hospital patients should be recorded at the rates established for individual full-pay patients (retail prices), regardless of the ultimate prospects of collection. This policy should apply to full-pay individual patients, contract patients, and those who may become the recipient of courtesy or charity discounts. An increasing number of hospitals are following this practice. Adjustments of the accounts receivable are recorded as various types of allowances: (a) bad debts for the individual full-pay patients; (b) contract allowances (if any); (c) free service or charity allowances; and (d) courtesy allowances.

The arguments in favor of accruing all hospital earnings at established prices, regardless of the ultimate reimbursement by the patient or his financial sponsor are the following:

(1) Better control of charges is possible when a charge is recorded for every professional service rendered to patients and posted to accounts receivable. This is specially important when charges for the special services are not included in the day rate for board and room.

(2) Every credit to a patient's account is supported by the receipt of cash or an allowance memorandum approved by some person other than the bookkeeper or cashier. This is especially important in hospitals where the bookkeeping and cashiering functions are not completely segregated. Adequate control of cash is extremely difficult under the cash basis of income accounting, because of the possibility of failure to make a record of all services rendered or to post all charges to patients' accounts.

(3) The procedure gives a rough check on the adequacy of the hospital rates. Total charges to all patients should be sufficient to cover the costs of operating the hospital.

(4) The services rendered by the income-producing departments can be compared with each other and with previous fiscal periods. The value of the service rendered is not lessened by the failure of the patient to pay all or part of his bill.

(5) The financial problems of hospitals arise chiefly from the fact that, contrary to general business procedure, a large portion of their product is given away. The knowledge of how much is given away, and to whom, is essential to good management and sound public relations.

(6) Every hospital patient can be presented with a bill showing the regular charges for the service rendered, with an appropriate subtraction for the discounts allowed. The purpose is not to embarrass the patient, but merely to let him know the value of the service given to him. Fortune may smile tomorrow on today's charity patient.

Some accountants have objected to this bookkeeping procedure on the grounds that it is burdensome to post charges and immediately charge them off as allowances. But experience in many hospitals shows that accrual records of earnings involve no more work than the cash basis, whether the hospital has a manual bookkeeping system or machine installations. The analysis of cash according to the departmental services is very difficult when partial payments are received. In some hospitals, the allocation is made on an arbitrary basis which completely obscures the relative value of the special services performed.

Cost analysis and departmental control

Cost analysis in hospitals has the same basic objectives as in private business, namely: (a) the control and appraisal of departmental activities; (b) the establishment of prices for individual or composite services. Each will be discussed briefly.

Effective control of costs requires that some individual must be held responsible for their incurrence. This fact underlies the uniform classification which groups objects of expenditure by department or function. A departmental direct expense report, shown as Exhibit III, sets forth the direct unit costs of service under the administration of various departmental heads and supervisors. Fluctuations in these unit costs are useful in appraising the effectiveness of internal management.

Most department heads willingly accept responsibility for the salaries and supplies directly under their control, but they

EXHIBIT III

EREHWON GENERAL HOSPITAL

Departmental Direct Expense Report

For the Period June 1, 1949, to May 31, 1950

		SERVICE UNITS		
DEPARTMENT	TOTAL EXPENSE	DESCRIPTION	NUMBER	UNIT COST
Administration	$ 80,800	% of Total Expense	...	8.08%
Dietary	232,900	Meals served	473,855	$ .49
Housekeeping	59,300	Square feet	95,573	.62
Laundry	30,400	Pounds	560,000	.59
Maintenance of personnel	26,700	No. residence-days	27,375	.98
Operation of plant	66,000	Square feet	134,600	.49
Repairs & maintenance	28,000	Square feet	134,600	.21
Motor service	5,000	Mileage	10,000	.50
Nursing service	185,350	Patient days	73,400	2.53
Nursing school	7,850	Student—year	69	113.77
Medical & surgical service	27,700	Patient days	73,400	.38
Medical records & library	11,200	Admissions	9,000	1.24
Social service	10,000	Cases	1,720	5.81
Operating rooms	22,300	Operations	2,400	9.29
Delivery rooms	11,900	Deliveries	1,200	9.92
Anesthesiology	24,400	Anesthesias	1,958	12.46
Radiology	55,400	Films	26,017	2.13
Laboratory	58,400	Tests	72,000	.81
Pharmacy	34,000	Patient days	73,400	.46
Basal metabolism	2,000	Tests	300	6.67
Electrocardiography	2,000	Cardiograms	400	5.00
Physical therapy	5,400	Treatments	6,000	.90
O.P.D.	13,000	Visits	24,500	.53
TOTAL	$1,000,000		...	...

rightly object to criticism for expenditures or activities which they do not supervise. A director of nursing has an opportunity to determine the expenses for nursing salaries and supplies, but she cannot influence the costs of the dietary department which may provide meals for her employees. The chief dietitian, in turn, cannot directly affect the expenditures for light and power, laundry, or the maintenance of equipment in the kitchen. The supervisor of an operating room controls the anesthetists' salaries and the use of operating room supplies, but is not responsible for the costs of feeding operating room employees or heating the operating room.

Cost units selected for departmental direct expense analyses should be agreeable to the administrative head of each department. The director of nursing service may select any of several units, such as patient day, nursing hours, or total number of patients. The chief engineer may use floor space or cubic space of the hospital plant, or even such an item as patient days. The important consideration is that each department head accept the cost unit as a proper measure for comparing trends and indicating the general efficiency of his service to the institution.

The departmental direct expense report is a type of immediate cost analysis which can be used by even the smallest hospital, and prepared directly from the expense ledger, without allocation of any overhead costs. The units of measurement for departmental direct costs are the bases which might be also used for charging institutional

EXHIBIT IV

EREHWON GENERAL HOSPITAL
Distribution of Expense
Between
In-Patient and Out-Patient Service
Year Ended May 31, 1950

ITEM	TOTAL EXPENSE	IN-PATIENT SERVICE	OUT-PATIENT SERVICE
Administration	$ 80,800	$ 76,000	$ 4,800
Dietary	232,900	227,900	5,000
Housekeeping	59,300	56,000	3,300
Laundry	30,400	28,000	2,400
Maintenance of personnel	26,700	25,500	1,200
Operation of plant	66,000	60,000	6,000
Repairs & maintenance	28,000	26,000	2,000
Motor service	5,000	4,600	400
Nursing (general)	185,350	175,000	10,350
Nursing school	7,850	7,500	350
Medical & surgical service	27,700	24,000	3,700
Medical records	11,200	8,000	3,200
Social service	10,000	5,500	4,500
Ambulance	...	...	...
Board & room	...	...	...
Operating rooms	22,300	20,000	2,300
Delivery rooms	11,900	11,900	...
Anesthesiology	24,400	24,400	...
Radiology	55,400	45,400	10,000
Laboratory	58,400	46,400	12,000
Pharmacy	34,000	25,000	9,000
Basal metabolism	2,000	1,200	800
Electrocardiography	2,000	1,300	700
Physiotherapy	5,400	3,000	2,400
Out-patient department	13,000	...	13,000
TOTAL	$1,000,000	$902,600	$97,400
Cost per patient day		$ 12.30	See Note

NOTE: There is no inclusive cost-unit for out-patient service which corresponds to the patient-day of bed care. Some out-patients come to the hospital for clinic and emergency visits to physicians; others merely appear for X-ray diagnosis, laboratory tests, physiotherapy treatments, etc. (See Exhibit III.)

services to the revenue-producing departments. We recommend this report as a valuable instrument for managerial control, as well as a possible preliminary to more comprehensive analyses of hospital costs.

Cost analysis and rate setting

Prices of specific classes of professional services (X-ray films, laboratory tests, etc.) are seldom based upon the total costs involved in their production, including allocated overhead costs of non-revenue-producing services. More important factors in rate setting are: (a) the public's attitude toward prices for certain services provided in hospitals; (b) the effect of a price change upon the utilization of the various services; (c) the total financial needs of the hospital and its revenue from other sources; (d) the differential costs involved in expanding or contracting the volume of certain professional services.

Composite costs of inclusive service are being used increasingly as the basis of reim-

EXHIBIT V

EREHWON GENERAL HOSPITAL

Comparison of Revenue-Producing Services, Net Earnings, and Costs

Year Ended May 31, 1950

REVENUE-PRODUCING SERVICES	NET EARNINGS FROM PATIENT SERVICES (1)	COST (EXCLUDING DEPRECIATION) (2)	GAIN OR (LOSS)
Room, board, and general care	$595,225	$ 701,500	$(106,275)
Special services:			
Operating rooms	30,566	30,400	166
Delivery rooms	15,284	17,100	(1,816)
Anesthesiology	26,747	31,500	(4,753)
Radiology	61,351	65,200	(3,849)
Laboratory	62,672	72,750	(10,078)
Pharmacy	42,438	42,100	338
Basal metabolism	3,243	2,400	843
Electrocardiology	3,725	2,550	1,175
Physiotherapy	8,149	6,500	1,649
Subtotal	$254,175	$ 270,500	$ (16,325)
Clinic and emergency visits	12,000	28,000	(16,000)
TOTAL	$861,400	$1,000,000	$(138,600)

(1) Gross earnings from Patient Services (Schedule I) less Allowances shown on Exhibit I, allocated to each of the Revenue-Producing Services. Allowances for "special services" (Radiology, Laboratory, etc.) granted to Out-Patients are credited to these services and not to earnings from Clinic and Emergency Visits.

(2) These figures include both the "direct" expenses shown in Schedule II for the Revenue-Producing Services, plus an allocation of all other "overhead" expenses (administration, dietary, household, nursing, etc.). The basis of allocation would normally be the service-units shown in Departmental Direct Expense Report (Exhibit III).

bursement by contracting agencies such as Blue Cross Plans, industrial firms, and government units. "Cost per in-patient day" is regaining stature as a measure of value and efficiency in hospitals (Exhibit IV). But care should be taken to include only the costs which are reimbursable in the contract.

There are many factors which affect the cost per patient day incurred by a hospital during a period of time. Some of them are: wage and price levels; amount and complexity of professional services; locality and design of the hospital plant; percentage of bed occupancy; degree of utilization of special facilities; definitions used for costs, for patients, and for days. All of these factors must be considered when comparing the per-diem costs of institutions.

In the calculation of cost per patient day the American Hospital Association recommends the following practices to insure uniformity. (1) Include only costs of services rendered to patients occupying bed facilities, excluding all costs of special services to ambulatory (out) patients. (2) Include as patient days only stays of adults and sick children, excluding days applicable to well new-born infants. (3) Include only expenses applicable to patients' services, excluding costs of related activities, such as gift shops, management of investment funds, etc. (4) If depreciation is included as an expense, it should be indicated separately from other operating costs.

Is it useful for hospitals to allocate their total costs in terms of the revenue-producing services, such as board and room, operating rooms, laboratory, etc.? (Exhibit V.) Yes, under some circumstances, but several facts should be recognized clearly when this is done. The various revenue-producing services are dependent upon institutional and general activities (housekeeping, dietary, nursing, etc.) which represent more than twice the amount of expenses which are charged directly to the professional service departments appearing in the chart of accounts.

The total cost of a revenue-producing department, including allocated expenses, may become an important consideration in the drawing of a contract with a radiologist or pathologist who is to receive a percentage of the net earnings for such professional services in the hospital. Likewise, there may be instances where a contracting agency will agree to pay for certain services (X-ray films, laboratory tests, or health examinations) at calculated unit costs, including allocated indirect expenses. Failure of a professional service to yield a net profit would seldom lead to discontinuance of such a department.

A glance at the chart of expense accounts (Schedule II) will show that the total costs of board and room service (the largest source of earnings from service to patients) would have to be determined entirely by allocation of administration, dietary, household, and general professional expenses. Such distribution is not difficult from the mathematical viewpoint, but administrative judgment will differ as to the ratio of overhead to be absorbed by the various departments. Likewise, there will be much discussion as to whether the interrelations of dietary, housekeeping, laundry, and other expenses should be computed before their ultimate apportionment to the revenue-producing services. The degree of accuracy required in such detailed cost analyses will be affected by the uses to which the results are to be placed, and the acceptability of the calculations to the agencies or groups which are to pay the costs on a contract or retail-price basis.

Depreciation of plant and equipment

Depreciation of hospital plant and equipment is part of the total expense of hospital service. But records of depreciation seldom are found in hospitals. Very few maintain plant ledgers of buildings and equipment, and some even fail to carry accounting records of the original cost.

The explanation of this practice is to be found in the traditional attitude of hospital trustees and administrators toward hospital capital. Many business enterprises failed to record depreciation as an expense of doing business until taxation of business income made such an inclusion profitable to the enterprise. Depreciation on permanent plant and equipment has been excluded from hospital records and reports on the general theory that the buildings were provided by contributions and, therefore, did not represent an actual expense of the period during which the plant and equipment were utilized.

The lack of depreciation records for short-term equipment has a different origin. The replacement of furniture and scientific equipment has been handled as an item of expense and charged directly against operating income, regardless of the intermittent character of these disbursements. The result has been, of course, the showing of variations in departmental expenses, whenever a group of hospital beds were purchased, an operating room table was replaced, or a modern fluoroscope substituted for one which had become obsolete.

The American Hospital Association recommends a complete accounting for plant and equipment, with depreciation charges on a time or service basis, rather than charges to expense at time of replacement. Such a policy implies a reasonably complete plant ledger with a record of the items to which the allowances for depreciation apply. Differences between the book value and disposal price of replaced equipment would be charged or credited to the plant account, as the case may be.

Some hospitals already include a depreciation allowance on permanent plant as an item of "operating expense." Some of them include such an allowance as "other expense" in determining the total hospital experience. Other hospitals make no record at all. The recording and reporting of depreciation on plant and equipment, with this amount appearing as a separate item in the operating statement, permits trustees and public representatives to know immediately whether depreciation on plant and equipment has been included in the calculations. Unless an estimate of the amount of depreciation appears explicitly somewhere in the operating statement, it is impossible to know whether it is hidden within general classifications of operating expense.

Depreciation is properly included in the costs used for contracts with outside agencies who purchase care on behalf of full-pay patients. It is generally assumed that philanthropic contributions for hospital plant and equipment are made for the benefit of people unable to carry the full share of the costs of the services which they require. The contracting agencies frequently assert that they wish to pay the full costs of service, calculated on a business basis, including allowances for depreciation of plant and equipment. Unless record of such depreciation is currently maintained in the double-entry accounts, such contracting agencies may rightly object to their being included among the reimbursable costs.

Plant-depreciation accounting is an important device to remind the community of the total costs of its hospital care. The service of plant and equipment is no less valuable because it has been paid in advance by philanthropic contributors or by the general public. Ultimately, hospital replacement will be financed to a greater degree from current payments than from irregular campaigns. But we believe that depreciation records are desirable regardless of whether a sinking fund is established for plant construction.

Summary

Hospitalization costs the American people in excess of $3 billion annually. It is essentially a public service with more than 95 per cent of the investment having been provided from philanthropy and governmental taxation.

Hospital accounting has improved with the need to provide information for private patients and contracting agencies. Adequate accounting data contain the information which are necessary to improve quality of service in hospitals, to stabilize their income, and to control their costs. Experience indicates that decisions arising from complete accounting records and reports may influence the total expenses of a hospital by as much as 5 per cent, or $150 million annually, for governmental and non-government institutions combined.

Uniform definitions of hospital service and accounting classification are developing rapidly through leadership of hospital representatives and the cooperation of the accounting profession. The recommendations are in accord with sound accounting principles and the special needs of nonprofit hospitals to justify public support.

Hospital earnings should be recorded at uniform prices, even though allowances are later granted to contracting agencies, to free and part-pay patients, or as courtesies to special groups in the population. Hospital care is furnished on a personal, individual basis, but payments are increasingly made through contractual arrangements with third parties.

Unit costs of professional services are seldom the basis for charges to hospital patients. Unit costs for composite services are, however, frequently used in effecting contractual arrangements with third parties on behalf of a group of patients.

The total costs of a professional department, including allocated overhead, may be important in determining a contract with a professional employee. Interdepartmental expense allocation may be important in deciding whether to originate or discontinue one of the services within a hospital.

Departmental direct unit costs, based upon factors acceptable to the various department heads, are an effective device for comparing the efficiency of departments or processes and for rewarding good administration. They also provide the basis for a program of budgetary control for the institution, and its various departments.

Depreciation on hospital plant and equipment should be recorded as an item of hospital cost and reported in current statements of income and expense. Such accounting would emphasize the public character of hospital service and lead to more systematic planning for hospital replacement and expansion.

The American Institute of Accountants and its membership have an opportunity to render service of great value to the American people by encouraging their hospital clients to adopt and utilize complete and uniform records and reports in hospital administration.

Some observations on accounting for college and university endowment funds

by RALPH S. JOHNS, CPA

FOR ACCOUNTING PURPOSES college and university endowment funds may be regarded as in the nature of trust funds in that the income only is available for expenditure, the principal to be kept intact indefinitely. The income received from the investment of endowment funds may be unrestricted, that is, available for expenditure at the discretion of the trustees, or restricted, being expendable only for specific purposes; nevertheless, in all instances the principal of endowment funds is restricted, that is, nonexpendable. Being held in a capacity different from funds which are expendable, such as current funds or plant funds, they are usually presented in a separate balanced section of college and university balance sheets.

Endowment funds should be invested in a manner to produce a reasonable return of income without undue risk of loss in principal. They may be invested separately or may be merged for investment purposes in a common investment pool. Whether invested separately or not, the investment of endowment funds presents interesting accounting problems from time to time, particularly in an effort to maintain an equitable position between principal and income. Some of these problems are encountered in accounting for the following types of transactions: profits and losses on sales of securities, provision for depreciation of depreciable assets held as investments of endowment funds, amortization of premiums and accumulation of discounts, stock dividends, and stock rights. These and other problems relating to the accounting for college and university endowment funds will be discussed briefly hereinafter.

When an industrial corporation temporarily invests excess funds in marketable securities, any profits resulting from the sale of such securities are equally expendable for general corporate purposes along with the income received from such securities. This is not the case with respect to securities held as investments of endowment funds. Profits realized from the sale of endowment-fund investments are a proper addition to principal and losses sustained are chargeable against the principal of the fund holding the investment. In the event a common investment pool has been established for the investment of endowment funds, it is generally the practice to record profits and losses resulting from the sale of such investments in a separate principal account, a credit balance in the account representing, on a cumulative basis, the excess of profits realized over losses sustained.[1] The writer knows of but two major educational institutions which prorate profits and losses on sales of securities of an investment pool among the participating funds; in one instance it is practically incumbent upon the institution to do so for the reason that it commingles in its investment pool expendable and nonexpendable funds.

Profits and losses resulting from sales of securities held by an industrial corporation, of the character referred to above, ordinarily would be included in the cor-

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[1] For a discussion of the accounting problems relating to the inauguration of an investment pool for endowment funds, see the writer's article entitled "A Plan for Pooling the Investments of Endowment Funds," which appeared in the January, 1939, issue of *The Journal of Accountancy.*

poration's statement of income for the year in which the transactions occurred. In the case of profits and losses resulting from the sale of securities held as investments of endowment funds, being principal transactions, such profits and losses would be reported in a statement of changes in endowment funds principal and would not be included in the institution's annual statement of income. This being the proper method of accounting for such profits and losses, it follows, therefore, that a qualification in the certificate of the independent public accountant under such circumstances such as the writer has observed upon occasion, is not in order.

Profits and losses resulting from sales of securities held as investments of funds other than endowment funds, such as restricted current funds or plant funds, would of course result in increases or decreases, as the case may be, of the funds holding the investments. In the case of securities held as investments of unrestricted current funds, profits and losses resulting from sales, being themselves unrestricted, would be included in the annual statement of income.

Sales of securities from one endowment fund to another, or from an endowment fund separately invested to an investment pool, generally should be recorded at current market values; thus, any profits or losses resulting from such sales would be recorded as transactions relating to the principal of the funds selling the securities. Profits or losses resulting from the sales of partial lots of securities should be computed on the basis of the average cost of the entire lot of each security so sold as this procedure produces a more equable result than the use of either the first-in, first-out basis or the identified-certificate basis (as such transactions of educational institutions are not subject to federal income taxes, the related federal income-tax regulations on this subject are not pertinent).

Income from investments

Each endowment fund should have a separate income account whether or not the endowment fund is separately invested and irrespective of the existence or absence of restrictions relating to the expenditure of the income. If the principal of the endowment fund is separately invested, the income will usually consist of the actual cash received by way of interest, dividends, net rentals, etc., less any items properly chargeable thereagainst, such as premium amortization or accrued interest purchased. In the case of an investment pool, it is customary to credit income in the first instance to a pool income account, distributions therefrom being shared pro rata by the participating funds; such distributions are usually determined in advance for the ensuing fiscal year and are usually done on a basis which leaves an undistributed balance to be carried forward in the pool income account. The principal account representing the accumulated profits and losses on sales of securities, referred to hereinbefore, should not share in the distribution of income.

The establishment of an income distribution rate in advance facilitates the administration of the expenditures therefrom by means of budgetary procedures inasmuch as (except for additions to principal received during the year) the amounts available for expenditure are known at the inception of the fiscal year. Any differences between estimated income and income actually realized are absorbed by the undistributed income from pooled investments account. This procedure makes possible reasonable stabilization of income and avoids numerous small adjustments throughout the endowment fund income accounts at the close of the fiscal year for differences between estimated and actual income.

Income on investments of nonprofit institutions generally is not accrued as is customarily done with corporations organized for profit. In the opinion of the writer such income of nonprofit organizations need not be accrued for the reason that accrued income on investments is not a resource available for the payment of obligations (the writer knows of only one major educational institution which accrues income on endowment fund investments).

Provision for depreciation

With respect to certain phases of the broad problem of providing for depreciation in educational institutions,[2] there exists a considerable difference between the generally accepted practice of educational institutions and the generally accepted practice of corporations organized for profit, a situation which at times tends to confuse the thinking of some independent public accountants and others on the subject. However, whatever real differences of opinion may exist, they are for the most part outside the area of endowment funds.

It is generally agreed that provision for depreciation should be made with respect to depreciable assets held as investments of endowment funds. This is particularly true as to depreciable assets purchased (including dormitories, if any) with endowment funds. An exception might be claimed as to gifts of real property, the income of which is restricted on the theory that gifts "in kind" do not require that such provision be made; however, it is believed that from an accounting point of view no exception should be made even for a transaction of this nature for the reason that provision for depreciation is essential to the maintenance of the principal of the fund and therefore likewise is essential to the continuance of income being available for the purposes specified.

Obviously the practice indulged in by some educational institutions of providing for depreciation only in the event the net income exclusive of depreciation exceeds a specified return on the original investment, should be avoided.

Amortization of premiums and accumulation of discounts

Premiums on bonds purchased with endowment funds should be amortized in order that endowment principal may be kept intact. The usual practice is to amortize such premiums on the "straight-line" basis. It is also advisable to give consideration to call dates, if any, in determining the amount of amortization required.

It does not necessarily follow that discounts should be accumulated when bonds are purchased below par. The purpose of amortizing premiums is to protect the principal of the funds. To accumulate discounts may defeat this purpose. While, as between income and principal, the rights of income should be recognized along with the rights of principal, it is doubtful whether income should be enhanced currently by the process of accumulating discounts (transferring principal cash to income cash). Inasmuch as the very fact that the bond may be purchased at a discount may be an indication that it may not be paid in full at maturity, if any recognition of the principle of accumulating discounts is to be made, it should be deferred until the collection in cash of the face amount of the bond has been effected, presumably at maturity. To do otherwise might result in an unwarranted enhancement of income at the expense of principal.

Stock dividends

Accounting Research Bulletin No. 11 sets forth the recommended accounting treatment for stock dividends in relation to corporate accounts. In general it is in agreement with the statement on stock dividends issued by the New York Stock Exchange in October, 1943. The Bulletin discusses in part I the proper accounting treatment to be accorded stock dividends on the books of the issuing corporation, with which we are not here concerned. In part II of the Bulletin it is stated, in effect,

[2] For an excellent discussion of depreciation as it relates to colleges and universities see "Depreciation of Real Property in Educational Institutions," by George E. Van Dyke reprinted as *Financial Advisory Bulletin 2* of the Financial Advisory Service of the American Council on Education. The following conclusion is quoted therefrom:

"The following principles applicable to educational institutions may be drawn from this discussion of depreciation:

"1. Educational institutions will find little or no benefit from the annual computation of, and accounting for, depreciation on their educational property.

"2. Depreciation should be accounted for on property used by the auxiliary enterprises and activities in order that the total cost of operating these activities may be known, and as an aid in determining rates of fees and other charges. If it is expected that this property will be replaced out of the income of the activities, it is essential that depreciation be accounted for.

"3. Institutions should account for depreciation on property held as the assets of endowment funds in order to maintain the principal of the funds.

"4. If depreciation is taken, it should be funded; i.e., cash should be set aside in replacement, or depreciation funds.

"5. Three purposes may be served by the calculation of depreciation on educational plant, namely, determination of insurance values of property and equipment, determination of the true costs of instruction, and determination of the minimum amount that should be appropriated each year for replacement.

"6. Information on depreciation necessary for these three purposes should be recorded in subsidiary or supplementary records, and not as a part of the regular accounting procedure."

that the corporation receiving an ordinary stock dividend should not record it as income in any amount. With respect to the corporation receiving the stock dividend, a major question usually is the proper treatment of the transaction for income-tax purposes, the general rule being that like on like (for example, common stock on common stock of the same corporation) is not taxable, while stock received in unlike shares (for example, preferred stock of an issue already outstanding on common stock of the same corporation) constitutes a taxable dividend. Educational institutions are not concerned with this feature of the problem either.

The question of stock dividends as it relates to the endowment funds of educational institutions is a matter of principal versus income. In many instances the pronouncements of the committee on accounting procedure of the American Institute of Accountants and the New York Stock Exchange and the proper treatment to be accorded the transaction for federal income-tax purposes are helpful in arriving at a satisfactory conclusion for accounting for endowment funds of educational institutions. However, this is not always the case. Nor are the various state laws always clear as to the proper accounting treatment of stock dividends as between principal and income of estates and other trusts, thus diminishing their usefulness as a guide for educational institutions.

In any future examination of the subject of stock dividends it is hoped that all phases of the subject will be explored, including the matter of principal versus income as it affects the endowment funds of educational institutions. For example, assume the following facts: The XYZ University is the holder of 10,000 shares of stock of the ABC Corporation as an investment of its endowment funds. The ABC Corporation has been earning in excess of \$10 a year and paying cash dividends of \$8 a year. In 1949 the ABC Corporation earned \$10.56 a share, paid cash dividends aggregating \$2.50 a share, and a stock dividend of one share of its own common stock having a market value of \$110 a share for each twenty shares of stock held. A transaction such as the foregoing parallels very closely a dividend payable in either cash or stock. Would good accounting permit the XYZ University, under the circumstances described above, to take into income in 1949 the same amount as in previous years, namely, \$80,000, instead of limiting itself to the amount of the cash dividends received, \$25,000? While it is not proposed by any means that all stock dividends constitute income, it is felt in certain quarters that the present recommended procedure is at times unduly restrictive, particularly where current operations, as is frequently the case with educational institutions, are dependent upon the income received from investments. The writer believes that the subject warrants further exploration.

Stock rights

In the case of the exercise of stock rights received, no monetary entry need be made except to increase the carrying value of the investments in the amount of the cash outlay made upon exercising the rights. However, the exercise by one fund of the rights received on securities held by another fund (for example, because the latter fund did not have principal cash available for investment) should be treated as a sale and purchase of the rights at current market values. In the case of the sale of stock rights received, the profit should be computed in accordance with recognized procedure (published services are available to assist in making this computation), unless the amount involved is inconsequential, in which case the entire proceeds of the sale may be applied to the reduction of the carrying value of the investment.

Funds temporarily functioning as endowment

It is a fairly common practice to include with endowment funds other funds which technically are not endowment funds or at least were not endowment funds at the time of their receipt; for example, unrestricted gifts and legacies of substantial amounts are frequently placed with endowment funds. Such inclusion does not necessarily mean that the funds have been merged with endowment funds for investment purposes, although this, too, is done in instances. It usually means that the funds are temporarily at least regarded as nonexpendable and therefore are classified with endowment funds for balance-sheet purposes.

There are differences of opinion as to the status of such funds. Some authorities are of the opinion that "once endowment, always endowment" (an action that cannot be reversed somewhat like the capitalization of earned surplus); others regard funds voluntarily added to endowment by action of the governing board as reversible and therefore available for other purposes by subsequent similar appropriate action of the governing board. Funds temporarily functioning as endowment have upon occasion been used to cover operating deficits, expand plant facilities, and for other purposes.

In order to remove any doubt as to the status of funds temporarily functioning as endowment, the writer suggests that consideration be given to the following steps:

1. Each fund so added voluntarily be done so by action appropriately worded so as to leave no doubt that the fund is being only temporarily classified as endowment and indicating that further action may be taken at a later date as to its ultimate disposition;
2. Financial statements and supporting schedules be so identified so as to avoid misleading inferences; for example, the asset side of the endowment-fund section of the balance sheet may be captioned somewhat as follows: "Endowment and other invested funds"; and the liability side may be captioned: "Endowment and other nonexpendable funds." The supporting schedule of the principal of the funds may be classified, or the individual funds identified, to indicate the status of each fund;
3. The use of any fund temporarily functioning as endowment for operating or other purposes to be done only by appropriate action of the governing board and with the approval of legal counsel.

There can be no question, in the opinion of this writer, that funds voluntarily added to endowment to "match" other gifts or grants for endowment are irrevocably endowment to the same extent that the other gifts or grants so matched are endowment.

Commingling of nonendowment with endowment fund investment

Occasionally current funds or plant funds are merged with endowment funds for investment purposes. Sometimes this practice is indulged in as a course of least resistance in order that those responsible for investments may review one list of investments instead of several; sometimes the reason given is enhancement of the rate of income received on investments. The practice tends to obscure the line of demarcation as between the equities of the various types of funds in the income received and the profits realized and losses sustained on sales of securities. While the writer is not qualified to comment upon the legality of this practice, from an accounting point of view it does not appear to be the best practice to merge the investments of funds held for such varying purposes and in such different capacities as current funds, plant funds, and endowment funds. It would appear to be better practice to establish separate investment pools in order that the assets supporting each class of funds may be clearly identifiable. An individual would not be regarded as prudent if he merged assets held in a fiduciary capacity with his personal assets. Likewise, corporate fiduciaries do not merge securities held in trust with securities held outright for investment purposes. The foregoing comments should not be interpreted to be critical of the practice of merging endowment cash with other cash, providing, as is done in the case of corporate fiduciaries, the accounting records clearly disclose the equities of each.

Investment of endowment funds in educational plant

The propriety (or impropriety) of investing endowment funds in the educational plant is not one as to which a categorical answer can be given. The question may first be divided into two parts: (1) the investment in nonincome-producing educational plant property, such as academic buildings, and (2) the investment in income-producing educational plant property such as dormitories.

It is generally regarded that endowment funds should be invested in income-producing assets only. The practice of investing endowment funds in nonincome-producing educational plant should be frowned upon, whether or not entries are made purporting to pay interest either from current funds or plant funds to endowment funds for amounts so invested. The preferable balance-sheet treatment for investments of this character is to show the transaction in its true light, namely, a "due-from-plant funds" as an asset in the endowment-funds section and a "due to endowment funds" as a liability in the plant-funds section for the amount involved.

The situation is not so clear with respect to investments of the second class, namely, income-producing plant property. Among the reasons which may be advanced for not approving such investments are the following:

1. Trustees should not act in a dual capacity, that is, they should not invest in enterprises in which they, collectively or individually, are actively managing (in the case of dormitories a decrease in rental income may coincide with a drop in tuition revenue);
2. Endowment funds invested in educational plant property may lose its protective status as to possible attachment by creditors;[3]
3. Such investments are in a sense "frozen assets" (opponents point that insurance companies would be willing to take over the financing, thus "unfreezing" the investment).

In this connection it is of interest to note that the annual report of the General Education Board for the fiscal year 1931–1932 discloses that a committee appointed by the Board gave special consideration to the question of whether investment of endowment funds in dormitories is justified when such dormitories are conducted on an income-producing basis. After considering very carefully both the legal and practical aspects of the question, the committee rendered an opinion on which the following Board minute was based:

[3] See *Hobbs* v. *Board of Education*, 126 Neb. 416, 253 N. W. 627 (1934).

It is the judgment of the General Education Board that funds received by a college earmarked "for endowment" (or by other equivalent phrase) cannot be properly invested in plant or buildings of the college used for any of its general or charter purposes, whether such plant or buildings be income-producing (e. g., dormitories, or laboratories for whose use fees are charged) or not.

A donor who has earmarked his gift "for endowment" is thinking of safety of principal and certainty and adequacy of income, to the end that the income may always be available to serve the general purposes of the college. He does not wish the principal of his gift to be so used; he wishes that set aside, "invested"; he sharply distinguishes between the *use* of his principal and its *investment.* Expenditure on a dormitory is not the sort of investment he has in mind, because although it may happen to be an income-producing expenditure, the production of income return is not the sole purpose of the expenditure. The choice of this expenditure is not solely determined by safety of principal and certainty and adequacy of income; it is determined largely by the importance of housing students, a social function. If such an investment be allowed, the trustees have that duality of interest or motive which is the bane of all good trusteeship, and the temptation is offered to them to disregard or override the considerations which solely were present in the mind of the donor.

A dormitory, if an investment at all, is a "frozen" one; it would presumably sell to a market buyer at far below its cost to the college; the investment could not be changed into another form without serious loss of principal if the college should wish to move to another site, or the number of students should be cut down, or other housing become available. The income return is not determined by investment conditions, but by the arbitrary decision of the college authorities to charge so much rent to the students over whom they have control. The simple and natural understanding of the words "for endowment" seems to preclude their application to uses which form part of a college's general purposes.

The writer received a letter as of a recent date from the Secretary of the General Education Board stating that the resolution quoted above has not been amended and therefore represents the Board's present policy.

Despite the arguments advanced above, the investment of endowment funds in income-producing dormitories is not uncommon. The writer knows of two instances since 1932 involving two different states where legal counsel have expressed opinions that the investment of a reasonable proportion of the total endowment in income-producing dormitories is entirely within the rights of the trustees under the prudent-investment theory. Nevertheless, it appears that the observation made by the General Education Board is a pertinent one with reference to such investments being viewed more from the point of view of the necessity of constructing dormitories than from the point of view of the investment of endowment funds, for there appears to be no instance of a college or university investing its endowment funds in the dormitories of another educational institution.

It is suggested that endowment funds be invested in dormitories only after a legal opinion has been obtained in writing approving the specific transaction. In addition to being income-producing dormitories' provision should be made, as commented upon hereinbefore, for the protection of principal by suitable provision for depreciation out of current rental income.

The bibliography accompanying this paper is not represented as being a complete bibliography nor is it represented that each item appearing thereon is applicable to the specific subject matter of this paper. It is intended more as a general bibliography on the broad subject of accounting for educational institutions to assist those who may not know of the existence of such literature when encountering accounting problems in this field. It is unfortunate that a number of the publications listed are out of print, including the bulletins issued by the Financial Advisory Service of the American Council on Education and the book entitled *Financial Reports for Colleges and Universities*, prepared by the National Committee on Standard Reports for Institutions of Higher Education.

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Deficiencies in the filing of Form X-17A-5, uniform questionnaire for broker-dealers

by MICHAEL J. LA PADULA, CPA

RULE X-17A-5 requiring reports to be made by certain exchange members and brokers and dealers, together with Form X-17A-5 was adopted by the Securities and Exchange Commission on January 1, 1943. The Rule and the Form were devised after conferences with members of stockbrokerage firms, members of the accounting profession, experts in stockbrokerage accounting, accounting officials of the various national securities exchanges, officials of the National Association of Securities Commissioners, representatives of the American Institute of Accountants, and of the New York State Society of Certified Public Accountants. The completed Form and the Rule represented the best views of experts in the field of stockbrokerage accounting.

Although the Form has been in effect for approximately seven years, the Commission is still conducting an educational program with respect to the proper submission of information required by the Form. *The Journal of Accountancy* in the June, 1946, issue editorially set forth "a warning to auditors" in an effort to bring to the attention of public accountants the requirements governing the various types of audits which they undertook, particularly the examination of stockbrokerage accounts. This educational process is made necessary because often accountants with little or no special experience in the audit of financial statements for stockbrokerage firms make such audits and certify the financial statements based on such audits on the basis of what is generally designated as "commercial accounting practices." The submission of such statements to the Commission may result in the citation of deficiencies. The practitioner who attempts the audit of a stockbrokerage firm without previous experience and without advice or consultation with persons expert in the field of stockbrokerage accounting soon discovers that, like many other fields, stockbrokerage auditing is a specialty, and a certain amount of preparation and an understanding of the problems presented by the books of a stockbrokerage firm is essential in the preparation of Form X-17A-5.

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I wish to cite a few examples of deficiencies which the Securities and Exchange Commission has noted since the adoption of Form X-17A-5.

The deficiencies which have been most frequently cited in the filing of Form X-17A-5 appear to be the result of a lack of knowledge of stockbrokerage techniques with respect to the maintenance of securities accounts. At times deficiencies appear to arise from the failure of accountants to read Rule X-17A-5 and Form X-17A-5 carefully.

It is manifest from a reading of Form X-17A-5 that the answers to the various questions should not be made on the Form itself but should be stated in a separate report as answers to the various questions contained in the Form. In many instances brokers have submitted copies of the printed Form with money balances opposite the question number without furnishing totals.

Paragraph (b)(2)(A) of the Rule requires that there shall be attached to the report an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (a) the financial statement and supporting schedules are true and correct, and (b) neither the member, broker, or dealer, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified solely as that of a customer. However, statements often fail to include either the oath or the proprietary statement as part of the report. In the case of the oath or affirmation, it is a definite requirement of the Rule that all statements should be accompanied by a notarized affirmation. The statement with respect to proprietary interest in any account classified solely as that of a customer may be omitted from the affirmation only in those cases where the financial statements do not reflect any customers' accounts under Questions 6 and 7 of Form X-17A-5.

Instruction C appearing on page 1 of Form X-17A-5 states that the information furnished in response to questions contained in the Form should result in a statement of financial condition. It states further that a separate column should be used for ledger debit balances, ledger credit balances, long security valuations, short security valuations, gains in commodities futures and losses in commodities futures. All columns are required to be totaled; the totals of debits should equal the totals of credits; and the total valuations of long securities should equal the total valuations of short securities. Furthermore, Form X-17A-5 contains fourteen separate questions with various subdivisions thereof, the answers to which should provide information which will enable the Commission to determine compliance with the Commission's rules, particularly the rules with respect to net capital and aggregate indebtedness as contained in Rule X-15C3-1. This rule defines aggregate indebtedness and net capital and prohibits a broker-dealer from incurring indebtedness in excess of 2,000 per cent of his net capital as computed by the rule. Form X-17A-5 was so designed to furnish information necessary for the computation of net capital and aggregate indebtedness.

Deficiencies under instruction "C" sometimes result from the failure to include where required the market value of long and short securities; to balance the total security values and to balance the debits and credits.

A common error is the submission of the response to Form X-17A-5 in the standard form of a "commercial balance sheet" showing the assets on the left and the liabilities on the right with market values of long and short securities either not totaled or not shown against the appropriate debit or credit balance. Also, where this type of balance sheet is submitted, it is frequently found that net balances of long and short securities are furnished, whereas the market value of long securities and the market value of short securities should be stated separately against their respective debit and credit balances. In other cases, we find debit and credit balances are netted against each other; thus, eliminating certain essential figures necessary for the computation of aggregate indebtedness and net capital.

Question 2 of Form X-17A-5—*Money Borrowed, and Accounts Carried for Respondent by other Banking or Brokerage Houses, Secured by or Containing Customers' Collateral*—bears a specific footnote that money borrowings and accounts collateralized entirely by securities exempted from registration under the Securities Exchange Act of 1934 be stated separately. Where the report of financial condition fails to state separately those accounts which are collateralized by exempted securities, the accurate computation of aggregate indebtedness under Rule X-15C3-1 becomes impossible since that Rule excludes from the computation of aggregate indebtedness monies borrowed and collateralized by exempted securities. Failure to separate these borrowings properly results in a high computation of aggregate indebtedness; and where such computation indicates a violation of the net capital rule, inquiry must be made of the registrant or his accountant for an accurate separation of the amount of exempted securities and nonexempted securities hypothecated for the loan, in order that a proper computation of aggregate indebtedness may be made.

Question 9 of Form X-17A-5 is separated into (a) accounts of general partners who have signed agreements that cash, securities and equities recorded in these accounts are to be included as partnership property, and (b) all other individual accounts of general partners which are not subject to signed agreements. In many instances, the subdivision required by Question 9 is omitted and all general partners' individual accounts are included in one sum total. The result of such filing is that in the computation of net capital such securities and equities are not considered part of the firm capital, and, where an apparent deficiency in net capital occurs from such computation, it becomes necessary for the Commission to determine by supplemental inquiry whether there should have been a subdivision between part A and part B of Question 9.

Question 10—*Trading and Investment Accounts of Respondent*—requires under Part II—Supplementary Information of Form X-17A-5—that a separate schedule be submitted by the broker giving full description including quantity, price, and valuation of each security and commodity position supporting each total valuation reported in answer to Question 9. The deficiencies noted in response to this question are generally in the failure to furnish the schedule and the failure to state the market values of the securities. Where book values are used, rather than market values, the accountant should explain in detail the basis of the valuation. Part II of Form X-17A-5, calling for Supplementary Information, is often not read carefully with the result that schedules required by Part II of the Form are omitted in submitting the statement of financial condition.

The Commission has had many inquiries about the necessity for certifying the reports of financial condition required by Rule X-17A-5. Not all reports are required to be certified by a certified public accountant or a public accountant. Paragraph (b) of Rule X-17A-5 requires that a broker must file a certified financial statement (a) if he is required to file a certified statement with an agency of any state in which he does business as a condition of doing business in securities in that state, or (b) if he is required to file a certified financial statement with any national securities exchange of which he is a member. Also, the Rule requires that the statement be certified if, during the year preceding the date as of which its financial condition is reported, the broker has made a practice of extending credit in any form to customers such as carrying margin accounts or selling securities on a partial payment or installment basis, or if he has made a practice of holding securities owned by customers or of carrying credit balances of customers except where either of these is done as an incident to transactions with or for customers which are promptly consummated by payment. The question whether certification is necessary depends largely upon existing circumstances, and in cases of doubt the practitioner may find it wise to submit the existing circumstances to the Commission for an opinion as to whether certification is necessary.

Paragraph (b)(1) of the Rule states that where certification is required the statement should be certified by a certified public accountant or a public accountant who is in fact *independent*. In view of the fact that some accountants maintain accounts with stockbrokers, the question has arisen in the past as to the independence of an accountant who maintains an open account represented by cash or securities or both with a client—a stockbroker. In view of *Accounting Series Release No. 47*, dated January 25, 1944, it seems clear that such a relationship is of a kind which casts doubt on the accountant's independence. If the amounts involved are material in comparison with the registrant's assets or the accountant's resources, it is felt that the relationship as long as it exists precludes the recognition of the accountant as independent for the purpose of certifying statements of the client required to be filed with the Commission pursuant to Rule X-17A-5.

Paragraphs (g), (h), and (i) of Rule X-17A-5 contain the requirements for the accountant's certificate and it is in regard to the certificate that the majority of deficiencies seems to have arisen. The requirements of these paragraphs of the Rule are also contained elsewhere in Commission rules and have general acceptance. Certificates accompanying X-17A-5 reports generally contain the required statement as to auditing standards and generally accepted accounting principles, though there have been instances when these have been omitted. However, it has been found that in a great many instances the accountant fails to comply with paragraph (g)(2)(A) which requires the certifying accountant to state that he has reviewed the procedures followed for safeguarding the securities of customers. The particular paragraph of the rule reads as follows:

Representations as to Audit:
(g)(2) . . . The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to certain items in the report covered by the certificate, any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (C) shall state whether the audit made omitted any procedures deemed necessary by the accountant under the circumstances of the particular case.

The statement regarding customers' securities is unique in so far as accountants' certificates are concerned. It is found only in Rule X-17A-5 where it is particularly applicable, but it is frequently omitted by accountants. It is apparent that the purpose of this requirement is to require that where the procedures reviewed are deemed by the accountant to be inadequate, it is the accountant's duty to so state in his certificate.

Appended to Form X-17A-5 are "Minimum Audit Requirements Pursuant to Rule X-17A-5." These minimum audit requirements were evolved after considerable study and consultation with experts in the field of stockbrokerage accounting and authorities in the field of auditing. They represent what is generally believed to be the minimum steps which an auditor may take in order that he may properly certify to a financial statement submitted pursuant to Rule X-17A-5. Lack of familiarity with the techniques of stockbrokerage accounting and attempts to conduct an audit of a stockbroker's books along the same lines that an accountant uses to review the accounts and records of a commercial concern may result in serious violations of basic stockbrokerage accounting principles. It is of the utmost importance that in the preparation of financial statements pursuant to Rule X-17A-5, the accountant perform not less than the minimum audit requirements prescribed under the Rule. Numerous cases have come to the attention of the Commission where accountants have ignored the instructions and have omitted the confirmation of customers' accounts with other brokers and dealers, the physical verification of securities on hand, the verification of securities in transit or in transfer, the verification of securities collateralizing loans, and the obtaining of written confirmations with respect to bank balances.

In conclusion, I wish to state that the Commission's educational program will continue and that the Commission's personnel is available at all times for discussion. You may be sure that the Commission will continue this work with the accounting profession to the end that there may be developed a complete understanding of the requirements of Rule and Form X-17A-5.

Supervision of the financial condition of New York Stock Exchange member firms

by GEORGE A. CUFF

THE CONSTITUTION of the New York Stock Exchange vests in its Board of Governors the power to regulate and examine into the business conduct and financial condition of its members, allied members and member firms.

In accordance with the powers vested in it, the Board of Governors has promulgated rules and regulations applicable to all phases of the business of members, allied members and member firms. This paper will deal chiefly with the rules relating to the financial condition of member firms.

One of the important means of exercising control over the financial affairs of member firms is the financial questionnaire which was devised in the year 1922 and sent to member firms carrying margin accounts. In the year 1924, the Board of Governors ruled that such firms should cause an audit to be made in conjunction with each of the two answers to the questionnaire required in each calendar year. These audits had to be conducted in accordance with prescribed regulations but did not have to be made by independent public accountants.

During the year 1938, the scope of the required audit was the subject of a study by the Exchange and committees of the American Institute of Accountants and of the New York State Society of Certified Public Accountants. The Exchange approved the resultant audit program and in 1939 each member firm doing business with others than members or member firms was required to file answers to four financial questionnaires in each calendar year as of dates to be selected by the Exchange. At this time it was required that one of these answers be prepared by an independent public accountant who would conduct an audit in conjunction therewith in accordance with the approved audit program. Audits were not required in conjunction with the other three answers to the questionnaire.

Effective February 1, 1940, the Exchange adopted a ruling that the required annual audit be made by an independent public accountant at a date selected by him without prior notice to the member firm.

During the year 1942, discussions were held between the staff of the Securities and Exchange Commission, committees of the National Association of Securities Commissioners and the American Institute of Accountants, staffs of the National Securities Exchanges and others to develop a standard form of questionnaire which might be used or accepted by all regulatory bodies.

At about this time, the financial questionnaire of this Exchange was amended, the General Instructions, Part I and Part II thereof and the audit regulations being identical with Form X-17A-5 of the Securities and Exchange Commission. Part III was added to the questionnaire of this Exchange to provide for information not requested in Parts I and II.

Rule X-17A-5 of the Securities and Exchange Commission, effective January 1, 1943, requires reports, in accordance with Form X-17A-5, to be filed annually with the Commission by many security brokers and dealers. It also requires, among other things, that the report shall be certified by an independent public accountant if such broker or dealer is required to file a certified financial statement with any other agency

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of any state in which he does business or if he is required to file a certified financial statement with any National Securities Exchange of which he is a member or if he made a practice of extending credit in any form to customers during the year preceding the date of the report.

The New York Stock Exchange presently requires every member firm carrying accounts for others than members or member firms of this Exchange to submit answers to at least three financial questionnaires in each calendar year, one in each calendar third of the year. One of these answers must be prepared by an independent public accountant based on an audit made by him on a "surprise" basis. The other two answers need not be based on audits.

Other member firms which do not carry customers' accounts but which introduce such accounts to another firm and extend certain services to customers are required to file answers to at least two financial questionnaires in each calendar year, one in each calendar half of the year. One of these answers must be prepared by an independent public accountant based on an audit conducted on a "surprise" basis but the other answers need not be based on an audit.

Member firms doing no business with the public are required to answer two financial questionnaires in each calendar year neither of which requires an audit to be made in conjunction therewith.

Questionnaires answered by member firms fall into two categories, the special or "short form" which does not require an audit and the regular or "long form" which requires a coincident audit. The answers to those not requiring audit are submitted as of dates selected by the Exchange and may be prepared by employees of member firms but do not require valuations of securities to be reported to the Exchange relative to Questions 1 to 7, inclusive. Answers prepared in conjunction with the required audit must contain all valuations called for by the questionnaire. However, if a member firm does not carry customers' accounts on margin or extend credit on accounts in securities, valuations need not be supplied relative to Questions 1–7.

The financial questionnaire is designed to supply information necessary to determine the financial condition of the member firm which, insofar as this Exchange is concerned, is determined in accordance with Rule 415 (Capital Requirements).

The financial questionnaire and the capital requirements of the Exchange are discussed in following paragraphs. The term "proprietary accounts" used therein includes the personal or individual accounts of general partners provided such partners have signed agreements that cash, securities and equities recorded in the accounts are to be included as partnership property; trading and investment accounts of the respondent; capital accounts of all partners and accounts for income, expense and profit and loss.

The financial questionnaire consists of General Instructions and Parts I, II and III.

Among other things, the General Instructions require the balancing of ledger debit and credit balances, net losses and net gains in future commodities contracts and also security valuations when all valuations are to be reported. The instructions stipulate that security valuations must be based on current market prices and that material facts should be set forth in regard to substantial amounts of securities which are not readily marketable. They require an indication of the size of foreign currency balances if substantial.

Part I of the questionnaire comprises fourteen questions which are briefly summarized in the following paragraphs.

Question 1 asks for bank balances and other deposits.

Questions 2 and 3 request information on money borrowed from banks and others and on accounts carried for the respondent by others.

Question 4 relates to open items with other brokers and dealers such as securities borrowed, securities loaned, securities bought but not received and securities sold but not delivered.

Question 5 relates to the value of securities and "spot" commodities on hand, in transfer and in transit.

Questions 6 and 7 relate to customers' accounts and the status thereof.

Question 8 applies to accounts of officers and directors of corporations but the New York Stock Exchange has no corporate members.

Questions 9, 10 and 11 relate chiefly to proprietary accounts.

Question 12 requests information relative to accounts not specifically provided for in the preceding questions.

Question 13 requests relevant details on security transactions and other contractual commitments for proprietary accounts which are not recorded in a ledger account for money. Details of such commitments for customers' accounts are also required if they are substantial in view of the capital of the respondent.

Question 14 refers to contingent items such as lawsuits, endorsements, rediscounted notes and guarantees which are not recorded in a ledger account.

Part II of the financial questionnaire requires submission of schedules relating to security positions in proprietary accounts, security positions in customers' partly secured accounts and net contractual commitments for proprietary accounts. It also requests information relating to accounts carried by other brokerage houses in which any general partner of the respondent has an interest and information as to borrowings or claims which are unconditionally subordinated, in writing, to all claims of general creditors.

Part III requests, among other things, information relative to future commodity contracts carried for proprietary accounts and information relative to customers' security and commodity accounts so that proper charges may be made in computing the net capital of the firm. It also requests information as to financial obligations of partners.

All answers to the financial questionnaire submitted by member firms and by certain individual members of the Exchange are analyzed in accordance with the capital requirements of the New York Stock Exchange as set forth in Rule 415.

This rule states in part: "No member or member firm doing any business with others than members or member firms or doing a general business with the public, except a member or member firm subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its aggregate indebtedness to all other persons to exceed 1500 per centum of his or its net capital, which net capital shall not be less than $50,000 in the case of a member firm carrying any accounts for customers and shall not be less than $25,000 in the case of any other member firm subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member firm due to unusual circumstances."

The rule defines aggregate indebtedness and net capital and sets forth the debit and credit items entering into the computation of net capital.

Aggregate indebtedness, generally speaking, is the sum of all liabilities to others except liabilities related to securities owned by the firm or its general partners, equities in customers' regulated commodity accounts for which funds have been segregated under the Commodity Exchange Act, liabilities subordinated to claims of general creditors, money borrowings adequately collateralized by securities exempted from registration under the Securities and Exchange Act and liabilities on open contractual items.

The more important credit items used in the computation of net capital are the credit balances and certain percentages of the market values of securities and "spot" commodities in proprietary accounts and net profits in future commodity contracts carried for such accounts. Except for certain securities such as obligations of the United States Government, a state or a political subdivision thereof, securities are generally credited at only 70% of their market values to provide a safeguard against reduction in market values. Similarly, "spot" commodities are credited at 85% of their market values, if hedged and at 70% if not hedged. No credit is allowed for securities which do not have a ready market.

The debit items in general consist of debit balances in proprietary accounts, the market values of securities sold "short" and the net losses in future commodity contracts carried for such accounts, debit balances in accounts for memberships and fixed assets and 30% of the market value of long and short future commodity contracts carried for proprietary accounts other than those contracts representing "spreads" or "straddles" in the same commodity and those hedging "spot" commodity positions. This debit item of 30% also provides a safeguard against fluctuations in market values.

Other debit items arise from requirements based on the status of customers' accounts in securities and commodities. These debit items provide reserves against possible losses from such accounts.

Footnotes of Rule 415 refer to special treatment of certain securities in determining credit items and the application of contractual commitments for proprietary accounts in determining debit items.

It may be seen from the foregoing that the answers to the questionnaire provide information relating to aggregate indebtedness as defined by Rule 415. This information is found mainly in the answers to Questions 2, 4, 6, 7 and 12.

Information relative to the computation of net capital is obtained mainly from the answers to Questions 7, 9, 10, 11, 12 and 13 and Parts II and III of the questionnaire. The answers to Questions 6 and 14 also require consideration in such computation.

Now that brief summaries have been given of the financial questionnaire and the capital requirements of the Exchange we will deal with the answers to the questionnaire which are prepared by and require coincident audit by an independent public accountant, the regulations prescribed for audit, special instructions of the New York Stock Exchange and certain procedures of the Exchange.

Under the provisions of Rule 533, each member firm subject to that rule is required to select an independent public accountant to make an audit of the firm's affairs during the calendar year without prior notice to the firm. The member firm must file with the Exchange on or about January 10th of that year, an agreement signed by the accountant in which he agrees to make such audit, to notify the Exchange of the commencement of the audit, to prepare an answer to the questionnaire based on such audit, to submit to the Exchange a copy of such answer and to submit a report containing certain specific statements.

It is required that the first indication that a member firm will receive that an audit is to be made of its affairs will be the appearance of the accountant at the office of the member firm. The accountant will not be precluded from starting his examination a few days prior to the audit date for the purpose of accomplishing preliminary work. When the accountant commences the audit and notifies the Exchange to that effect, instructions with respect to the preparation and submission of the answers to the financial questionnaire and the regulations to be followed in conducting the audit will be forwarded by us to the member firm for delivery to the accountant.

Soon after the audit agreements, signed by the independent public accountants, are filed with us, a letter is sent to each accountant requesting him to advise us of the calendar third or half of the year, as the case may be, in which he expects to select the date as of which he will make the audit. The exact date as of which the audit is to be made is not requested. The main reason for this request is to minimize the possibility that the firm will be required to answer more than the required number of questionnaires.

In some instances the independent public accountant has made his audit of a member firm as of the same date over a period of years or has shown so little variation in his choice of dates that doubt exists as to whether the element of surprise is retained. It has been our practice to advise the accountant if this condition persists.

The regulations prescribed for audit under authority of Rule 532 of the Board of Governors of the New York Stock Exchange, which are identical with those prescribed by the Securities and Exchange Commission pursuant to Rule X-17A-5, accompany requests for answers to questionnaires. Briefly, they state that the audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date. The regulations state that the scope of the audit shall include at least comparison of ledger accounts with trial balances, balancing of positions in all securities and "spot" and future commodities, physical examination and comparison with the books and records of securities and other assets on hand, and verification of securities in transfer or transit. In general, the regulations also require written confirmations to be obtained with respect to bank balances which must be reconciled at two different dates, with respect to other assets and liabilities which can be confirmed, and with respect to all contractual commitments. Written confirmations are also required of partners' and respondent's accounts and certain guarantees. It will be noted that these are minimum requirements and that the accountant may adopt any other procedures which he deems appropriate.

Special instructions of the New York Stock Exchange, which are part of the financial questionnaire requiring an audit, provide that a written report, addressed to the firm, shall be prepared by the independent public accountant in which he shall attest that the requirements of the audit regulations have been observed in the conduct of the audit and specifically comment that he has made a review of the methods of internal accounting control of the firm and that he has reviewed its procedures for safeguarding securities. It is required that not later than forty-five days after the date of the audit, the accountant shall forward a signed copy of such report to the New York Stock Exchange. It is also required that a copy of the answers and all working papers relative thereto be retained for at least three years and be made available for review by a representative of this Exchange.

Of six hundred member firms of this Exchange at January 1, 1950, approximately five hundred and ten firms were required to have audits in accordance with the prescribed regulations. Over two hundred individual accountants and accounting firms were selected by our member firms to conduct these audits and twelve of these accounting firms were selected to conduct approximately 50% of the audits.

Supervision of the financial condition of member firms by means of financial questionnaires and audits is further exercised by a staff of examiners employed by the Exchange. It is the policy of the Exchange that its examiners make in each calendar year at least one unannounced visit to each member firm and to each branch office accounting point thereof.

The examinations made by the staff are not limited in scope and include inspection of the books and records to review the business conduct and financial condition of the member firms. These examinations generally include review of working papers and records relating to the firm's most recent answers to the financial questionnaire and a review of the records to determine the adequacy of capital at a current date.

Review of answers to financial questionnaires which were prepared by independent public accountants have disclosed errors, some of which have been substantial. During recent years, however, few instances have been noted where the scope of the audit by the independent public accountant has not been substantially in accord with the prescribed regulations.

The staff examiners also review the records of any firm applying for membership and the records relating to any individual applying for admission as a member of the Exchange or as a partner of a member firm if such firm or individual has been engaged in the securities business. This visit is completed before admission is granted.

Further control and supervision of member firms is achieved through Rule 550 which sets forth the deposits required to be obtained from customers in connection with transactions for their accounts and also through Rules 551, 552 and 616 which place limitations on commitments in securities for the account of the firm and its general partners which often operate to limit commitments for such accounts on a more restrictive basis than Rule 415. Weekly reports are received from member firms showing commitments and positions resulting from underwritings. In addition, the Department of Member Firms of this Exchange reviews partnership agreements and agreements relating to borrowings, for capital purposes or otherwise, by member firms and partners thereof. It also watches the market and its possible effect on the financial condition of member firms.

The enviable solvency record of member firms of this Exchange is protected, in large measure, by the control outlined herein.

At this point I should like to deal briefly with another rule of the Board of Governors with which the professional accountant is concerned. This is Rule 534 which states, in part: "Each member firm, except one subject to supervision by State or Federal banking authorities, shall make available to any customer of such firm at his request a statement of its financial condition as of the date of its most recent answer to the financial questionnaire of the Exchange or as of a date subsequent thereto. The financial statement shall be one which in the opinion of the firm fairly presents the financial condition of such firm."

This rule provides that each statement of account sent to a customer must bear a legend advising that a financial statement is available. It also provides that each member firm send to its customers a financial statement based on the required annual audit or a notice with a return post card advising that a copy is available upon request. The rule also requires the member firm to file with the Exchange a copy of its financial statement based on the required audit when it has been submitted to a customer. These copies are inspected and compared with information submitted in the related answers to the financial questionnaire.

Financial statements filed with the Exchange, most of which are prepared by independent public accountants, generally appear to present information in a clear and concise manner. Questions have arisen from time to time relative to the lack of disclosure of certain items and to the presentation of others. Some of these items are covered in following paragraphs.

Instances have been noted where material unsold commitments, not recorded on the books, such as underwritings, have not been disclosed. It is our opinion that disclosure should be made of the size of such unsold commitments where material.

Instances have also been noted where no disclosure has been made of material net commitments in future commodity contracts carried for proprietary accounts. The net worth or the interest of the partners in the business is adjusted to reflect any profit or loss at the market in such contracts but this does not result in disclosure of the risk position. In our opinion, the statement, by footnote or otherwise, should indicate the size of such material risk positions where the future contracts do not represent hedges against "spot" commodities or against other future contracts in the same commodity.

Profits and losses at the market in open future commodity contracts should be applied to the ledger balances in the related customer's or broker's account when reporting assets and liabilities in financial statements. In some instances, statements have described the asset or liability as equities in such accounts when in fact only ledger balances have been shown.

It is our opinion, in instances where the book value exceeds the market value, that it is preferable to show memberships in exchanges at the market value rather than to state them at book value with a parenthetical notation as to the market value.

Instances have been noted where the value of securities sold but not yet purchased for proprietary accounts, generally described as short sales, have been deducted from the value of other securities owned by the firm and the net amount shown as an asset. Values of securities owned by the firm and those sold "short" should be shown as assets and liabilities respectively.

In accordance with a ruling of this Exchange, disclosure should be made of any liabilities of the firm which are subordinated to claims of general creditors when a firm relies thereon for any part of its capital.

The staff of the Exchange is always available and welcomes the opportunity to discuss with the personnel of member firms and with independent public accountants any problems in connection with the preparation of answers to financial questionnaires and condensed financial statements of our member firms.

The examination program of the National Association of Securities Dealers, Inc.

by GEORGE RIEBER

THE INVESTMENT banking and securities business is a composite of several distinct operating units, all of which combine to provide an integrated mechanism for the development of capital for industry and for the transfer of interest in that capital from one owner to another.

After securities have been distributed by an issuer negotiating their sale to the public through an underwriter, subscribers to such securities may dispose of them by negotiating their sale to or through a dealer who, in turn, finds some member of the public who wishes to buy. The dealer will sometimes act as agent for his customer in disposing of or acquiring securities for him. On the other hand, there may be several reasons why a dealer cannot or does not act as an agent in a given transaction; in such instances he will buy the security from the customer or sell it to him as principal and for his own account. Such transactions are made off the floor of securities exchanges, and are known as "over-the-counter" transactions or "negotiated trades."

Some securities are so widely distributed that it is reasonable to expect that a buyer and seller always exist. Under such circumstances, a security might be fully listed on a registered exchange or admitted to unlisted trading privileges there. Members of exchanges always act as agents when effecting exchange transactions for a public customer. These transactions constitute the "exchange" or "auction" market.

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As you have seen from the remarks of others on this panel, several organizations supervise the activities of much of the investment banking and securities business. The National Association of Securities Dealers, Inc., however, is empowered by Section 15A of the Securities and Exchange Act of 1934 to enforce rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market." (Sec. 15A(b)(7)).

The Association exercises this general power by codifying it in certain documents. One of these, its Certificate of Incorporation, announces as one of its objects the standardization of the principles and practices of the investment banking and securities business. The Rules of Fair Practice of the Association provide, among other things, that "a member shall keep and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable Federal and State laws and all rules and regulations promulgated thereunder."

To the professional accountant, therefore, it is plain that the job of supervising the conduct of N.A.S.D. members' business requires some specialization.

Although its powers are not precisely limited in that respect, the National Association of Securities Dealers, Inc., has found it desirable to concentrate its supervisory activities on those transactions by its members in the over-the-counter market, whether the securities involved are listed on a registered exchange or not. This voluntary limitation may be likened to that of a policeman patrolling a specified beat, although sworn to uphold the law wherever he finds any dereliction. It is practiced only because the Association is fully aware that other agencies are doing an excellent supervisory job in their own fields. Such a procedure permits efficient coverage of the conduct of members, and at the same time avoids unnecessary duplication.

As noted, one of our rules requires that members shall keep their books and records in conformity with all applicable federal and state laws and regulations. There are several such rules, but they all boil down to the simple doctrine that securities dealers shall keep adequate records of a type required by the trade, and that they shall be clear and complete enough for an ordinary accountant to be able to read and understand.

Many of the larger investment houses, especially those doing business in metropolitan areas, are extremely active in all branches of the business. Naturally, these dealers maintain elaborate records which have been set up for them by their accountants, or have been installed by their comptrollers, who are themselves experienced accountants. But many other firms, because of their unfamiliarity with federal requirements or those of the state in which they operate, keep records of which the least criticism could be that they do not comply with such requirements. Many of these firms are in this situation because no competent securities accountant was within their reach. As part of its service, therefore, the Association has prepared a "bookkeeping kit" which it makes available to all members of the Association. Copies are also available to any public accountant who cares to apply for them at the executive office of the Association in Washington, D. C. The kit contains specimen bookkeeping forms which may be used by dealers either as prepared, or with any adjustments necessary to properly record the type of business done. If the forms can be used without alteration, they can be obtained in moderate quantities from a stationery firm in Chicago which prepares a large supply and sells them in retail lots. The forms have been reviewed by the Securities and Exchange Commission, which has accepted them as being in conformity with its requirements.

It is now evident that Association members are looking to their public accountants for advice and counsel with increasing frequency so as to be sure they are keeping their records and conducting their business in accordance with the requirements of various supervisory organizations. It seems imperative, therefore, that accountants familiarize themselves with such requirements if they plan to advise their clients on matters of this kind.

To underscore subject matter with which an accountant must be acquainted to discuss the requirements of the National Association of Securities Dealers, Inc., it might be appropriate to state the approximate range of an examination conducted by representatives of the Association when they visit members.

An examiner always keeps in mind the fact that members of the Association may also belong to registered exchanges or other organizations which supervise the conduct of their members. He is also aware that overlapping examinations can be a nuisance and a waste of time. Consequently, although it is not mandatory that he do so, he is inclined to limit his survey to that portion of a member's affairs which are directly supervised by the Association, and which have not already been reviewed by an auditor of one of the other organizations.

After a preliminary interview with an official of the member firm, in which the examiner attempts to determine the scope of the survey he is to make, he looks over the accounting system used by the dealer. During this review, he checks the adequacy of the records and their conformity with the requirements of Securities and Exchange Commission Rules. He also analyzes the balance sheet of the firm to determine, among other things, the amount of the firm's net capital. Although the Association's rules do not contain a minimum capital requirement, Rule X-15C3-1 of the Securities and Exchange Commission provides that no broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 20 times his net capital. This rule further provides the formulae by which both aggregate indebtedness and net capital shall be computed.

While he is reviewing the books, the examiner also determines the extent to which the firm complies with the requirements of Regulation T of the Federal Reserve Board. This is a set of rules promulgated by the Board to regulate credit extended on securities. Since most sales by over-the-counter firms are made with the understanding that the purchasing customer will pay for his purchase promptly, such transactions are usually qualified for entry in one or more of a group of accounts known as "special cash accounts." The examiner, therefore, is mainly interested to see if the firm has complied with the regulation by obtaining payment from his customer not later than seven full business days after the transaction, or, failing to do so, has taken the necessary steps to conform to the alternative provisions of the regulation, such as obtaining an extension canceling the transaction, or selling out the contract.

The manner in which a firm confirms its transactions is also subject to scrutiny. An established and accepted procedure, backed by rules of the Association, almost all registered exchanges, and the Securities and Exchange Commission, requires that a dealer disclose to his customer the capacity in which he has acted in a transaction, and the source and amount of any commission received in connection with it, if he has acted as agent. A broker must also volunteer to furnish the name of the person from whom a security was bought or to whom it was sold, together with the time the transaction was made.

The books should clearly show the procedure followed by a broker-dealer in placing securities in safe keeping for the benefit of customers who have paid for them in full. There are several ways in which this can be done, and an examiner is inclined to accept any system in which the broker-dealer acknowledges his trusteeship, and segregates his customer's fully paid securities in such a way that he will never use them in the conduct of his business, and keeps them available for immediate delivery to his customer at all times.

These are only a few of the more important items which are reviewed by Association representatives. These examiners, who are themselves trained accountants, pick up all kinds of information from the books they examine, and at the same time are often able to suggest ways to improve the member's accounting procedures.

For example, in 1941, during a survey of a member's books, an examiner ran across some entries which indicated that the broker-dealer was selling some of his own stock to a customer. Further investigation disclosed the customer had bought the stock on the representation that the 7 per cent dividend would surely be paid on it during the foreseeable future. Apparently to quiet the customer's fears, disbursements were actually made as dividends on the stock, although there were no earnings out of which to pay them. Having struck a hot trail, the examiner took a real look at the books, and soon developed a whole pattern of misdemeanor. Not the least item was a transfer of a reserve for bad debts to the credit of the drawing account of the president of the firm, who reduced his overdraft by that means, and thus placed himself in a position to continue his withdrawals. All these departures from good practice had occurred between visits of the dealer's accountants, a reliable firm which no doubt would have refused to countenance any such malpractice. The president of this broker-dealer firm had made a fairly good attempt to bury his derelictions by means of obscure entries on his books, but he was exposed by one item he was not clever enough to cover.

If a dealer conducts arbitrages or deals in "when issued" securities, his records will receive the particular attention of an examiner. In 1942, the Association examiners visited a member doing business in a community of medium size. The affairs of this member had become so confused that he was not sure whether he had any working capital or not. The local district attorney was becoming disagreeable, and the dealer felt that he was being persecuted. Examination disclosed that this dealer had been treating his when-issued contracts in the same manner as if the securities were actually deliverable. His practice was to debit his customer's account with the full cost of the contract, at the same time crediting his New York correspondent with the offset. When he received payment from the customer, the credit was placed in the customer's account, closing it as to money. Thereafter, the dealer posted entries covering deliverable contracts in the same accounts as those recording when-issued trades. Having thoroughly buried the credit balances of his customers by this method of keeping books, he attempted to determine the amount of this liability by running through the ledgers and picking them out with an adding machine at his elbow. Even a person whose academic instruction has not gone beyond elementary accounting will be reminded by this case of the office boy who proudly reported to his boss that he had done a thorough job of adding a column of figures seven times on the adding machine and was ready with the seven answers. Two Association examiners worked until three o'clock in the morning trying to pick out the credit balances and succeeded in finding all but $1200 of them. They also succeeded in proving what was already suspected, that the dealer had dissipated nearly $20,000 of his customer's money. Subsequent investigation disclosed that the accountant who had set up the records for this dealer had done the best he could with an experience limited to the audit of small commercial and industrial enterprises. He would have saved his client much embarrassment and discomfiture if he had recognized his limitations and consulted a more experienced practitioner before setting up the records.

These two incidents are not related to discredit any branch of the accounting profession; the vast majority of accountants are capable and conscientious workers who give their clients excellent service. The examples are used only to point out some of the difficulties in this phase of accountancy.

It might be worthwhile to cover two additional points, neither of which has to do directly with accounting as such, but both of which could easily be matters upon which a dealer might consult his accountant.

The first is the matter of discretionary accounts sometimes carried by a dealer for his customers. A discretionary account has been defined as one where a broker or one of his employees is authorized by the customer to make purchases and sales in his own discretion in the customer's behalf, without specific instructions from the customer or consultation with the customer concerning each transaction. The full extent of the liability assumed by a dealer who carries such accounts is almost beyond measure. But an accountant who sees discretionary accounts on books he is auditing would certainly be well advised to conduct a thorough investigation of the basis upon which discretion is being exercised.

The New York Supreme Court has said that the relationship between a broker and a customer who conferred discretionary authority on the broker was of the most delicate fiduciary character, and one which no agent should have undertaken, and which no principal should have entrusted to an agent. (*Cohen* v. *Rothschild* 169 N.Y. Supp. 659). Although the National Association of Securities Dealers, Inc., has only one rule which specifically mentions transactions in discretionary accounts, improper exercise of discretion could violate the Association's high standards of commercial honor, and constitute a breach of its just and equitable principles of trade.

A dealer who accepts and exercises discretion in a customer's account is also bound to accept all the risk and responsibility that goes with it. Certainly, then, an accountant would be doing a great service if he revealed to his client his fears that discretion was being exercised improperly. But a somewhat paradoxical situation arises here. It is presumed that an accountant who can recognize improper use of discretion is sufficiently well informed on the subject to be capable of advising his client how to correct erroneous practices. Yet he may be reluctant to give such advice because he may be laying himself open to the charge that he is practicing law. Perhaps the safest advice that a client could get on this subject is that he should accept no discretionary accounts except those actually forced upon him by his customers. Even then, he should see to it that the terms of the discretionary agreement are so clear and are so meticulously observed that the possibilities of subsequent dissatisfaction are reduced to a minimum.

Finally, the Association has been obliged to interest itself in the so-called "public market" in mutual fund shares presently being conducted by dealers who have no agreements with sponsors of the funds. Ordinarily, mutual fund or open-end investment trust shares are sold by an issuer through a sponsor. The sponsor executes agreements with dealers who sell the shares to the public at a public offering price which is computed twice a day. Under these agreements, dealers are compensated by taking down the shares sold at a discount from the public offering price.

All open-end trust shares are redeemable by tender back to the issuer. The redemption price is computed twice a day, just as the public offering price is. However, it is not compulsory to purchase from a dealer who has an agreement with a sponsor, nor to redeem shares by tender to the issuer. A member of the public may buy and sell where he chooses. Consequently, an open market has sprung up in mutual fund shares, and with it many complications.

A dealer who buys such shares in the open market for resale either to a member of the public or to another dealer should bear in mind at least two very important rules. One is Section 22(D) of the Investment Company Act of 1940, a federal statute. This section provides that no dealer shall sell open-end trust shares at less than the public offering price to any one except another dealer. The other is a series of rules of the National Association of Securities Dealers, Inc., which state in substance that no member of the Association shall grant discounts to non-members of the Association or to members of the public. Anyone desiring to apply the above rules should study them in their entirety, but these brief descriptions will indicate the care a dealer must exercise if he wishes to trade mutual funds at prices which may be between the redemption price and the public offering price of such shares, and at the same time avoid violation of the law and the rules of the Association.

The National Association of Securities Dealers, Inc., naturally has a keen and sympathetic realization of the intricacies and problems in the investment banking and securities business. It also understands that a dealer must know the rules under which he operates, and is inclined to impose upon his accountant the burden of helping him understand those rules. It maintains an executive office in Washington, D. C., and has fourteen district offices throughout the United States to which written inquiries as to the application of its rules may be submitted. Since it may not absolve a member for violation of its rules because of the member's ignorance, the Association earnestly tries to prevent such difficulties and thus avoid the necessity of penalizing its members for departure from its code of high commercial honor.

NOTE: *Most of the documents mentioned in this article may be obtained by application to the National Association of Securities Dealers, Inc., 1625 K Street, N. W., Washington 6, D. C.*

Chicago Board of Trade capital requirements and financial questionnaires

by JOSEPH J. SHANLEY

THE Chicago Board of Trade is a public marketing institution where buyers or their representatives, or sellers or their representatives, meet to buy and sell commodities such as wheat, corn, oats, rye, barley, soybeans, lard, cotton or some of the by-products, such as crude soybean oil, cotton seed oil and so forth. Here the actual commodity is traded, either on a cash basis, or on futures contracts. The price is determined by the competitive forces of supply and demand of the actual grain itself.

The function of the Board of Trade is to provide services in the handling of the physical product such as policing of grain in warehouse and in cars, sampling grain, weighing, and assisting members in transactions involved in shipping of grain. In addition to these, there are many other kinds of services which the Board of Trade renders to its members.

The financing involved in grain trading covers the physical commodity, whereas in securities trading, the financing relates to the capital structure of an enterprise. The price risk or price insurance on the grain bought and sold on grain exchanges is available only through hedging, which is handled in the futures contract market. About one-half of the grain crop is harvested in about three months, and unless there was a liquid and fluid market in grains there would be a wide fluctuation in price range depending on season.

The principal difference between a securities exchange and a grain exchange is in the nature of the character of the thing traded in on the particular exchange and the extent of the business operations of the individual firm.

Requirements of securities exchanges can be more easily set up; for example, the member firms of the New York Stock Exchange are all partnerships and either carry their own customers' accounts or turn them over to another firm. Also the main business of most of these firms is the handling of securities; while at the Chicago Board of Trade, members carrying customer accounts may be either individuals, partnerships or corporations and because of the varying types of operations in which they are engaged, different qualifying standards apply according to the type or types of business. This is especially true in those cases where members or member firms conduct multiple operations made up of a combination of two or more of the following: commission merchants, millers, processors, grain elevator and warehousing operators, meat packers, co-operative organizations and various other types of commercial or industrial enterprises. It is because of these circumstances that the Board of Trade has found it difficult, and practically not possible, to set up a single standard of qualification to cover all cases.

Members of the Chicago Board of Trade who are also members of the New York Stock Exchange are required to file with the Business Conduct Committee a copy of each questionnaire which they file with the New York Stock Exchange. In these cases, we apply the same requirements as the Stock Exchange with the exception of margin on municipal securities and U. S.

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Government securities and also the capital requirement of $^1/_2$ of 1 per cent on customers' open commodity contracts is slightly different.

We require a margin of 10 per cent on municipal securities and 5 per cent on U. S. Government securities of over one year maturity.

Our capital requirement for customers' open commodity contracts is likewise $^1/_2$ of 1 per cent but permits clearing members to deduct spreads in the same grain on the Chicago Board of Trade for bona fide trade accounts and omnibus accounts insofar as they apply to customers' transactions.

The members of the Chicago Board of Trade who are not also members of the New York Stock Exchange, and who carry margin or cash grain accounts for customers, are normally required to answer two financial questionnaires each year at such times as the Business Conduct Committee shall request them. Where it is deemed necessary, the Business Conduct Committee calls for answers to additional questionnaires. Special forms for this purpose are sent to the respective members at the time of the call, one type to cover individuals and partnerships, and another type to cover corporations.

The Board of Trade does not require a questionnaire from corporate members who do not carry margin or cash grain accounts for customers. However, it does require that these members furnish a statement of condition at the close of each fiscal year to insure solvency.

While the Board of Trade does not require an audit by independent accountants, nor the preparation by them of answers to financial questionnaire, they recommend and strongly encourage members to have annual audits made by independent public accountants. It also encourages members to have these outside experts assist in preparing answers to at least one of their semi-annual questionnaires.

Members of the Chicago Board of Trade who carry accounts for customers are required to have a minimum net operating capital of $10,000, unless a temporary exception is made by the Board, due to unusual circumstances. In computing capital requirements, there is a material difference in many of the accounts of members of the Board of Trade and New York Stock Exchange. The assets of members of the Board of Trade, other than customers' trading accounts and cash, consists mainly of inventories, accounts receivable, elevators, equipment, etc., whereas the assets of Security Exchange members are normally composed of memberships, furniture and fixtures.

Another point of difference between the Chicago Board of Trade and the New York Stock Exchange is in the way the debit balance computation is arrived at. At the Board of Trade, after the net operating capital is determined, 5 per cent of the customers' secured debit balance is required; (this is approximately the same as 2000 per cent required by X-17A-5) whereas on the New York Stock Exchange, $6^2/_3$ per cent of the customers' aggregate indebtedness is included as a capital requirement.

The specimen answers to a questionnaire following is that of a hypothetical partnership engaged in elevator operation, and carrying commodities and securities accounts for customers. Because of the securities business the firm would be required to report annually to the SEC on form X-17A-5, a copy of which would be accepted by the Board of Trade; but we will assume that the form illustrated on pages 182–184 (Exhibit) I is furnished in response to a semi-annual call by the Board of Trade.

The analysis form presented on pages 185–187 illustrates the procedure followed in determining working capital from which the various margins required are deducted in order to arrive at the "net operating capital," against which the over-all capital requirements based on volume of business being handled, as measured by secured debit balances and open commodity contracts, are applied (Exhibit II).

In analyzing financial statements, where elevators and equipment are part of the assets, consideration is given to any long-term bonded or mortgage debt to qualify as capital, providing it meets with the requirements of the Board of Trade. Complete details must be furnished, including due dates and any prepayments due within one year.

Subordinated borrowings will not be considered unless signed copies of subordination agreements have been submitted and are approved by the Business Conduct Committee.

With reference to inventories, the net appreciation or depreciation, i.e., the difference between market value and book value whichever the case may be, is credited or charged to capital. In addition, a margin of 10 per cent of the valuation of the inventory is required (this being the approximate financing requirement).

In figuring the margin on advances against cash commodities, against bills-of-lading, or against commodities in store, 90 per cent of the market value of commodities is allowed. If the amount advanced exceeds that percentage, the difference is charged as additional margin required. Also, 5 per cent of the debit balances in these secured accounts of customers are charged as a capital requirement.

Margin is also figured separately on many other items, a few of which are: current accounts and notes receivable, grain in transit, accrued handling, storage and R. R. switching charges, etc.

There are two other major items to consider in analyzing financial statements: (1) Open trade controlling balances in commodity contracts, and (2) Segregation of customers' funds. In reconciling the open trade balances in commodity accounts as shown on the questionnaire, all profits and losses in open contracts, including those with correspondent brokers, must balance. The open trade controlling balance includes all amounts deposited and withdrawn from clearing houses, to bring open contracts to the market, or credits or debits arising from price differences on contracts open through correspondent brokers.

With reference to segregation, it is necessary to determine that all customers' funds received to margin, guarantee or secure trades or contracts, and all funds and equities accruing to such customers as the result of such trades or contracts, shall be separately accounted for and segregated as belonging to such customers. These funds, whether deposited in a bank, clearing corporation, or invested in Government securities, must clearly show that they are customers' funds segregated as required by the Commodity Exchange Act.

One of the principal weaknesses found in the answers to financial questionnaires is the lack of sufficient information which should be furnished by members in order for the Business Conduct Committee to make a complete and comprehensive analysis of their statement. This could be easily and readily remedied at the time of preparation by supporting those items which are not self-explanatory with factual evidence or explanatory narration. The independent auditor should recognize the printed questionnaire form as a guide to be altered to meet unusual conditions.

The particular items falling in this category are those covering accounts receivables and securities. With factual information supporting accounts and notes receivable, the degree and type of security behind the receivables would materially help in determining their real value.

In the case of securities, a schedule showing the nature and the market value of the securities would be of considerable aid in the analytical processing of these items.

There are other specific items which require further investigation, such as profits and losses in open commodity accounts which are quite often omitted, and even when reported do not always balance with the control account and/or correspondent account.

Another source of difficulty is that the market value of bills-of-lading or warehouse receipts, held against advances against cash commodities, are often not stated. Also amounts necessary to bring commodity accounts up to a fully margined condition are not always reported.

If adequate and factual information were furnished the Board of Trade with the questionnaire covering these and other items that are not self-explaining, our analytical work could be done much more efficiently and expeditiously. At the same time many hours could be saved by eliminating unnecessary correspondence with members in order to develop proper information concerning the items under question.

In conclusion, if independent public accountants knew more about the grain exchange business, and had a better understanding of the Board of Trade requirements, undoubtedly a large part of these shortcomings in analyzing financial questionnaires would disappear.

EXHIBIT I

FINANCIAL

ASSETS		COL. 1 LEDGER DEBIT BALANCES	COL. 2 MARKET VALUE OF SECURITIES AND COLLATERAL
1 **Cash in Bank and on Hand**	General C. C. F.	23,000. 20,400.	
2 **Clearing Corp. Stock and Contributions**		5,000.	
3 **Margin Certificates** (Enter Securities, if any, in Column 2 in red)	Cust. House	40,000. 3,000.	
4 **Advances Against Cash Commodities (Fully Secured)**			
(A) Against Bills of Lading		20,000.	24,000.
(B) Against Commodities in Store		5,000.	6,000.
5 **Accounts with Correspondent Brokers**			
(A) Commodity Futures Accounts (Profit $____ or Loss $ 1,000. in Open Contracts)		11,000.	
(B) Securities Accounts (Against Short Sales on ____ Shares))			2,500.
Cash Sales	)Contra		5,000.
6 **Open Trade Controlling Balance in Commodity Contracts**			
7 **Customers' Accounts**			
(A) Commodity Futures Accounts with Open Contracts			
(1) Fully Margined (Profits $ 3,000. or Losses $____ in Open Contracts)		500.	
(2) Fully Secured but Undermargined (Profits $ 500. or Losses $____ in Open Contracts)		100.	
(3) Partly Secured (Profits $ 100. or Losses $____ in Open Contracts)		200.	
(4) Ledger Debits with Losses (Losses $ 100. in Open Contracts)		100.	
(B) Securities Accounts			
(1) Margined 130% or more		60,000.	85,000.
(2) Margined 100% but less than 130%		10,000.	12,000.
(3) Partly Secured—Less than 100%		5,000.	3,000.
(4) Purchases on Cash Settlement Basis (Since Cleared)		12,000.	12,000.
(C) Debit Balances without Open Commitments		2,000.	
8 **Partners' or Proprietor's Debit Balances**			
(A) Commodity Accounts (Profits $____ or Losses $____ in Open Contracts)			
(B) Securities Accounts		1,000.00	1,500.
(C) Other Debits—Drawings, etc.			
9 **Commodities on Hand—Inventory**		100,000.	103,000.
10 **Firm's Commodity Trading and Hedging Accounts** (Profits $____ or Losses $ 3,000. in Open Contracts)			
11 **Firm Investment—Listed Securities**		5,000.	5,500.
12 **Firm Investment—Unlisted Securities**		2,000.	2,500.
13 **Memberships** (Present value $____)		10,000.	
14 **Real Estate and Buildings (Used in the Business)**	$60,000. 10,000. Reserve	50,000.	
15 **Equipment, Furniture and Fixtures**		5,000.	
16 **Other Assets (in Detail)**			
Accounts Receivable - Cash Grain		15,000.	
Note Receivable - Past Due		1,000.	
Prepaid and Deferred Charges		3,000.	
TOTAL ASSETS		409,300.	262,000.

EXHIBIT I

STATEMENT

LIABILITIES AND CAPITAL	COL. 3 LEDGER CREDIT BALANCES	COL. 4 MARKET VALUE OF SECURITIES AND COLLATERAL
17 Money Borrowed and Value of Collateral Pledged		
(A) Secured Bank Loans	70,000.	100,000.
(B) Unsecured Bank Loans		
(C) Other Loans		
18 Advances Drawn Against Bills of Lading	10,000.	12,000.
19 Accounts with Correspondent Brokers		
(A) Commodity Futures Accounts		
(Profits $____ or Losses $____ in Open Contracts)		
(B) Securities Accounts	45,000.	67,000.
20 Open Trade Controlling Balance in Commodity Contracts	10,600.	
21 Customers' Accounts		
(A) Commodity Futures Accounts with Open Contracts		
(1) Fully Margined	50,000.	
(Profits $ 13,000. or Losses $ 1,000. in Open Contracts)		
(2) Fully Secured but Undermargined	2,000.	
(Profits $ 1,000. or Losses $ 500. in Open Contracts)		
(3) Partly Secured	1,000.	
(Profits $____ or Losses $ 1,500. in Open Contracts)		
(4) Losses with No Ledger Balance		
(Losses $ 100. in Open Contracts)		
(B) Securities Accounts		
(1) Short Sales Margined 10 Points or more (No. of Shares 100)	4,000.	2,500.
(2) Short Sales Margined 1 to 10 Points (No. of Shares____)		
(3) Short Value Greater than Credit Balance (No. of Shares____)		
(4) Sales on Cash Settlement Basis (Since Cleared)	5,000.	5,000.
(C) Free Credit Balances — Customers' Commodity Funds	3,000.	
Other Free Credits	20,000.	
22 Partners' or Proprietor's Credit Balances		
(A) Commodity Accounts	1,000.	
(Profits $ 200. or Losses $____ in Open Contracts)		
(B) Securities Accounts		
(C) Other Credits	9,000.	
23 Funded Debts, Mortgages on Real Estate, etc. Due 1955	10,000.	
24 Capital Accounts		
(A) Capital	125,000.	
(B) Surplus and Undivided Profits	28,700.	
25 Market Value of Securities and Collateral on Hand (Col. 4 only)		
(A) Listed Securities (Value $5.00 per Share and Over)		49,500.
(B) Listed Securities (Value Under $5.00 per Share)		2,500.
(C) Unlisted Securities		2,500.
(D) Warehouse Receipts, Bills of Lading, etc.		21,000.
26 Other Liabilities (in Detail)		
Accounts Payable - Cash Grain	10,000.	
Sundry Liabilities	5,000.	
TOTAL LIABILITIES AND CAPITAL	409,300.	262,000.

(See Supplementary Questions on Reverse Side)

EXHIBIT I

SUPPLEMENTARY QUESTIONS

27 Has your firm any contingent liabilities which are not included in a ledger account?

Answer NO

If so, send brief description in memorandum form.

28 Have any partners, or the proprietor, of your firm, individually or collectively, any security or commodity accounts or commitments carried by other banking or brokerage houses which are not reflected on your books?

Answer NO

If so, send separate complete statement.

29 Does the capital account, as stated, or the personal accounts of the members of the firm, as stated, reflect any monies or values which are the result of borrowings—subordinated or otherwise?

Answer NO

If so, send separate complete description of amounts and/or values, stating the terms of agreement as to repayment, or in the case of subordination, a copy of such agreement.

30 Does the stated "Surplus and Undivided Profits" item include any amounts appropriated for or subject to distribution within the next six months?

Answer Subject to year end distribution

If so, send particulars.

31 Do the "Articles of Partnership" under which your firm at present operates, or some supplemental agreement thereto, specifically provide that the equities in the partners' individual accounts are to be considered as a part of the firm's capital?

Answer YES

Analysis of open commodity contracts to be furnished on form supplied for that purpose and to be considered a part of this questionnaire.

EXHIBIT II

ANALYSIS OF OPEN COMMODITY CONTRACTS

(SEE INSTRUCTIONS ON REVERSE SIDE)

AS OF JULY 31st 19 50 FIRM. NO. 000

B.C.C. 9 2M 10-45 O

COMMODITIES	AGGREGATE OF OPEN FUTURE CONTRACTS								AGGREGATE OF CLEARING POSITION			
	Accts. of Customers Fully Margined (Group 1)		Accts. of Customers Not Fully Margined (Group 2)		Accts. of Partners or Officers (Personal) (Group 3)		Accts. of Proprietor, Firm or Corporation (Group 4)		With Clearing Houses (Group 5)		With Other Brokers (Group 6)	
	Long	Short	Long	Short	Long	Short	Long	Short	Long	Short	Long	Short
WHEAT- CHGO.	60	15	5	5				30	45	30		
CORN - CHGO.	95	215		5				20		145		
OATS - CHGO.	45		5					5	50	5		
RYE - CHGO.	80	5	5	5					75			
SOYBEANS- "	135	50	15		5				105			
COTTON- N.Y.	10										10	

What amount of money would be required to bring the accounts in the following groups to a fully margined condition—each account considered individually and margin requirements computed at Clearing House rates? (The amount reported should include liquidating deficits.)

Group 2. Accounts of Customers not fully margined .... $ 4,200.

Group 3. Accounts of Officers or accounts of Partners not considered as firm capital (Not specifically covered by agreement per Question 31.) .... $

What are the total Clearing House requirements for the following groups of accounts?

Group 3. Accounts of Partners considered as firm capital (Covered by agreement per Question 31.) .... $ 1,000.

Group 4. Accounts of Proprietor, Firm or Corporation .... $ 6,400.

ANALYSIS OF QUESTIONNAIRE SUBMITTED BY FIRM — AS OF JULY 31, 1950

BOARD OF TRADE OF THE CITY OF CHICAGO

Capital:			
Capital or Capital Stock		$125,000	
Surplus or Undivided Profits		28,700	
Firm's Equity in Commodity Trad. or Hedg. A/cs		3,000	
Firm's Equity in Trading—Investment A/cs		1,000	
Partners' Individual Security Accounts		500	
Partners' Individual Commodity Accounts		1,200	
Partners' or Proprietor's Balances		9,000	
Appreciation of Inventory		3,000	
Funded Debt		10,000	
Total Capital			$175,400
Permanent and Non-Liquid Assets:			
Firm's Equity in Partly Secured Commodity A/cs		$ 900	
Firm's Equity in Partly Secured Stock A/cs		2,000	
Customers' Unsecured Balances		2,000	
Memberships		10,000	
Real Estate (Net)		50,000	
Furniture & Fixtures (Net)		5,000	
Notes Receivable (Unsecured)		1,000	
Miscellaneous Accounts Receivable			
Prepaid and Deferred Charges		3,000	
Investments			
Total Permanent and Non-Liquid Assets		$ 73,900	
Less: Reserves Applicable to the Above			73,900
Net Liquid Assets—(Working Capital)			$101,500
Margin Requirements:			
Customer Accounts:			
Advances Against Cash Cmdys.	$		
Secured 100 to 130% Long A/cs	1,000		
Secured 100 to 130% Short A/cs			
Partly Secured Long Accounts	900		
Partly Secured Short Accounts			
Cash A/cs Long—Securities			
Cash A/cs Short—Securities			
Commodities—Futures	3,300		
Accounts Receivable	3,750		
When Issued Securities			
		$ 8,950	
Firm Accounts:			
Firm Commodity Trading A/cs	$ 6,400		
Firm Investment & Trad. A/cs	2,900		
Inventory	10,300		
Partners' Indiv. Security A/cs	450		
Partners' Indiv. Commodity A/cs	1,000		
Good Faith Deposits			
		$ 21,050	$ 30,000
NET OPERATING CAPITAL			$ 71,500

ANALYSIS OF QUESTIONNAIRE *Continued*

BOARD OF TRADE OF THE CITY OF CHICAGO

FIRM 000
DATE 7-31-50

Net Operating Capital			$71,500
Capital Required:			
Customers' Ledger Balances:	$		
Secured 130% or more	60,000		
Secured 100% to 130%	10,000		
Secured Portion of Partly Sec.	3,000		
Cash Accounts	12,000		
Advances Against Cash Cmdys.	25,000		
Accounts Receivable	15,000		
Total	$125,000		
5% of Customers' Secured Debit Balances		$ 6,250	
1.25% of Market Value of Predominant Side of Customers' Total Open Contracts (See schedule attached)		15,621	
Total Capital Required (Minimum $10,000)			21,871
Excess or Deficiency in Operating Capital			$ 49,629

NOTES

Ratio of Debit Balances to Net Operating Capital 1¾ to 1

Contingent Liabilities

COMMENTS

Analyzed by

Date 8-18-50

ANALYSIS OF QUESTIONNAIRE *Continued*

BOARD OF TRADE OF THE CITY OF CHICAGO

SAFETY FACTOR COMPUTATION
FIRM 000
DATE 7-31-50

Commodities	Customers' Contracts Long	Short	Rate (1.25% of Market Value)	Extension On Predominant Side
WHEAT—CHICAGO	65	20	$ 28.75	$ 1,868.75
CORN—CHICAGO	95	220	19.00	4,180.00
OATS—CHICAGO	50		9.75	487.50
RYE—CHICAGO	85	10	19.50	1,657.50
SOYBEANS—CHICAGO	150	50	33.50	5,025.00
COTTON—NEW YORK	10		240.25	2,402.50
TOTAL SAFETY FACTOR				$15,621.25

Problems encountered in sponsoring or opposing state regulatory legislation

by JUDGE JAMES LANGAN

WHILE THE WORK of accountancy has not been recognized until relatively modern days as standing alongside the learned professions of law and medicine, yet it is as old as either of the two.

It is because our economic system has become more complex and the transaction between men, corporations, and government has become more involved, that the true importance of the accounting profession has been recognized. The services of the accountant have become indispensable to our complex life. There has developed in the public a desire for a designation that would indicate a standard on which they could rely in handling tax matters, a standard for determination of financial status, for cost, and for many things that would be the basis for decisions as to policy, employment, wages, and every other phase of business.

It was in this soil of public need that accountancy grew to full stature as a learned profession. In the establishment of the CPA certificate there has been created a standard that has become recognized as representing a high degree of professional skill.

Men who work in the profession as certified public accountants are sought after because they have the designation that has created a feeling of justified confidence in those who need the services of experts in accounting.

We have become a nation that must look to the labels of approval which indicate that without going through a series of tests of trial and error we can, with confidence, have a job well done.

It is only to be expected that others working at accounting should attempt to gain a status of some kind that would put them in a category similar to or identified in the eyes of the public with certified public accountants. It is only human on the part of a great number of men practicing accounting who do not have a CPA status to want either it or some similar status created by law.

So we have seen in the past few years an effort, in almost every one of the forty-eight states, to set up legislation to give a status to accountants.

The form of the legislation may vary but it all has a fundamental substance:

A. Model bill:
  (1) Give a legal status to accountants.
  (2) Requirement that certified public accountants register with a board of registered accountants.
  (3) Establish the two-class system—certified public accountants and public.
  (4) Permit the registration of public accountants *without examination*—tax consultants, accountants, bookkeepers, or those holding themselves out as public accountants.

B. A waiver of certain requirements now existing to attain the status of CPA (educational) (experience).
  (1) Dying class.
  (2) Grandfather clause.

C. Variations of the above which set up extremely radical, unworkable provisions.

In the presentation of the various bills to the legislature, and in seeking passage of the so-called "model bill" or any variation

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of it, or of any bill seeking to waive or lower standards of CPAs, a technique is adopted which tends to convince legislators:

1. That public accountants should be under regulation as is the CPA and the public would benefit thereby (establishing a status for public accountants) . . . i.e., the need for legislation.

2. Legislation is needed because the CPAs have created a monopoly that can be broken by the help of legislation (that the monopoly is maintained and guarded by severe selection).

3. CPA examinations are unnecessarily difficult and there is no need for such.

The only reason that justifies regulation by legislation of an activity or profession is that such legislation is necessary for the public good—and that the proposed legislation will react to the public welfare. (There cannot be any justification for regulation to satisfy the personal desires or advancement of a group or class.)

1. There is no public need for legislation such as the "model bill"—for such legislation would tend to destroy or weaken by confusion the confidence which the public now has in a CPA standard which has been established by training and experience resulting in technical qualifications to a proven degree that the public can and does rely on.

2. There can be no public good or service by legislation that creates a new status among accountants who receive from the *state* a certificate that "such class is qualified as public accountants" without any evidence whatever that they are so qualified.

Suppose a man who could not pass the bar as a lawyer or who wasn't willing to try could receive by legislation from the state a status of "legal expert" *without* examination merely because he said he was a "legal expert."

The people seeking this type legislation say "let us in without examination as PAs because we hold ourselves out as such, but when we are in, make everyone else prove that they are experts by an examination."

Wherein does the public interest lie? Not in the private relationship between the accountant and the one who employs him. *But* a bill which would have the state certify as qualified a public accountant who has not by any test or measure shown such qualification, misleads the public and destroys or weakens a recognized proven type of certification, *that of CPA.*

There is no public demand for any such legislation because of any abuses or existing conditions, nor is there any clamor for a greater number of certified public accountants because of need.

The examination for public accountants would either be the same as the one for certified public accountants, in which case there is a useless duplication, *or* it would be a different one with lower standards which would in the future (after it had initially admitted a large group without examinations) permit men in great numbers to become public accountants and confuse the public as to the distinction between *public accountants* and *certified public accountants*, or perhaps there would come the attempt to then have all admitted as *certified public accountants.*

The uniformity of standards created by certified public accountants is of great importance to the public in the certification of all statements of every kind, for they are certified to be true and accurate according to "commonly accepted accounting practices." It is by virtue of CPA status that the public can be assured that the accountant is learned in *accepted accounting practices*. Substitution of state examinations and certificates can only weaken such certification.

From the analysis of the effects of such proposed legislation it can be logically concluded that the true objective of it is not the *public good or interest*, but the personal desires of those seeking to obtain an advantage through the back door, to attain by legislation that which they failed to attain either because of lack of ability to pass requirements or because they have been unwilling to try.

Legislators are told that the accountants who sponsor the legislation do so because they are prevented from becoming certified public accountants by a monopoly (jealously guarded and discriminatory in its operation); that the bill will give an opportunity to this class of persons who are qualified but never can become certified public accountants because of the monopoly. Of course it would give them an opportunity; it would do more—it would create for them a false, fictitious, and improper status which they never earned.

Now these very noncertified men are permitted to do everything a certified public accountant can in accounting except certify as a certified public accountant—and that certification of a certified public accountant indicates that he has voluntarily submitted to a searching examination and passed to the satisfaction of the state—the stamp of approval for the public—that what he has received is earned, valid, and proven. Yes, I suppose the field of certified public accounting *is* a monopoly in the same sense that the profession of law or medicine is—in that it sets up a minimum standard to be met without which a man may not practice as a certified public accountant.

"Look at the small number percentagewise that pass the CPA examination," some say in an effort to show it is a monopoly. Now let us analyze that:

1. The growth of the profession of certified public accountancy in the U.S.A. over about a 28-year period is 57 per cent as compared to 20 per cent for doctors, 50 per cent for lawyers.

2. The percentage of those who do not pass include persons who have passed some part and retake others in some of the four parts; so that were we to take fifty persons and determine the percentage of those who eventually pass, it would be much higher than the percentage of those who pass in toto a given examination.

3. In the first instance the educational requirements have been low (a high-school education in Massachusetts), and as compared with the educational requirements for law and medicine (college), candidates for CPA are not expected to come as well prepared. Now more and more aspirants are obtaining a college education first, or at least some basic training.

But, at any rate, men in the profession of accounting and those coming in, preparing diligently and faithfully and with sacrifice—many of them attending college first—do not want the standards lowered or requirements waived.

They want the standards kept—and they are willing to meet the standards. These men are coming into the profession in greater numbers, willing to meet all the standards required. The law and medicine have, and still are, requiring higher standards. Accounting has no right to allow, even by indirect action, a lowering either of standards or public confidence in the status of certified public accounting.

To face the issue and meet the challenge it became necessary to analyze the problem not only as to the subject matter of the various bills, but also as to the procedure by which these men seek the legislation they say is necessary, and so our attention is directed to that branch of the government in which the proponents of the bills seek legislation to accomplish their purpose.

It must be remembered that the members of the legislation are a cross section of the citizens of the state—farmers, lawyers, businessmen of all types and from every walk of life; they are from the country where there are few CPAs, and from the city where there are many; they are men of high training, as well as men of minimum education. They are called upon each year to pass upon many hundreds of bills, covering many different subjects. No one can reasonably expect them to be expert on them all, or to be well enough informed in the subject matter to make judgment without relying on information furnished them.

Assume, for the moment, that a group of men sought to have the model bill, or some of the varied forms of accounting bill, passed.

The arguments presented:

1. That such a bill was necessary because it would create a responsibility on the part of the accountants to the public and create a standard they would have to observe.

2. That the CPAs had set up a monopoly that prevented many good men from getting a certificate they deserve.

3. That it wouldn't do any harm to let the present group in and everyone in the future would be held to one standard.

4. That the state should have some say in approving accountants and instead it is being controlled by the national set-up as to examinations and policy.

The legislators, not being informed on the subject, and not having the time or opportunity to delve into it on their own, unless they were given the objections to such legislation, would not observe any glaring or fundamental harm that would result.

The groups proposing the legislation have had ample opportunity in approaching the members even before the bills are filed. They have presented in personal form their cause well colored, and perhaps created the original sympathetic impression, in setting themselves as the underdog—the abused seeking relief from the monopolist, from the big man. That group is in the category of those who would have closer association and personal acquaintance with more of the legislators than would CPAs.

Much legislation has been passed because legislators *felt*

1. They were curing an unfair condition.
2. That such legislation would harm nobody but would please a great many people who were their friends and constituents.
3. That it would be popular.

But—legislators as a whole are fair and do their work with its responsibilities well. They would not be human, however, if they were not susceptible to the desire to seek to combine that which is right with that which meets the widest approval.

It depends, in great measure, upon how the opposition to such bills is organized, and presented, as to the success or failure of those seeking passage.

The knowledge has come to those who must deal with the legislature each year that if you have a cause to present, it is most effectively done through the grass roots rather than depending entirely in advance upon the halls of the legislature.

The legislators will have received a knowledge of the problems involved in such bills. Their interest will be keener because they receive the knowledge from those to whom they are attentive.

The state is divided into legislative districts, and, while it is true that the committee of certified public accountants charged with the responsibility of handling legislative matters may know but one or two of the legislators, or perhaps even none, they have at their command the entire organization who as certified public accountants represent many individuals or corporations in each of the districts, who have intimate and influential relationship with the legislators. Through them a receptive ear can be had.

It is through this method that groundwork can be laid to dissipate the false concept of the objects of the legislation and a complete presentation of opposition obtained by an interest that has been made personal and intelligent.

The presentation to a committee and legislation is but a climax to this and similar groundwork. The help of the national association is indispensable in the preparation of material and the assistance they render in pointing out the reasons for uniformity and interstate recognition and injury to the state-standing nationally by the passage of legislation, but it is basically a local problem and its legislators so regard it.

We are not without some experience in this accounting legislation in this commonwealth—successful, at least to date, I am happy to say. Here in Massachusetts we had a bill, S 433, which was a "model bill" with such abortions that would make even the most radical member of the National Association of Public Accountants wince.

In its defeat, there was displayed an excellent example of the national society that gave full cooperation and invaluable help, of a state society that put the full force of its power to work with intelligent vigor, and of a legislative counsel whose work was made relatively easy in putting opposition forces to route.

The men who seek legislation to accomplish a change in the law either as to the model or waiver of requirements in some form or in dying class or grandfather legislation should be properly challenged. Such challenge can stop their claims of public need, public demand, monopoly, of need for relief of injustice and lay bare the selfish desire of men whose motives are born in self-aggrandizement rather than in the interest of the public or the profession.

Recent developments in federal taxation

by GEORGE J. SCHOENEMAN

One of the basic objectives of a professional society such as the American Institute of Accountants is to provide opportunity for the discussion of mutual problems and the exchange of ideas for dealing with them. It is my desire to make a small contribution to that end by telling something about the specific and immediate problems that we in the Bureau of Internal Revenue have had to face during recent weeks, and how we are trying to deal with them.

In a very real sense, many of the problems of the Internal Revenue Service are also problems of the members of the American Institute of Accountants. All of us desire to have the internal revenue laws interpreted clearly and equitably, and applied uniformly to all taxpayers who are in like circumstances. You serve your client by making certain that his books of account are accurate, that they reflect his tax liability correctly, and that the revenue statutes are applied properly in the computation of that tax liability. When accountants perform these functions for their clients, they are at the same time serving the interests of their government. The more of the client's tax problems the accountant can resolve adequately and correctly before he files his returns, the lighter is the enforcement job of the Bureau of Internal Revenue. Conversely, if clear and logical regulations are issued as Treasury Decisions, if our interpretative rulings are uniformly consistent, and if the return forms and instructions to taxpayers are simple and explicit, the easier it is for the accountant to advise his clients and help them to keep their houses in order taxwise.

GEORGE J. SCHOENEMAN has been Commissioner of Internal Revenue since 1947. In 1945 he had been appointed Administrative Assistant to the President, and later was advanced to Special Executive Assistant.

The subject assigned to me is "Recent Developments in Federal Taxation." I shall place emphasis on an aspect that has been of particular concern to me during the last few weeks—namely, administrative developments in response to current new tax legislation.

To be more specific, I wish to tell about some of the steps we are taking and adjustments we are making to activate HR 6000 (the Social Security Tax Amendments of 1950) and HR 8920 (the Revenue Act of 1950).

The new Social Security Act, signed by the President on August 28, will bring approximately 10 million additional persons under the coverage of the Social Security system. The classes of newly covered employees include household workers, agricultural workers, self-employed persons, employees of nonprofit organizations, governmental employees not covered by some form of group insurance outside of Social Security, and workers in Puerto Rico and the Virgin Islands. The immediate problem in the application of the tax to these groups of workers is the more difficult because there is no background of experience in the administration of employment taxes in this area.

The more important responsibilities of the Bureau of Internal Revenue under the tax provisions of the new Social Security Act are these:

(a) Interpret the statute by promulgating regulations and issuing rulings in response to inquiries from interested citizens—both employers and employees—in regard to their obligations and rights;

(b) Build up and maintain classified registers of the employers becoming subject to Social Security tax for the first time under the new law;

(c) Distribute quarterly the necessary return blanks to approximately 2,500,000 employers;
(d) Receive and process the returns and account for the taxes voluntarily reported;
(e) Obtain the return and enforce the collection in the case of delinquent taxpayers;
(f) Forward the wage reports submitted as a part of the returns to the Social Security administration for its use in compiling the wage records of individual employees; and
(g) In full cooperation with the Federal Security Agency but without duplicating effort in any way, engage in a comprehensive educational program to acquaint the new taxpayers with their obligations, and to inform taxpayers previously subject to Social Security tax of changes in their tax obligations resulting from the enactment of HR 6000.

It is evident that the performance of these functions will entail a vast amount of work. More particularly, it requires considerable planning that must be done before field operations can be started. To illustrate, let me refer to the problems of developing suitable return forms and establishing specific reporting requirements for the employers of these several classes of newly covered employees.

1. *Household workers.* We are drafting a special form to be filed quarterly by housewives and other employers of regular domestic workers. This form will be just as short and simple as we are able to make it. The first returns will not be due until April 30, 1951, but the tax becomes effective the first of next year. Accordingly, detailed instructions must be prepared and placed in the hands of housewives before January 1. If the head of the household is also a businessman-employer, he will be allowed to add his household employees to the regular return covering his business employees.

2. *Farm workers.* Only regularly employed farm workers—that is, persons fully employed for at least two consecutive quarters—are covered by the new Act. We have tentatively concluded that the forms now used by business employers (Form 941) will also serve for the returns of farmer employers. Our policy is never to have two return forms if one can be made to serve adequately.

3. *Self-employed persons.* The first payment by these newly covered persons will not be due until March 15, 1952. The special Social Security tax on self-employed will be reported and collected annually, not quarterly. Reporting for this purpose will be on the regular income-tax return, and no additional form will be required. A single dual-purpose return represents an important contribution to simplified tax administration, and I wish to refer to it again a little later.

4. *Employees of governmental agencies and nonprofit organizations.* The provisions of the new Act relating to these classes of employees are so complex that I am going to detour around a discussion of the problems they entail. In passing by, however, it may be noted that we do not anticipate any serious difficulties with the form of the return. Instead, our largest initial job will be to make proper application of the statutory provisions to employee groups reflecting a wide variety of specific employment circumstances. Mass treatment of the problems presented by these classes of employees is not feasible, since nearly every employee group will manifest unique features, and thus must be accorded individual attention.

5. *Employees in Puerto Rico and the Virgin Islands.* Our plans for applying the provisions of the new Act to these insular workers have not been completed as yet, and I shall not hazard any anticipatory discussion of them.

A few moments ago I referred to the matter of a single combined return to be used by persons reporting self-employment income, rather than one return of income tax and a separate return of Social Security tax. This may seem a rather small issue, but actually it involves a number of important and intricate questions, both legal and administrative. As an example: if each tax is subject to a separate and distinct type of collection procedure, then the use of two separate return forms is virtually inevitable. Under such a system, changes in the income or deductions affecting both taxes might result in a deficiency with respect to each tax, yet the procedures for the determination and collection of such deficiencies would be entirely different. Suppose it should be determined by the Internal Revenue Agent that expenses affecting the computation of both taxes are overstated by $1,000. The disallowance of such deductions would result in a maximum self-employment tax deficiency of $22.50 and an income-tax deficiency of $200, assuming the first bracket rate for 1951. If the taxpayer desires to contest this Bureau finding of deficiencies, the remedies available to him under the separate-collection system are substantially different from those under the single-collection system. Under the separate-collection system, his only recourse with respect to the self-employment tax deficiency would have been to pay the tax and sue for refund in the Federal District Court or the United States Court of Claims. He would then have followed the same course with respect to the income-tax deficiency, or he could have adopted the alternative remedy of appeal to the Tax Court of the United States, which is the customary procedure. In the latter event he would not have been required to pay the tax until the Court made a determination as to the amount of the deficiency. It would have been exceedingly difficult to rationalize these separate procedures to an aggrieved taxpayer. Moreover, troublesome legal and administrative problems would have been inevitable if cases involving identical parties, identical issues, and identical facts were litigated in separate forums. In contrast, under the single-return procedure adopted, a single deficiency of $222.50 results in the case described, which the taxpayer can accept or contest under the one set of procedures applicable to income-tax deficiencies; that is, he may pay the entire deficiency and sue for one refund, or he may appeal the entire deficiency to the Tax Court before he pays the deficiency. Also, the settlement procedures of the Bureau (with provisions for independent review inside the Bureau) are applicable to the single deficiency. In view of considerations such as these, you can readily appreciate how gratified we are that the Congress saw fit to make the collection procedures applicable to the income tax also applicable to the self-employment tax, and thus permit the use of the single combined return.

The advantages of the single return from the standpoint of the Bureau's workload are equally impressive. We will have only one half as many returns to process, one half as many remittance items to account for, and one half as many mathematical verifications to make. We will be able to make simultaneous audit adjustments of both types of tax. Also, we anticipate that the inclusion of the self-employment tax computation as a part of the income-tax return will produce better initial compliance and more accurate reporting by the taxpayer.

I have gone into this matter in considerable detail in order to emphasize the point that the seemingly small task of developing return forms actually reflects ramifications that extend into the largest and most difficult aspects of tax administration. It follows that if we do a good job of form drafting, we are well on the way toward efficient and economical administration of the tax.

I must not fail to mention that all of our plans for administering this new Act have been formulated in close consultation with the Social Security Administration. Continuing full cooperation between the two offices is essential for efficient and economical administration, and also to insure adequate service to both taxpayers and social security beneficiaries.

The Revenue Act of 1950

For a second illustration I now turn to the Revenue Act of 1950. This, as you know, is a voluminous measure of 58 sections which extend or revise more than that number of sections of the Internal Revenue Code. It covers the individual and corporate income, the estate and gift, and the excise tax fields.

As accountants, you are of course interested in the many substantive changes in the income-tax laws made by the Revenue Act of 1950. These include a revision of the corporate-rate structure, including the elimination of the so-called "notch" provisions and the application in most cases of identical corporate credits for both the normal tax and the surtax. Under these credit provisions, the great majority of corporations may in the future compute both normal tax and surtax in one operation. However, a special computation of tax, necessary in the case of certain fiscal years beginning before June 30, 1950, is an unavoidable burden during the period of transition to the new rate structure.

The new legislation also restores to the Internal Revenue Code a provision similar to the World War II provision for an accelerated amortization of emergency facilities; it provides special rules which will apply in the case of income from a specifically defined type of stock option; and it revises the existing law in respect to net operating losses to provide for a one-year carry-back and a five-year carry-over of losses sustained after 1949. The new legislation also deals with certain so-called loophole situations, such as those involving collapsible corporations, short sales of property, and amortization in the case of certain tax-exempt bonds and certain convertible bonds.

Another new matter of general interest is an extensive provision dealing with the treatment of income of, and gifts and bequests to, certain tax-exempt organizations. This is noteworthy as being the first major legislation in this field in a great many years.

The Bureau of Internal Revenue is now intensively engaged in preparing rules and regulations under these and the many other new provisions which became law on September 23, 1950. These rules and regulations will be issued as speedily as possible. As any one of these items of legislation would lend itself to a very extended discussion, I cannot at this time treat any one of them in detail.

The feature of this Act that is of greatest interest to the majority of taxpayers, however, is the provision for increased individual income and withholding tax rates.

The bill was passed by both Houses of Congress on September 22, and signed by the President on September 23. It provided that the increased withholding rates should apply to wages paid on and after October 1. Thus, the interval between the signing of the Act and its impact on taxpayers was only one week, or five working days. If we had not done advance planning for the administration of this portion of the bill, obviously it would have been impossible to furnish the public with the necessary materials and instructions by October 1. What we actually did was to anticipate the passage of the bill by a series of steps, some of which involved commitments that might have left us "holding the bag" if the bill had undergone basic revision prior to enactment.

We took a chance—quite literally so—on the withholding tables and rates incorporated in the Senate version of the revenue bill. An advance printing was made of several million copies of the new withholding tables and rates, and accompanying instructions for use by employers. These materials take the form of a little booklet entitled "Supplement to the Employer's Tax Handbook, Circular E." A supply of the Supplement was shipped to each Collector of Internal Revenue, and he preaddressed one copy to each employer in his district. The Collectors were advised to hold the addressed copies until instructions for release were received. Early on the morning of September 25—the Monday following the Saturday on which the Act became law—we issued telegraphic instructions to the Collectors for the release of the revised rates and tables. So our calculated risk paid off, and every employer was furnished with the necessary materials and instructions a few days before the new rates went into effect.

In view of the extremely short time in which to prepare, it will not be easy for some employers to institute the new withholding rates on October 1. Nevertheless, we are confident that employers generally will make every reasonable effort to comply with the provisions of the Act in respect to the new rates. We are trying to make it emphatically clear to everyone—employers and employees alike—that failure on the part of the employer to withhold at the proper rate on wage payments made on or after October 1 does not affect in any manner the responsibility of the employee to meet his full tax liability as required by the Revenue Act of 1950 when he makes his income tax return for the year 1950.

A relatively minor problem arises in connection with persons who have filed declarations of estimated tax for 1950, computed on the basis of the former lower rates. For their benefit and convenience, we intend to make available a revised declaration incorporating increased rates, Form 1040-ES, in order that they may make additional payments on or before January 15 to reflect the increased taxes imposed for the tax year 1950.

The regular individual income-tax returns, Forms 1040A and 1040, will be mailed as usual during December and January. The Form 1040, on which the taxpayer makes his own computation, must reflect the rates prescribed by the new Act. We are confident that this can be accomplished without adding either to the length or the complexity of the computations needed to be made by the taxpayer.

Only the individual who reports on a fiscal-year basis beginning before and ending after September 30, 1950, will be required to make the dual computations necessary to give effect to the different tax rates applicable before and after October 1, 1950. Since only a comparatively few thousand persons report on such basis, this additional computation, although doubtless annoying to the taxpayers, will not present a serious problem in over-all tax administration. For a time we were fearful that it might be necessary for every individual income taxpayer to make such dual computations on his 1950 return. What this would have meant in confusion to some 50 million taxpayers and additional work to the Bureau is better imagined than experienced.

The steps and plans that I have described will—we hope—carry us over the immediate hurdles on the road to effective administration of these two most recent tax Acts. All of you realize, however, that this is only the first mile on a very long road. The end of the road will not be reached for many years, or until such time as every issue involving interpretation of the provisions of these Acts has been resolved, and until every dollar of 1950 taxes owing to the Treasury thereunder has been collected.

This point deserves a further word of explanation. In referring to the Revenue Act of 1950, I have mentioned specifically only the most immediate administrative problems. A host of other problems—no less important, but somewhat less pressing in terms of the calendar—now confront us, and all must somehow be disposed of sooner or later. Likewise, a full complement of administrative problems can be traced back to virtually every one of the other 57 sections of the Act. A ready example is the fact that almost all of our income and estate-tax return forms must be revised to some extent in order that the taxpayer may be able to compute his tax liability correctly under the new provisions of law. The other primary functions—revising the regulations, issuing interpretative rulings, processing the returns and accounting for the receipts, liquidating delinquent accounts, holding conferences with taxpayers and their representatives in respect to disputed issues, and obtaining judicial resolution of interpretative issues that cannot be settled otherwise—all such as these must be handled in due course.

Viewing the Bureau of Internal Revenue as a whole, over 90 per cent of our employees are assigned to the large activities and mass operations, such as distributing and receiving returns, accounting for remittances, maintaining bookkeeping records on over 50 million taxpayers, handling information documents, investigating and auditing tax returns, collecting delinquent accounts, and performing regulatory and inspection work pursuant to the enforcement of the alcohol-tax laws. At the other extreme, only a little over 1 per cent of our total personnel is assigned to interpreting the revenue laws, issuing taxpayer rulings, developing return forms, and doing over-all coordination and advance planning work. These small groups of experts may be regarded as the "shock troops" of the Internal Revenue service. They must receive and absorb the first impact of new tax laws. They must also coordinate the planning work being done under the Bureau's management improvement program, which itself is a subject so large that I must no more than mention it at this time.

There are times when I feel almost overwhelmed by a realization of the size of the entire task that has been entrusted to the Internal Revenue Service, and the weight of responsibility associated with that task. As a generalization, it may be said that the size and complexity of our job increase a little with each new tax law. I point to this simply as a fact of life, but without any implication whatsoever of either criticism or complaint. Speaking only as a citizen and a taxpayer, and not as an economist or a political scientist, it seems to me that it is perhaps inevitable that the growth of our domestic economy, the scale of our new international activities, and the attendant increase in the size of our tax load, should result in persistent pressure for increase in the complexity of our federal taxing system. The effect of any such increase on the nature of the Bureau's job is obvious. In order to meet our responsibilities properly, we have need for the cooperation of every citizen, and particularly of such a skilled professional group as the members of the American Institute of Accountants. It is with profound sincerity that I bespeak your cooperation in the interest of the public welfare. With equal sincerity, I wish to say that I am confident your approach to our mutual problems has been and will continue to be in that spirit of cooperation.

Members of the tax panel

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LESLIE MILLS, CPA, ***New York, Member, Committee on Federal Taxation, American Institute of Accountants***

Questions and ans-

QUESTIONS 1 to 5 are based on the following assumed facts:

Three individuals, A, B, and C, plan to start a manufacturing business. A is to contribute $20,000 in cash. B is to contribute machinery and equipment, which has an adjusted basis of $8,000, and a fair market value of $20,000. C's contribution to the new enterprise is his technical knowledge and a patent having no cost and no proven market value. It is planned that all three men will devote their full time to the new enterprise. They desire to acquire an equal equity in the business and to share profits and losses equally.

1. What factors should be considered in determining whether the enterprise should be organized as a partnership or a corporation?

CHARLES MELVOIN: Factors to be considered in determining choice of entity, whether a partnership or a corporation, may include, amongst others:

(1) The prudent businessman's tests; namely, what are the risks and financial hazards? This is a new venture exploiting an untried patent with no previous market value and may involve obligations that would best be limited by a corporate undertaking. The ages of the individuals involved and their life expectancies might likewise contribute towards the use of the corporate form rather than the partnership.

(2) Tax consequences. Exchanges of assets with varying or no bases to some of the contributors may be deemed taxable, resulting in the immediate recognition of gain, unless subject to the provisions of IRC Section 112(b)(5).

(3) Anticipated level of earnings. Computations should be made of what the tax costs will be under varying levels of anticipated earnings, taking into consideration compensation for personal services. A long-range view of this should be borne in mind,

particularly the trend of rates both as it affects corporations and individuals.

(4) The outside income of the individuals. The business may operate initially at a loss. If the individuals have other personal income, this loss can be availed of forthwith in a partnership venture. If incorporated, however, such a net loss carry-over may never be realized in the event of liquidation, etc.

(5) The presence or possibility of wholly tax-exempt or partially tax-exempt interest, dividends from domestic corporations, or capital gains. In a corporation income of the foregoing, types lose all identity when distributed in the form of dividends to shareholders, but in a partnership the identity continues into the hands of the individual owners. The venture may prove very profitable and investments involving the foregoing types of income may be made and the tax effect should be taken into account.

(6) Transferability of interests. The ease with which corporate shares can be alienated, whether by gift, by assignment, or through death or operation of law, without affecting the life of the corporation, is of course well known and should receive consideration.

(7) The family marital status. The split income provisions in cases of married persons would favor the partnership form.

(8) Future sales of the business. If the patent without a cost base should prove valuable so that prospective buyers are intrigued, the ownership of the patent by a corporation may make the sale difficult, involving as it would possible double taxation, and moreover would leave a corporate purchaser of the securities with an unchanged base, except under certain conditions not involving liquidations pursuant to 112(b)(6). However, ownership in a partnership would be more attractive to a purchaser, who could thereupon obtain a new base.

(9) Equality of proprietary interests. Notwithstanding unequal contributions, a partnership being a flexible creature, permits equal participation in the profits as well as in the capital, whereas in a corporation that is a rather cumbersome vehicle and might involve, as indicated previously, immediate tax results.

(10) The matter of reasonableness of compensation and dividend policies are always of tax concern to a corporation. These are avoided in a partnership enterprise.

2. *Assuming that they decide to organize a partnership, how can the capital investment of each be equalized and what income-tax or gift-tax problems are involved?*

LESLIE MILLS: The partnership is a legal concept only partially recognized for tax purposes. But since the relations between the partners is entirely a matter of agreement between them, their agreement will control the tax impact of the partnership transactions so long as it does not impute one party's income to another.

On the facts stated, proper accounting for the partners will result in recording the asset contributed by each at $20,000 and crediting the capital account of each with the same amount. While this will mean that each has an equal share in the partnership assets, I do not consider that any gift-tax problem is involved since on the presumption of arm's-length dealing, each party's contribution in property and services is of equal value. The circumstances of the agreement imply a $20,000 value for the patent contributed by C.

However an attempt to provide complete equalization of equity presents problems. The tax rules are that no gain or loss is recognized to the partners in their transfers to the partnership, and the basis for gain or loss or depreciation is that to the transferors. Thus, under the specific circumstances the partnership will have to depreciate and amortize machinery and patent respectively at $20,000 each, while the tax deductions for such depreciation and amortization will be computed on

$8,000 and zero respectively. Equalization of the partners' interests would require charging to the contributing partner's share of profits the write-offs not available for tax purposes. A similar provision would be necessary to provide allocation to the contributing partner of a realized gain on disposition of property representing unrealized appreciation up to the time of transfer to the partnership. The regulations provide in general for such treatment, but, since the partnership agreement will control, I believe it better to spell out the desires of the parties in the agreement. Thus, in the specific case, I would provide that the partnership accounting be based on values at organization, and that additional taxes resulting from partnership costs and expenses not deductible should be charged to the profits of the partner who contributed the asset which is involved in the disallowance.

3. ***Assume that the business has been successful and A agrees to sell his interest in the partnership to B and C at a price in excess of his cost. What are the tax consequences to A? Is the basis of the assets of the partnership increased?***

ROBERT CALDWELL: Under GCM 26,379 issued in May of this year the Bureau has revoked its former ruling and now holds that the sale of a partnership interest is a sale of a capital asset. The ruling goes on to say, however, that payments made to a retiring partner which represent his distributive share of earnings for past services should be treated as ordinary income rather than as proceeds derived from the sale of his interest.

A has agreed to sell his interest in the partnership at a price in excess of his cost and he, therefore, has a capital gain, with his holding period dating back to the time of the acquisition of his original interest in the partnership. His cost basis would include his $20,000 original investment plus the balance of earnings credited to his account and upon which he has been taxed and his distributive share of earnings for the current accounting period to the date when his interest terminates. In accordance with GCM 26,379, this latter amount would not escape taxation as ordinary income even though payment for A's final distributive share of partnership net income might be included in his selling price.

In a recent case decided by the 7th Circuit, *Max Swiren* v. *Commissioner*, 1950 CCH paragraph 9384—July 14, 1950, it was held that the excess of the selling price of his interest by Swiren, a member of a law firm (reporting on a cash basis), over his cost basis was all capital gain, despite the Commissioner's allegation and a Tax Court decision that a portion of the selling price represented untaxed income in the form of unbilled and uncollected fees. In the year of sale Swiren reported as ordinary income profit distributions actually received in cash, which apparently represented the total of his distributable share.

The basis of the assets of the partnership is not disturbed by the sale, but B and C have an increase in their separate respective bases for their partnership interests to the extent of their payments to A. (Robert E. Ford 6 TC 499).

4. ***Assuming that they decide to organize a corporation but B and C do not want to have any taxable gain recognized on the transfers to the corporation, how can the incorporation be accomplished as a tax-free exchange under Section 112(b) (5)?***

H. CECIL KILPATRICK: In order to qualify as a nontaxable transaction, it is necessary, among other things, that:

(a) The exchange be an exchange of "property" for stock;
(b) The transferors of property must be in control (i.e., owning 80 per cent or more) of the corporation immediately after the exchange;
(c) The stock received by each of such controlling stockholders must be substantially in proportion to his interest in the corporate property prior to the exchange.

A's cash,[1] B's machinery and equipment, and C's patent all constitute "property," and these three together are in control, so

[1] *Halliburton* v. *Comm.*, 78 F. (2d) 265; GCM 24415, 1945 CB 219.

the first two tests are met. Is the stock of each substantially in proportion to his interest in the property prior to exchange? The test is the relative value of contributed property as compared with the relative value of the stock received.[2] If C's patent has no value, the test is not met, and both B and C would be taxable on the exchange, because C's services, for which the stock is really being issued, do not qualify as "property" under Section 112(b) (5),[3] and A and B, who exchanged property for two-thirds of the stock would not have the required 80 per cent control.

However, our hypothetical case is one of no "proven" market value. If C's technical knowledge (services) were not a factor, and A and B, dealing with C at arm's length, were each willing to put in $20,000 of property against C's patent, each to get a third of the stock, this would be the best evidence that the patent was worth $20,000 —and the transaction would qualify as nontaxable. The burden would be upon the taxpayers, of course, to establish that C's stock was given him solely for the patent, and that there was no understanding that C would be obligated to contribute services as part of the consideration.

5. *Assume that the corporation has been very successful and has a favorable financial position. A dies and his estate desires to sell his stock. Can B and C finance the purchase with corporate funds? Would it be preferable to have the corporation purchase or redeem A's stock?*

JOHN C. MESSERSMITH: The question here presented is the somewhat familiar one of troubles encountered upon the death of a holder of a substantial proportion of the capital stock of a closely-held corporation. It is assumed for the purpose of this discussion that the surviving shareholders would be unwilling to have the shares held by the decedent's estate sold to an outsider, and, consequently, the retirement of A's estate from participation in the business must inevitably result in a partial liquidation or contraction of the enterprise in that there has been a diminution of working capital or net assets. These circumstances usually present problems of varying aspects—business economics, legal, and income taxes, but we will confine ourselves here to those relating to income taxes. Presumably, the corporation's cash position is adequate and there would be no difficulties as to the source of funds used to retire the stock (in most jurisdictions a corporation may properly acquire its stock only out of surplus).

If the surviving shareholders were to purchase A's stock with corporate funds, the funds could be obtained in two ways, either in the form of loans or as dividends. If the funds were received as dividends, the "tax bite" under present high tax rates would be so great as to require dividends in an amount substantially in excess of the purchase price of the stock, with a resultant materially greater diminution of corporate net assets. Borrowing of the funds from the corporation would not result in any immediate tax problems to the share holders (assuming that the loans would not be construed as dividends in disguise) but the shareholders could repay the loans only out of taxable income, i.e., dividends or compensation for services (it is assumed that they have no outside capital or income), and here, too, the tax bite would result in a siphoning-off of corporate funds into the coffers of the United States Treasury. The regulations pertaining to the surtax under Section 102 mention as evidence of the purpose of preventing the imposition of surtax on the shareholders withdrawals by the shareholders as personal loans or the expenditure of corporate funds for the personal benefit of the shareholders; consequently, prompt repayment of the loans would seem to be highly advisable if the danger of an attack under Section 102 is to be avoided. A possible method of liquidating the loans would be for the remaining shareholders to sell their newly acquired stock to the corporation; however, in at least one case, the resale of the stock to the corporation was held to result in a dividend (*Lowenthal* v. *Commissioner*, 169 F. (2d) 694, CCA 7, 1948).

Redemption or purchase by the corpo-

[2] *Bodell* v. *Comm.*, 154 F. (2d) 407; C. S. Eaton, 37 BTA 715.
[3] *Columbia Oil & Gas Co.*, 41 BTA 38, *aff'd.* 118 F. (2d) 459; *Record Petroleum Co.*, 32 BTA 1270; *Schwieg, Hungate & Katsian*, 27 BTA 337.

ration of A's stock would at least avoid the pitfalls of excessive taxes previously commented on which would result if the surviving shareholders purchased the stock with corporate funds, although all would not necessarily appear to be clear sailing. The cancellation or redemption of all of a retiring shareholder's stock by the corporation ordinarily is a partial liquidation under Section 115(c), resulting in capital gain or loss to the vendor. The danger of assertion of a taxable dividend under Section 115(g) does not appear to be present in view of the statement in Section 29.115-9 of Regulations 111: "On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder so that a shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." While the regulation speaks of cancellation or redemption of the stock, it appears to be well settled that sale of stock would be covered by the same protective shield.

It appears reasonably sure that sale or redemption would result in no taxes other than the capital-gains tax to the retiring shareholder. As a matter of fact, if the stock held by A's estate were purchased or redeemed by the corporation within a reasonable period after the date of death, the redemption or purchase price would probably be considered to be the value for estate tax purposes and there would be no taxable gain on the sale or redemption. However, when the corporation purchases or redeems the stock, does it thereby become more vulnerable to possible attack under Section 102? Presumably, the corporation has accumulated substantial earnings and profits and it might be argued that no corporate purpose is served by the retirement of the stock and, hence, that the earnings must have been "permitted to accumulate beyond the reasonable needs of the business." In the case of *W. H. Gunlocke Chair Company*, 145 F. (2d) 791 (CCA 2, 1944), affirming Memorandum Tax Court Decision Docket No. 109,983, entered October 4, 1943, the Commissioner pointed to purchase and retirement of the corporation's preferred and common stocks as one of the evidences of unreasonable accumulations. There is no evidence in the record that the purchase and retirement of the stock was a fatal or decisive factor but the case does seem to indicate the danger of attack if other unfavorable (from a Section 102 standpoint) factors are also present. In this connection, it is interesting to note that Congress has apparently recognized the need of relief where stock is redeemed to pay death taxes; Section 210 of the Revenue Bill of 1950 (H R 8920) amends Section 115(g) of the Code to exempt from treatment as ordinary dividends amounts distributed in redemption of stock not in excess of the taxes imposed because of decedent's death. Whether this amendment will have an ameliorating effect on the Commissioner's position, expressed in the *Gunlocke* case, that redemption of its capital stock implies unreasonable accumulation of surplus remains to be seen.

It seems clear, therefore, that the purchase or redemption of A's stock by the corporation appears to be highly preferable over the purchase of the stock by B and C, financed with corporate funds.

6. *May the common shareholders (no other class of stock outstanding) cause the corporation to issue preferred stock pro rata, either as a dividend or in recapitalization, in order to permit the shareholders by means of a sale to realize in the form of capital gain the earned surplus reflected in the preferred stock?*

KENNETH W. BERGEN: The practical answer to this question is no. This answer is largely due to the policy of the Treasury Department formulated since the *Bazely-Adams* decision[1] of the United States Supreme Court. In that case, it was held that debentures issued pro rata to shareholders in a recapitalization should be taxed as dividends because the recapitalization had the effect of a dividend distribution of the debentures.

Now no ruling or closing agreement will be issued if there is a present intention on the part of the common shareholders to sell or redeem their preferred stock received by way of a dividend or recapital-

[1] 331 US 737 (1947).

ization.[2] If there is no such intention, in general, a favorable ruling or closing agreement will be granted if the request for the ruling or closing agreement negatives such an intention.

The fact that the Treasury Department will not issue rulings or closing agreements where there is a present intention to sell preferred stock is a storm signal which cannot be ignored by taxpayers or their advisers. It is an indication that the Treasury Department may attack the receipt of the preferred stock as a taxable dividend. If such an attack is made, there is no certainty how the litigation will ultimately be decided. It would not be at all surprising to find the Treasury Department and a court holding the selling shareholder the recipient of ordinary income in the case of a preconceived plan to issue preferred stock either by way of dividend or recapitalization to be sold by the controlling shareholder and redeemed by the corporation shortly after the sale. Such a transaction is in effect a cash distribution disguised as a preferred stock dividend or recapitalization and should not be permitted capital gain treatment.

If the Bureau should take this type of case through the courts and win, the next step conceivably might be to attack all preferred stock dividends and recapitalizations whether or not the preferred stock had been sold or redeemed. It is possible that the Supreme Court would overrule the *Sprouse-Strassburger* decision holding nontaxable a preferred stock dividend on common where only common was outstanding.[3] However, the present view of the Bureau appears to be that a preferred stock dividend, or recapitalization with a business purpose, is nontaxable unless there is an intention to dispose of the preferred stock.

Because of the uncertainties in this field and the large potential tax liability if the preferred stock should be held a dividend, it would seem advisable to obtain Bureau approval through a ruling or closing agreement before attempting a preferred stock dividend or recapitalization. As no ruling or closing agreement can be obtained on the facts stated in this question, the answer has as a practical matter been in the negative, although if the question were taken to court the answer might be in the affirmative.

There is one possible exception to the above statement. It is understood that a ruling or closing agreement can be obtained if the purpose of the preferred stock dividend or recapitalization is to provide the shareholders with a source out of which their estates can pay death taxes. This is particularly important in view of Section 210 of the Revenue Act of 1950 which permits a redemption of stock for the purpose of paying death taxes without the proceeds being treated as taxable dividends under Section 115(g) of the Internal Revenue Code. A person with a large estate whose chief asset consists of stock in a closely-held company now has a means of meeting his death taxes without having his family lose control of the company.

It is also to be observed that, although there may be no present intention of a stockholder to sell or redeem his preferred stock, circumstances subsequent to the issuance of the preferred stock might alter the intention so that a sale or redemption would be possible. In the case of such a sale or redemption, the stockholder should be prepared to answer a charge of fraud or misrepresentation on the part of the government, particularly if the sale or redemption occurs soon after the original transaction.

7. *Where a corporation is to be liquidated, may its assets be sold without the resulting profit being taxed to the corporation? In other words, can corporate assets received as a liquidating dividend be sold by shareholders without liability for a tax on the corporation as well as the stockholders?*

Walter A. Cooper: The answer clearly is "Yes," particularly in view of the recent

[2] Under the present Treasury policy, no distinction is being made between preferred stock dividends and preferred stock recapitalization, except for the business-purpose requirement in the case of recapitalization, as there is no essential difference in the result accomplished.

[3] 318 US 604 (1943). For discussions on the arguments pro and con as to whether preferred stock dividends and recapitalizations should be taxable at ordinary income rates, see Darrell, "Recent Developments in Nontaxable Reorganizations and Stock Dividends," 61 *Harvard Law Review*, 958; DeWind, "Preferred Stock 'Bail-outs' and the Income Tax," 62 *Harvard Law Review*, 1126; Tarleau, "Corporate Recapitalizations as Affected by the *Bazely-Adams* case, 6th Annual Institute on Federal Taxation, New York University, 266.

decision of the Supreme Court in *Cumberland Public Service Co.*[1] In that case the taxpayer, a closely-held corporation, was long engaged in the business of generating and distributing electric power. In 1936 a local cooperative began to distribute TVA power in the area served by the taxpayer. It soon became clear that the taxpayer utilizing Diesel-generated power could not compete with TVA power. The stockholders of the taxpayer thereupon offered to sell all their stock to the cooperative. The cooperative refused to buy the stock but countered with an offer to buy from the taxpayer corporation its transmission and distribution equipment. This counteroffer was rejected because of the capital-gains tax which the taxpayer corporation would have to pay on the resulting profit.

In order to avoid the corporate capital-gains tax, the stockholders orally agreed with the cooperative that they would acquire the transmission and distribution equipment and would then sell such equipment to the cooperative. Following this, the taxpayer corporation distributed the transmission and distribution systems to its stockholders in partial liquidation. The remaining assets were sold and the taxpayer corporation dissolved. Upon receipt of the transmission and distribution systems the stockholders consummated the contemplated sale to the cooperative.

The Commissioner contended that the shareholders had been used as a mere conduit for effectuating what was really a corporate sale and on this theory assessed the taxpayer corporation with a tax on the sale. The Court of Claims found that the method by which the stockholders disposed of the properties was avowedly chosen in order to reduce taxes, but that the liquidation and dissolution genuinely ended the corporation's activities and existence. The court also found that at no time did the corporation plan to make the sale itself. On the basis of these findings the conclusion was reached that the sale was made by the stockholders and not by the corporation.

In sustaining the decision of the Court of Claims, the Supreme Court laid down the following rules:

(1) A corporation may liquidate or dissolve without subjecting itself to the corporate capital gains tax, even though a primary motive is to avoid the burden of corporate taxation;

(2) Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidating distribution cannot be attributed to the corporation for tax purposes;

(3) It is for the Trial Court to determine factually whether the sale was made by the shareholders or by the corporation and once such factual determination has been made it should not be disturbed if adequately supported by the evidence.

The opinion in the *Cumberland Public Service Co.* case indicates that the factual question in cases of this kind is to be resolved on the basis of whether or not there was a corporate agreement to sell prior to a genuine liquidating distribution. This, in turn, gives rise to the question of when and under what circumstances a liquidating distribution will be regarded as genuine and prior negotiations for sale are to be attributed to the corporation.

From a careful analysis of the Supreme Court's opinion in the *Cumberland Public Service Co.* case, it would seem reasonable to conclude that the sale will be attributed to the stockholders only where (1) no negotiations for the sale of the corporate assets by the corporation were carried on prior to the distribution in liquidation, or (2) if there were negotiations prior to the liquidation, they were carried on by the stockholders on their own behalf with the express understanding that the sale was not to be consummated until after completion of the liquidation. Conversely, it would seem clear that a liquidating distribution will not be regarded as genuine where the corporation or its representatives as such negotiated for the sale of its assets, particularly where an agreement had been reached and then in order to avoid the corporate capital-gains tax the assets were distributed to the stockholders, who thereupon consummated the sale to the same persons who had negotiated with the corporation.

[1] 338 US 451, 70 S. Ct. 480.

Despite the *Cumberland Public Service Co.* case, the Commissioner continues to litigate this issue. In one case, decided on May 15, 1950, the Commissioner contended that the sale was made by the corporation and not the stockholders, and on the authority of the *Court Holding Co.* decision[2] claimed that the corporation should pay the capital gains tax.

In rejecting this contention the Tax Court found as a fact that the sale by the stockholders was not consummated or even agreed upon until sometime after dissolution of the corporation and receipt of its assets. By way of dictum the court stated that even if it could be found that the stockholders discussed and had decided upon the sale but on the advice of tax counsel had decided to defer the actual sale until after dissolution, such facts would be no more favorable to the Commissioner than were those in the *Cumberland Public Service Co.* case.

In a second case decided by the Tax Court on January 29, 1950, which also was subsequent to the Supreme Court's decision in the *Cumberland Public Service Co.* case, the corporation distributed in liquidation to its stockholders shares of stock in another corporation which at the time were pledged with creditors of the liquidating corporation. Shortly thereafter the stockholders sold these shares to one of the creditors and the proceeds of sale were applied in payment of the loans for which the shares were held as security.

Claiming that the transaction was born of a preconceived plan for the avoidance of taxes, hastily executed and devoid of any business purpose, the Commissioner urged the Tax Court to find that the corporation was actually the seller and not the stockholders. In refusing to so find, the Tax Court referred to the *Cumberland Public Service Co.* case, in which the Supreme Court said: "Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."

Turning to the real factual question in the case, the Tax Court found no evidence that the corporation prior to dissolution entered into any negotiations for the sale of its assets or that any negotiations were carried on by the stockholders prior to the commencement of liquidation, which might be construed as indirect negotiations by the corporation. On the basis of these two findings the court concluded that the sale was made by the stockholders following a genuine distribution in liquidation.

In a third case, decided on January 26, 1950, also subsequent to the *Cumberland Public Service Co.* decision, the Tax Court found that the sale had been made by the stockholders and not the corporation, and in so finding made two factual determinations: (1) While the corporation had carried on some negotiations with individuals who had indicated a desire to buy, it had received no satisfactory offers prior to the date on which action was taken to dissolve, and after adoption of the resolution to dissolve the corporation refrained from making any effort to sell; (2) While the stockholders conducted negotiations with the individuals with whom the corporation had been in touch, they received no offers and finally the sale was made to a buyer with whom negotiations had not been initiated until after action had been taken to dissolve.

In one other case antedating the *Cumberland Public Service Co.* case, the decision went against the taxpayer on appeal of the Commissioner to the Tenth Circuit Court of Appeals. However, in that case the evidence established that prior to the liquidation an agreement for the sale of the complete assets had been entered into between the buyer and the corporation by its president.

It is interesting to note that since the *Cumberland Public Service Co.* case the Commissioner has announced its acquiescence in two decisions of the Tax Court, each of which held that a sale of assets could not be attributed to the liquidated corporation where the stockholders sold all their shares to a purchaser who, desiring the assets, forthwith liquidated the corporation.

The important lesson to learn from these decisions is that the time to think about

[2] 324 US 331.

tax consequences is when the idea of selling out is first seriously considered. It is not easy to differentiate between John Jones as principal stockholder of X corporation and as president of that corporation. In normal business practice it would make no difference, but taxwise it is another story. Clearly he can liquidate his corporation and then sell the assets so received without corporate tax consequences, but it must be clear from the start that in negotiating the sale of the corporate assets he is acting as the stockholder who is going to take over, on liquidation of the corporation—and that he is not acting as an officer of and on behalf of the corporation.

8. *A stockholder realizes a long-term capital gain (or loss) on the complete liquidation of a corporation. In a subsequent year he pays his pro rata share of a deficiency in federal income taxes asserted against the dissolved corporation. How should this be treated by the stockholder for federal income tax purposes?*

STANLEY E. SURREY: This issue is at present working its way through the Tax Court to Circuit Court rulings. Moreover, since it is an area where one taxpayer's victory may be another taxpayer's defeat, an additional factor of uncertainty is present. The Tax Court seems fairly well committed to the proposition that the deficiency paid by the stockholder cannot be applied to reduce the gain previously taxed on the liquidation. *Pitman* v. *Commissioner*, 14 TC 449 (1950) so held, defeating the taxpayer's request, and *Switlik* v. *Commissioner*, 13 TC 121 (1949) (NA, on appeal) so asserts. A dictum in *Wurtsbaugh* v. *Commissioner*, 13 TC 1059 (1949) is to the contrary.

Usually, the liability is so contingent and in fact may even be unknown, that it cannot at the time of the liquidation enter into the stockholder's basis as an indebtedness assumed and thereby reduce his gain. Any tax later paid is therefore not a debt expressly assumed but a loss arising in connection with a transaction entered into for profit. The result is to treat the tax payment as a deductible loss in the year of payment. Ordinarily, the taxpayer will favor this, but he may not have income to offset the loss and would then prefer a reduction of the capital gain on liquidation.

At this point, another uncertainty enters —is the loss a capital loss or an ordinary loss? The *Switlik* case upheld the taxpayer's claim of an ordinary loss, and rejected the Commissioner's argument that since the gain on the liquidation was a capital gain, and since there was a direct connection between such gain and the subsequent loss, the loss should likewise be capital in nature. It would appear that this ordinary loss result follows from the initial decision not to so relate the payment to the liquidation as to warrant a recomputation of the gain or loss on liquidation.

In the rare case where the deficiency is sufficiently crystallized as to warrant regarding the taxpayer as having expressly assumed such debt, its amount would be added to his cost of the stock and thus reduce his gain on liquidation. Later payment of the deficiency would therefore not result in any deduction.

9. *How does a corporate taxpayer determine what constitutes a reasonable salary to be paid to officers who may or may not be stockholders as well?*

HARRY D. HOPSON: The determination of a reasonable salary for an officer that is neither a stockholder nor a relative of a stockholder is usually made with consideration of factors other than the question of whether the Treasury Department will approve a deduction. There are cases where a salary to such an officer may be challenged as to deductibility but in actual practice it is usually assumed that the board of directors would pay him no more than is ordinary and necessary.

When there is a motive for directors to pay as much as possible and yet obtain income-tax deduction for the full amount the problem begins. The decision as to the proper amount of salary may be made with good faith as to reasonableness but yet be subject to critical questioning by the Treasury Department.

A reasonable salary may be determined only by comparisons, preferably with salaries paid to those other than stockholders of corporations. Competitors records are usually unobtainable but some information or indications regarding salaries may be gathered in personal discussions and from trade associations. I understand that the National Industrial Conference Board has issued a booklet on executive compensation. Comparisons may be made with other salaries paid in the same organization to non-stockholders.

A pertinent comparison can be made with salaries paid for the same position in prior years. In practice, many of the proposed disallowances are due to increases over salaries paid previously. Proposed increases should be justified by changes in the facts.

The published opinions of the courts in cases involving reasonableness of salaries are of some value in making comparisons, although the decisions often seem to conflict.

Some of the factors governing reasonableness are:

Size of the business
Profits under normal conditions
Working conditions
Economic conditions
Availability of others for the job
Other employee benefits
Personal qualifications of the officer, such as prior training, leadership, creative talents, judgment of markets, buying or selling ability, and general ability to get the job done

Consideration may also be given to the adequacy of compensation in prior years, and to making up for any earlier deficiencies.

The inflationary trend has been a good reason for increases in salaries for officers. Their cost of living has increased and that increase must be met out of amounts left after paying individual income taxes. Furthermore, inflation causes a greater demand for the services of capable officer-employees.

The taxpayer's determination will probably be influenced by the prospect of avoiding disallowance of a portion of the proposed amount. The Treasury Department will give scrutiny to the amount of dividends paid, the total compensation paid to all stockholders and the division thereof in relation to stock held by each one, the time of year when the salaries are authorized, and increases over amounts paid in prior years.

10. *What is the best method of handling the expense accounts of corporate executives, both from the corporation's viewpoint and from that of the individual?*

MR. MILLS: In considering this problem, it is important to remember two basic rules on deduction of items for tax purposes:

1. To be deductible an item must be ordinary and necessary to the taxpayer, and as a practical matter it must be reasonable in amount.
2. A taxpayer may not deduct an item which is actually an expense or deduction of another taxpayer.

With these rules in mind, it will be found that in general the best method of handling executives' expense accounts is for a corporation to pay the items directly, and to account for them according to their character as advertising, sales promotion, etc. On occasion it may be possible for an executive to turn over a bill to the corporation and have that paid by corporate check. However, the more usual and practicable method for so handling the items is for the executive to submit expense vouchers or reports to the corporation for disbursements made for him, and receive payment for these specific amounts from the corporation. These vouchers should be approved by payment in accordance with the usual practice of the corporation, and in any event should be approved by someone other than the officer being reimbursed. If this practice is followed I do not consider that the executive should be considered to have received an expense allowance, which would have to be accounted for on his personal tax return.

It is also important that the expenses be adequately documented, not necessarily by receipts but at least by an adequate description of the nature of the item. Since the expense is deductible by the corporation only because it is ordinary and necessary, and reasonably related to the corporation's business activity, there should be enough support for the item to justify the acceptance by the corporation as an expense of doing business. A mere canceled check is not an adequate support for the corporation, since, while that may prove that the amount was paid, it offers no help in a controversy as to the propriety of the item as a corporate expense.

Sometimes business management prefers to set the compensation of its executives with the understanding that the amount is determined to be sufficiently high to permit and require the executive to use some of his personal funds for the entertainment of customers and for other purposes which will eventually enure to the benefit of the corporation. When this method is followed as a matter of business policy, it transfers a considerable burden to the executive, since he has to account for the entire amount as income, and then is entitled to deduction of such payments as he can maintain were for business purposes. It should be remembered that while under some circumstances being a salaried executive has been treated as if it was itself a business, this concept, which still seems strained to me, does not permit a taxpayer to deduct expenses of another taxpayer. Under such a situation, the executive himself will have to maintain records of disbursements made by him for the benefit of his employer, and since it is a general assumption that unreimbursed payments are for personal purposes, the scrutiny of such deductions will probably be more vigorous than would be the case if the corporation paid them specifically. The entire amount paid to the executive for compensation including an allowance for expenses will be reported by the corporation to the Treasury Department as income. If an executive is given predetermined round amounts for expenses, such payments will also be reported on form 1099, and in addition they will be subject to payroll taxes. Thus this method creates quite a burden to the individual.

If the executive's compensation is such that he is expected to use part of it for entertainment for the benefit of the corporation, he should for his own protection have a written statement of this understanding from the corporation, so that he will be able to demonstrate that as far as he is concerned a condition of his employment is that he shall spend personal funds for corporate purposes.

Difficult problems can arise if entertaining for the benefit of a corporation involves the use of a capital asset owned either by the corporation or by the executive. For example, it may be very good business for a corporate executive to entertain customers at his home or on his yacht. However, since such entertainment involves the use of property which is either largely or predominantly personal, it will be quite difficult to allocate the expenses and a portion of the capital investment to corporate purposes as distinguished from personal pleasure and use. Claiming such deductions also may cause trouble by encouraging a rather rigid scrutiny of all other expenses which by themselves might not be questioned. Ownership of a yacht by a corporation might create equally difficult situations, since to the extent that the corporate property was used for the executive's personal purposes, the executive may be considered to have income from the corporation to that extent, such income of course being deductible by the corporation if the aggregate compensation is reasonable in amount. The difficulty of proving the business character of entertainment in the executive's home, presumably involving the presence and services of his family, would generally be such that serious consideration should be given to waiving claim for deduction of such items, in view of the effect which controversy on them might have on deduction of other items which by themselves are more ordinary and acceptable.

The use of social clubs for business entertainment is sufficiently accepted American business practice to justify deducting such house charges as can be identified as being for business entertainment purposes. However, the courts have not been very generous about permitting deduction as business expenses of club dues and initiation fees. Such deductions have been allowed on a demonstration that except for business purposes the executive would not belong to the club, and in fact that the executive has a definite personal distaste for the activities of the club, such as golf, etc. However, the necessity of stating for the record that the individual would not use any of its facilities or attend any of its functions except for the possibilities of getting or promoting business, will usually cause enough personal embarrassment with fellow club-members to make it advisable to forego claim for deduction of the club expenses other than those specific ones which can be clearly identified as business in nature.

11. *Is it possible to provide deferred compensation for a few executives and obtain current deductions for the corporate employer without qualifying a plan under Section 165?*

MR. MELVOIN: It is assumed, of course, that the question does not extend to or embrace a situation where an accrual-basis employer defers payments otherwise due, on account of financial inability, or where the amount cannot be determined exactly until after the close of the accounting period. There, the employer gets the deduction, while a cash-basis employee defers reporting the income until receipt (Reg. 111, Sec. 29.23(p)-1). See likewise the case of *Veit* v. *Comm.*, 8 TC 809 (1947, Acq.), wherein, in an admittedly arm's-length transaction, based on past corporate practices, bonuses to be earned were payable in future years. The income was not taxed until received, although the employer, on an accrual basis, was permitted the deduction in the earlier year.

Plans to which reference is generally had include those which qualify as exempt under Section 165(a), and those not so qualifying, even though subject to certain provisions like 165(c) and 23(p)(1)-D.

Broadly speaking, the latter class involves the use of trusts, life insurance contracts, annuities, pensions and stock purchase arrangements.

The possibility of eating your pie and keeping it, or realizing the ideal solution of the conflict between an executive and his employer, is unattainable today by any plan which fails to qualify under IRC 165(a). As a result of judicial decision and legislation, particularly since the 1942 amendments, the employee is taxed immediately either on the basis of constructive receipt, economic benefit or special statutory provisions (Sec. 22(b)(2)-B, or 165(c)).

Prior to 1942 it was possible to provide deferred compensation for an employee and have an immediate deduction to the employer through the purchase of an annuity for the employee (IT 3346, 1940-ICB 62). But even before the 1942 amendments the Bureau reversed its position and started taxing employees who had vested interests in annuity contracts on the grounds of receipt of economic benefits, etc. Cf. *Deupree*, ITC 113 (1942); *Brodie*, ITC 275 (1942); *Girdler*, 2 TCM 482 (1943); *Ward* v. *Comm.*, 159 Fed. (2d) 502, (CCA-2, 1947).

By the Code amendments, if the annuity is not provided under a qualified plan, the employee escapes taxation on those contributions in the years in which his rights are forfeitable. But the employer gets *no* deduction (Sec. 22(b)(2)-B, and 23(p)(1)-D). If rights are nonforfeitable, he is taxable and employer gets the deduction. Thus it goes, round and round.

An entirely different approach is somewhat as follows. The employer buys an annuity, endowment or other insurance (or even sets up a trust for his own (*the employer's*) benefit), solely to provide a source of funds from which it is expected that eventually payments will be made to the executive, either on a voluntary or contractual basis, but without giving the employee any rights in the policies or fund so established. The annual premiums are not deductible, nor is the employee in receipt of taxable income until a later year. Likewise, deduction to the employer is postponed to the year of payment or retirement benefits or pension. Appropriate conditions should be attached to avoid against danger of subjecting employee to tax in one year on the entire value or to forever lose the deduction to the employer.

There seemingly is no provision in the Code relating to pension plans where the employer neither purchases annuity contracts nor makes contributions to a trust. Deduction is not permissible by a mere reserve entry even to the accrual-basis taxpayer. All taxpayers have been put on a cash basis, by Section 23(p) as far as deferred compensation is concerned. The deduction, if obtainable at all, is permitted in the year when paid.

Except as noted, in the case of financial inability, or necessity to defer making computations, as in profit-sharing bonuses, there appears to be no escape from the dilemna, except on the basis of sacrifices on the part of the executive or the employer.

12. *The closing inventory includes quantities of certain products which are in excess of the estimated sales of such products during the succeeding year. No reduction in sale prices is contemplated. On the lower of cost or market basis, is it proper to value the portion believed to be saleable within one year at cost and the excess quantities at lower estimated realizable values?*

MR. MESSERSMITH: Section 22(c) of the Internal Revenue Code provides that inventories shall be taken whenever the use of inventories is necessary in order clearly to determine the income of any taxpayer. Valuation of inventories is, as we all know, one of the basic factors in determining the amount of inventories and, consequently, the income for any accounting period, and this is recognized in the regulations promulgated by the Commissioner of Internal Revenue; Section 29.22(c)(2) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
(2) It must clearly reflect income.

The regulations also state that the bases of valuations most commonly used by business concerns and which meet the requirements of the statute are (a) cost and (b) cost or market, whichever is lower.

For the purposes of this discussion, it is assumed that the taxpayer has properly elected to use, and has consistently used, the basis of cost or market, whichever is lower, and that no part of the inventory quantities in question is defective or obsolete. It is also assumed that cost is less than selling price at the inventory date. It appears to be well-settled that the valuation of inventories is dependent upon factors present at the time inventories are taken and not upon occurrences in the following year; taxpayers invariably have failed to sustain market values based upon sales prices prevalent at a date considerably after the inventory date. Also, it appears that in the valuation of inventories, no distinction is permitted between units of regular goods; that is, it would not be permissible to value part of the quantity of an article on hand at cost and the remainder of the quantity of the same article at lower market because such remainder was in excess of current sales requirements.

In the case of *Cleveland Automobile Company* v. *United States*, 70 F.(2d) 365 (1934), the taxpayer (on the lower of cost or market basis) contended for the privilege of reducing the valuation of finished cars to the market value of what they would bring, with reasonable assurance, in the future, because they were not readily saleable and, therefore, should not be valued at the then current price; the Court held that "the basis of inventory valuation must be restricted to a consideration of actual value as of the last day of the taxable year based upon sales or offers of sale at or near such date and with relation to production and replacement cost." In *Industrial Lumber Company, Inc.*, v. *Commissioner*, 58 F. (2d) 123 (CCA 5-1932), write down of inventories was disallowed because losses submitted as evidence of market value were held to be due entirely to occurrences in a subsequent year and were not factors properly to be taken into account in valuing the closing inventory of the year in question. In *Summit Wholesale Grocery Co.*, 1 BTA 1040, the evidence was held sufficient as to inventory value of goods sold within thirty days after the inventory date, but not as to goods not disposed of for more than two years thereafter. In *Farmers Hardware Co.*, 2 BTA 90, it was held that offering of goods for sale was required as evidence of bona fide selling price of goods unsaleable at normal prices, and failure to show that this had been done resulted in disallowance of the write-down.

However, as already mentioned, the regulations provide that the inventory must conform "as nearly as may be to the best accounting practice in the trade or business." I do not believe that any accountant would seriously object to a reduction to estimated realizable values of the quantity believed saleable only after one year. Does this mean that the write-down would conform "to the best accounting practice" and, therefore, be acceptable? I do not believe the Commissioner or the Courts would so hold. While it is an accepted accounting principle to give recognition to events subsequent to the close of the accounting period which would result in a diminution of value as of the balance-sheet date, for income-tax purposes the income for each year must be separately determined, and losses are taken into account in the year in which falls the event giving rise to such loss.

Therefore, while it may be proper accounting-wise under certain circumstances to write down to estimated realizable values inventory quantities which are in excess of the estimated sales of such products during the succeeding year, if the sale prices at or shortly after the inventory date have not been commensurately reduced, the inventory write-down would for tax purposes be in the nature of an inventory reserve for future losses and would not be allowable in the determination of taxable net income.

13. *A purchaser desires to buy the assets of a corporation but its shareholders prefer to sell their stock in the corporation. Can the tax advantages to the purchaser be preserved by a purchase of stock and immediate liquidation of the corporation?*

MR. KILPATRICK: I assume that the "tax advantages" mentioned are the advantages of using the cost of the assets as a basis for depreciation and gain or loss on future sale. I also assume that the purchaser is a corporation, since no problem is presented if the purchaser is an individual. In the latter case, the liquidating distribution results in taxable gain or deductible loss to the stockholder if the fair market value of the corporate assets received is more or less than the cost of his stock.[1] If the liquidation occurs immediately after purchase of the stock, the price paid for the stock would be the best evidence of value of the assets, so that no gain or loss would result from the liquidation. There might be problems of allocating the cost among the assets, but an appraisal by a qualified appraiser would no doubt be accepted as a sound basis for such an apportionment. The value of the assets at time of such distribution, as so measured, would be the stockholder's basis for future depreciation or for computing gain or loss on future sale.

However, if the stockholder of a dissolving corporation is also a corporation, we must consider the effect of Sections 112(b)(6) and 113(a)(15). The former provides that no gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation; and the latter provides that, in such a case, the property retains the basis of the dissolved corporation, which may be, and usually is, much less than present value.

On the other hand, notwithstanding these Code provisions, it is now pretty well established that, if the stock of one corporation is acquired by another with the intention of immediately dissolving and taking over the assets, and the plan is carried out, these sections of the Code do not apply. The Circuit Court of Appeals for the Sixth Circuit stated the rule thus in *Commissioner* v. *Ashland Oil & Refining Co.*, 99 F. (2d) 588 (1938):

> . . . Without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority.

This language was recently quoted with approval by the Tax Court in *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 TC 74, where the acquiring corporation unsuccessfully claimed the old corporation's basis in such a transaction.

To the same effect, see:

Prairie Oil & Gas Co. v. *Motler* (CCA-10, 1933), 66 F. (2d) 309;

Warner Co. v. *Commissioner*, 26 BTA 1225;

Helvering v. *Security Savings and Commercial Bank* (CCA-4, 1934), 72 F. (2d) 874.

[1] Sec. 115(c), IRC.

It is of course important that the intention to dissolve immediately after acquiring the stock be recorded in the minutes of the acquiring corporation, and that the dissolution take place immediately.

14. *A business operated as a partnership has been very profitable but substantially all of its working capital consists of receivables and inventory. The partners want to incorporate the business. How can they do so and still obtain sufficient cash to pay their individual income taxes on their respective shares of the partnership income prior to date of incorporation?*

MR. COOPER: Under the circumstances the partners could obtain the necessary cash to pay their individual income taxes in any one of at least three ways, but with perhaps varying consequences.

First, the partnership could withhold from the new corporation a sufficient amount of receivables, then proceed to reduce such receivables to cash, either through collection or sale, and thereafter distribute to the partners their respective shares of the cash and stock of the new corporation.

Second, the partnership could borrow an amount equal to the estimated aggregate income tax liability of the partners, distribute this cash to the partners, and then transfer the partnership assets to the new corporation, with the latter assuming the partnership indebtedness.

Third, the partnership could exchange its assets for stock of the new corporation, withholding from this exchange sufficient receivables, which would be sold to the corporation, the latter borrowing the necessary cash to pay for such receivables.

Viewed from the standpoint of the Federal income tax, the three methods indicated above have been stated in the order of their preference. Clearly no tax consequence should result from the retention and collection or sale by the partnership of some of the receivables at a price not in excess of their tax base. Similarly under Section 112(b)(5) no tax consequence should attend the exchange of partnership assets for stock of the new corporation.

The second method would also appear to offer an effective means by which to obtain the necessary cash without tax consequence. Under Section 112(k) the assumption of the partnership indebtedness by the new corporation at the time of exchange would not be considered as the equivalent of cash so as to render taxable any gain on the exchange to the extent of the assumed indebtedness. However, if this were done, it would be desirable for the partners to file amended declarations of estimated tax and pay the same so as to establish clearly the purpose of the borrowing and that the assumption thereof by the partnership was not for the purpose of avoiding income tax.

Under the third method the partners could obtain the necessary cash but with perhaps tax consequence. The Commissioner would probably contend that the exchange of partnership assets for stock and the sale of receivables for cash represented but parts of one transaction in which all the partnership assets were exchanged for stock of the new corporation, plus a sum of cash; in other words, that the exchange of property was not solely for stock, but for stock and cash.[1] If this view were adopted, then under Section 112(c)(1) the excess, if any, of the fair-market value of the stock received plus the cash, over the tax basis of the assets transferred, would be recognized, limited, however, to the amount of the cash received. Appreciation, particularly of intangibles, would then be an important factor.

The opposing contention aimed at avoiding the recognition of gain would be that the exchange of assets for stock and the sale of the receivables for cash represented two separate transactions and that no recognized gain or loss resulted from either transaction. As to the exchange, it could be argued that nothing but stock was received and under Section 112(b)(5) gain or loss cannot properly be recognized; and as to the sale of the receivables, no gain or loss was realized since such receivables were sold at their tax basis. The success of the argument on either side would depend on the detailed facts, timing, etc., which will vary from case to case.

While it would appear that much could

[1] *Fred L. Dickey et al.*, 32 BTA 1283.

be said against treating the two transactions as part of a single transaction, the uncertainty as to the ultimate outcome suggests the avoidance of this method.

15. *What are the best arrangements for an accounting partnership in respect to the time and manner of paying out the interest of a deceased partner?*

MR. BERGEN: How post-death payments by surviving partners to a deceased partner's estate will be classified for tax purposes is largely a question of the intention of the parties as set forth in the partnership agreement. A payment representing the decedent's capital account is not taxable income to anyone but is includable in the decedent's gross estate for estate-tax purposes. The decedent's share of income accrued to the date of his death is includable in his final income-tax return if the partnership can be regarded as terminating at his death and is also subject to estate tax, but a credit is allowed on the income-tax return for estate tax attributable to such income.[1] If under the partnership agreement the partnership does not terminate at the death of the partner, the present trend of authority is not to tax any part of the income of the whole partnership year in the decedent's final income tax return but in the first income tax return of his estate.[2] Query whether any part of such income is subject to estate tax.

Payments to the decedent's estate representing current collections of the decedent's interest in work in process are not income to the surviving partners but to the decedent's estate subject to a credit for estate tax attributable to such income. However, a lump-sum payment by the surviving partners to the deceased partner's estate on account of work in process to be paid for in future years has been held not to be deductible by the surviving partners, although the payment may be offset against fees as they are received.[3]

The most difficult question concerns the provision frequently found in the agreements of personal-service partnerships to the effect that a deceased partner's estate shall share in the post-death earnings of the partnership for a period of years. If these payments represent the "purchase" price paid by the survivors for the decedent's partnership interest, the payments are not deductible by the surviving partners because they are made for the acquisition of a property right of the decedent; but if they represent the payment of a distributive share of partnership income to the estate as a participant in the partnership, or a payment under an agreement in the nature of an insurance arrangement, they are deductible by the surviving partners. Moreover, "purchase" payments received by the decedent's estate are includable in the decedent's gross estate for Federal estate-tax purposes to the extent of their commuted value,[4] and there is some danger that the same payments may be subjec to income tax to the estate in the year of their receipt without any credit for estate tax paid thereon. While there are some who argue for the double tax, even though there is no indication that such payments are "purchase" payments, the Bureau of Internal Revenue is apparently following *Bull* v. *US*, 295 US 247 (1935) and is not attempting to collect the estate tax in the cases of post-death periodic "income" payments to the estate of a deceased partner where the partnership was a personal service partnership to which no capital was contributed and which has only a nominal good will and no tangible property. This whole field is extremely uncertain and makes the careful drafting of the partnership agreement all the more important.

A case illustrating the importance of the language in the partnership agreement is *Charles F. Coates*, 7 TC 125, involving an accounting partnership. The partnership agreement there specifically provided for the payment of a deceased partner's undrawn earnings and "capital interest" in the firm. In addition, the agreement provided that on the death of a partner the partnership should not terminate but should continue as a partnership among the survivors and the estate of the deceased partner for a period of five years. The estate was to share in the profits but not in the losses during this period. The Court held

[1] See Section 126(c) of the Internal Revenue Code.

[2] See *Girard Trust Co.* v. *U S*, CCA 3, June 7, 1950, P-H Par. 72,756.

[3] *Raymond S. Wilkins*, 7 TC 519, *aff'd* 161 F. (2d) 830, CCA, 1, 1947.

[4] *McClennan, Exec.* v. *Comm.*, 131 F. (2d) 165, CCA 1, 1942.

the income of the partnership earned after the death of a deceased partner and paid to his estate not taxable to the surviving partners. The Court found that no value was placed on firm assets, such as good will or office equipment, and that the parties could not have intended the income payments after death to have been a purchase of such assets by the surviving partners. Rather, the Court thought, these payments were under an agreement which was intended to be in the nature of a mutual insurance contract.

Coming to the specific question, the all-important consideration relative to the payment by an accounting firm of the interest of a deceased partner is that of drawing proper provisions in the partnership agreement. The agreement should specifically provide for the method and amount to be paid the estate of a deceased partner for his interest in the capital assets of the firm, including the capital account, good will, if any, office equipment, library, etc. If the understanding is that no value is to be attributed to such items as good will, office equipment, library, or other specific assets, and that the estate is to be entitled to no payment therefor, that should be specifically spelled out in the agreement. Such provisions would go far in precluding the government or a court from finding additional value. The agreement should also provide for the method of payment for work in process. To prevent more than one-year's income from being telescoped into one year, in case the taxable year of the partnership differs from that of the deceased partner, the agreement should provide that on the death of a partner the partnership shall not terminate but shall continue to the time desired. If there are to be payments from or measured by income earned after a deceased partner's death to his estate, it would be advisable to have the estate of the deceased partner continue as a partner, if that is possible under the laws of the jurisdiction governing the partnership. If that is not possible, the wording of the agreement might be such as to indicate that the payments are to be in the nature of an insurance arrangement. If the estate is not to continue as a partner, and there is serious concern that the surviving partners might be taxed on income which produces or measures payments to the decedent's estate, the agreement could contain a provision whereby the estate would indemnify the surviving partners for any liability determined against them for such payments to the estate, from or measured by income earned after the particular partner's death. It is to be appreciated that these suggested provisions would not fit many cases. Each agreement must be tailored to fit its particular situation.

16. *To what extent should considerations of public policy affect the deductibility of certain items for income tax purposes?*

PROFESSOR SURREY: The traditional rule in this area is that expenses contrary to public policy are not deductible. This rule is primarily of judicial origin, with its roots in the interpretation of the "ordinary and necessary" language of section 23(a) in relation to such expenses. It has had application in the disallowance of bribes, of fines and penalties, and of unusual lobbying expenses. The Supreme Court, in refusing in *Commissioner* v. *Heininger*, 320 US 467 (1943) to apply the rule to legal expenses incurred in defense of allegedly illegal business methods, expressed the rule in terms of the denial of deduction for those expenses the allowance of which would frustrate "sharply defined national or state policies."

The rule has recently been considerably scrutinized in connection with its application to various situations. Thus, the generalization that fines and penalties are not deductible has been modified under taxpayer pressures to deduct amounts paid to the OPA to compromise price violations. In *Jerry Rossman Corporation* v. *Commissioner*, 175 F.(2d) 711 (2d Cir., 1949), Judge Learned Hand said the rule was only that *some* penalties were not deductible, and permitted deduction of a "penalty" in the form of an overcharge payment to the OPA since he decided that such deduction would not frustrate the policies of the OPA law. The 9th Circuit in *National Brass Works, Inc.*, v. *Commissioner*,—F. (2d)—(9th Cir., 1950) has also acted to restrict the penalty rule, its device being to remove from the scope of the rule all penalties resulting from those violations of law which are neither intentional nor the result of an unreasonable lack of care. Interestingly enough, this recognition of the hazard of unwitting violations of complex regulatory measures as a normal condition of business finds a counterpart in a recent Bureau ruling. A special ruling (50 CCHP 6134) states that "fines" regularly experienced by truck operators whose loads are in excess of the weight limits of some states traversed by their routes are in reality tolls charged for such overweight loads and hence a necessary incident of the business operations.

At the same time that the class of fines and penalties regarded as normal occupational hazards or occurrences are apparently being withdrawn from the coverage of the rule, additional vitality is being imparted to the rule by the Tax Court as a consequence of its understanding of the scope of the public policy criterion. In *Lilly* v. *Commissioner*, 14 TC (1950), the Tax Court found, without the assistance of a state statute or a judicial or administrative determination of the point, that kickbacks paid by an optical company to doctors were against public policy and hence non-deductible. This decision that the Tax Court can now declare public policy may be difficult to square with the Supreme Court's statement of the rule in terms of a "sharply defined" state policy.

In summary, it appears that the contours of this judicially constructed public policy restriction on deductibility are in the process of judicial clarification and that this process will probably lead to a narrowing of the scope of the restriction.

17. *When must research and development expenses be capitalized? On what basis can the amount capitalized be written off against income?*

MR. CALDWELL: No option exists with respect to the treatment of research and development expenses. Reg. Sec. 29.24-2 states that amounts paid for increasing the capital value of property are not deductible from gross income. Clearly research and experimental costs incurred in the development of patents, copyrights, processes, drawings, patterns, models, etc., are not deductible currently and the cost may only be deducted as depreciation over the life of the patent or copyright or the useful life in cases where no patents or copyrights are obtained. The burden of proof is on the taxpayer to prove that the asset has a limited life (otherwise no deduction is allowable) and also to prove the method of claiming depreciation on a period of time or unit basis (Reg. Sec. 29.23(1)-3, 29.23 (1)-7 and 29.23(1)-8).

If the taxpayer regularly undertakes general research and development which does not culminate in patentable products or processes nor improve products or facilities, the Commissioner may allow such expenditures to be deducted currently. However, a consistent manner of treatment of such expenditures is required in order to reflect income accurately.

In cases where it is doubtful whether the deduction will be allowed, it is safer to claim it currently, assuming an immediate tax benefit exists. The Tax Court held that expenses capitalized by the taxpayer in outlawed years were ordinary expenses deductible only in the years incurred, with the result that the taxpayer's claim for deduction in the year of abandonment was disallowed. *Kent Machine Co.*, 6 TCM 441.

Where a patent becomes obsolete prior to its expiration or a process, etc., is abandoned, the remaining amount not previously allowable as a deduction is allowable in full in such year. Complete abandonment of the project must be shown, otherwise the Commissioner may be successful in alleging that all or part of such costs were of value in subsequent related projects. *Dresser Mfg. Co.* 40 BTA 341.

In cases where, for example, a company may incur heavy expenditures for development of a machine, the sales of which will represent a substantial portion of its total annual income, it is advisable to consider claiming amortization of the development costs over an estimated number of machines to be sold. In this manner if annual sales vary greatly net income will be held to a more consistent ratio to total sales and large amortization deductions will not be claimed in years when little or no tax benefit may be obtained.

18. After the death of an officer-stockholder the corporation continues salary payments to his widow. When are such payments deductible by the corporation or taxable to the widow?

MR. HOPSON: The answer to this question should reveal an instance where the Commissioner of Internal Revenue has issued a ruling that is practical and sensible but which grants a tax advantage that has been unexpected to many upon reading the ruling for the first time.

Considerable litigation has already followed the ruling but it still seems possible, under some circumstances, for salary payments to be deductible by the corporation and also non-taxable to the widow.

Section 29.23 (a)(9) of Regulations III provides that "when the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of the services rendered by the individual such payments may be deducted."

During the year 1939, in response to inquiry, IT 3329 was issued. In brief, the ruling was that payments made in 1937 and 1938 by M Company to the widow of an officer—stockholder who died in January, 1937, though not required to be made by any contractual obligation, were deductible by the corporation as business expenses and that such amounts were gifts to the widow and therefore not taxable income to her.

Apparently the Treasury Department continues to give effect to the ruling under its conditions and restrictions. Some of the litigation involving the ruling has been about the determination of the length of time under which the payments are deductible by corporations. The period during which deductions may be taken has not been defined and each case will rest on its particular facts. Several rulings or cases point to a period of approximately 24 months as being acceptable to the Commissioner.[1]

The Tax Court has seemed reluctant to agree that voluntary payments to widows are deductible unless such payments represent additional compensation for services rendered by the deceased and unless the aggregate compensation is reasonable and the Court has indicated that in cases where the Commissioner does not agree to the deductions, taxpayers must establish their rights under the language of Code Section 23(a).[2] However, in a very recent case the Tax Court ruled that 24 months was a "limited period" in that situation instead of 18 months as proposed by the Commissioner and 40-1/2 months as contended by the taxpayer.[3]

The phrasing of resolutions authorizing payments to widows is very important. Deductibility rests upon a motive to make payments in recognition of services rendered. If the motive impelling payments is the need of the widow, the deduction will probably not be allowed, under I.T. 3329 or otherwise.

The question as to whether the payments are taxable to the widow revolves fundamentally on whether the payments are gifts. In situations where payments are voluntarily made by the corporation without obligation, express or implied, the amounts are non-taxable to the widow. But if there is an obligation, express or implied,[4] upon the corporation to make the payments, the widow would be taxed upon them under the provision of the Code that gross income in respect of a decedent, which is not taxable in the final return of the decedent, is taxable to those who receive the items of income.

IT 3329 is most helpful in enabling deductions by the corporation in cases where the payments would not have been taxable to the widow without resorting to the ruling.

The Louise K. Aprill case[5] was concerned with the taxability of payments received by a widow where the corporation, according to the facts recited, adopted a plan of payments with knowledge of I.T. 3329. The corporation made payments for 27 months but had agreed to the disallowance of payments for the last 5 months. Later, the Commissioner proposed that payments during 1944 (included in those disallowed

[1] See: IT 3329—1939-2-CB 153. *McLaughlin Gormley King Co.*, 11 TC 68 (1948) CCH Dec. 16, 622; *Louis K. Aprill*, 13 TC 92 (1949) CCH Dec. 17, 275 (see facts regarding examination of corporation return); *I. Putnam, Inc.*, 15 TC 13 (1950) CCH Dec. 17, 785.

[2] See *McLaughlin Gormley King Co.*, supra.

[3] See *I. Putnam, Inc.*, supra.

[4] See *Mary Sutro*—Dist Ct Calif—42-2 USTC 9523. See *LouiseK. Aprill*, supra.

as deductions) were taxable to the widow in the form of a distribution of earnings and profits. The Tax Court found that the payments were made as gifts to the widow, in reliance on IT 3329 and that the corporation's treatment of the payments as salary expense was explained by the desire of its officers to comply with IT 3329. This case is an interesting example of benefits obtained by advance tax planning.

Source reading (*in addition to cases or rulings referred to*)

CCH Rewrite Bulletin (1950) Paragraph 8521
25 *Taxes* August, 1947, page 711
Rabkin & Johnson E2-12
IT 3708
IT 3840
Article by Samuel Brodsky, Attorney New York proceedings of New York University Eighth Annual Institute of Taxation
W. D. Haden Co. TC Memo Apr 9, 1946—CCH Dec 15103(M) (re disallowance of deduction)

Note:

Since the annual meeting in Boston, the Commissioner, through IT 4027, released in Internal Revenue Bulletin No. 21 dated Oct. 16, 1950, has materially modified IT 3329.

It was stated in IT 3329 that "when an allowance is paid by an organization to which the recipient has rendered no service, the amount is deemed to be a gift or a gratuity and is not subject to Federal income tax in the hands of the recipient." The emphasis was placed upon the fact that no services were performed by the recipient of the pension. The Bureau now believes that to be a faulty construction, and that the essential factor is whether services were rendered to the employer.

The Bureau bases its reasoning upon Section 29.22 (a)—2, Regulations III, which reads in part as follows: "However, so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable." Whereas the regulations stress the position of the payer, IT 3329 incorrectly emphasized the position of the payee. The regulations are deemed not to be applicable if services have been rendered to the person making the payments and the fact that the recipient of the payments did not render such services is immaterial.

It is now the position of the Bureau that irrespective of a "plan," voluntary or involuntary, definite or indefinite, payments of the type herein considered constitute taxable income, and it is held that payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for federal income-tax purposes.

This new ruling will not be applicable to payments received prior to January 1, 1951.

19. *Can a net loss of a predecessor corporation be carried over and utilized by its successor corporation? Can a net loss of the successor corporation be carried back to the predecessor?*

PROFESSOR SURREY: A cautious general answer to these questions is "No." In other words, the adviser interested in safe-tax planning should proceed on the premise that net losses may not be carried forward or backward between corporations standing in the relationship of predecessor and successor. Hence, if corporation A with a net loss is absorbed by corporation B, either a new or an existing corporation, the net loss drops out of the picture. This is so whether the absorption is by a purchase of assets or a tax-free reorganization. But if the loss corporation A is the surviving corporation, then its loss may be generally carried over to future years, even to wipe out income from the assets received from profitable corporation B.

This is the general background, cautiously stated. The developing case law in this field, however, presents a more unsettled picture. The Supreme Court had held in *New Colonial Ice Co.* v. *Helvering*, 292 US 435(1934) that a loss could not be carried forward to a new corporation succeeding to the business of a financially embarrassed predecessor. Technically, the new corporation was not "the taxpayer" who had suffered the loss, or, stated the other way, the "taxpayer" claiming the deduction the new corporation, had not suffered the loss. The law was regarded as fairly well settled, and legislation in certain areas proceeded on this premise, as for example the act specifically allowing the carry-over in certain railroad reorganizations. Recently, however, the Second Circuit in *Stanton Brewery, Inc.*, v. *Commissioner*, 176 F. (2d) 573 (2d Cir., 1949) allowed a carry-over of unused excess profits credit where the corporation with the unused credit and its parent had merged into a new corporation. It held that the new corporation was "the taxpayer" entitled to the credit. The decision does not attempt to deal with the *New Colonial* case, and instead discusses solely excess-profits tax provisions. It would appear, however, that its stress on the new corporation resulting from the merger as being possessed in law of the rights, privileges and obligations of the constituent corporations would apply equally to the operating loss provisions.

The Tax Court, in *Standard Paving Co.* v. *Commissioner*, 13 TC 425, involving a transfer of assets by a subsidiary to a parent followed by dissolution of the subsidiary, denied a carry back of losses of the parent to the subsidiary. It relied on the *New Colonial* case and stated that the *Stanton Brewing* case, even if considered correct, was inapplicable since it involved a carry forward and not a carry back.

Thus, we can see some possible lines of future inquiry: the extent to which certain transactions will be regarded as sufficiently continuing the identity of the deficit corporation to support a carry forward; a possible distinction between carry backs and carry forwards, which, parenthetically, does not appear to be warranted. In addition, to the extent that deficits are permitted to flow between successors and predecessors, what will be the effect of Section 129, which disallows deductions acquired for tax reduction purposes? This question is also pertinent where the continuing corporation is the deficit corporation if it was acquired for its deficit. Moreover, these questions must find their place in the larger issue, especially if they are to be considered in the light of legislative policy—to what extent and in what areas should a successor corporation stand in the shoes of the predecessor; to what extent should the results depend on which corporation disappears and which corporation continues the business?

Reference may be made to 63 *Harvard Law Review* 897 (1950); 2 *Stanford Law Review* 422 (1950).

20. *May the capital of a corporation be furnished in large part as borrowed capital and in small part as equity capital in order to minimize taxes?*

MR. COOPER: The answer is definitely "Yes," but that immediately brings up the problem of the extent to which operating capital may be represented by debt; in other words, how "thin" may the equity capital be? While the present tax law does not attempt to lay down fixed rules regarding the permissible capital structure of a corporation, it is interesting to note that the Revenue Acts from 1909 through 1916 limited the amount on which interest was properly deductible by a taxpayer corporation.[1] The restrictions were removed upon the introduction, during World War I, of the first excess-profits tax, which did not provide for the inclusion of borrowed capital in computing invested capital. No attempt was made to reinstate the prior limitations, after the repeal of the excess-profits tax. Section 23(b) of the Internal Revenue Code, permitting the deduction of interest paid or accrued within the taxable year on *indebtedness* does not define or restrict the latter term.

Really, therefore, the question should

[1] The Revenue Act of 1909 (36 Stat. 113 (1909) at Sec. 38 Second) allowed a deduction for "the amount of interest actually paid within the year on its bonded or other indebtedness not exceeding the paid-up capital stock of such corporation."

Liberalizing this provision, the Revenue Act of 1913 (38 Stat. 173 (1913) at Sec. II G(b)) extended the deduction to "the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year." Whereas the Revenue Act of 1909 recognized indebtedness only to the extent of the paid-up capital stock of the corporation, the 1913 Act permitted adding equity and borrowed capital together and recognized one-half of the total as allowable indebtedness. Obviously, the cited provision of the 1913 Act was intended to benefit a corporation with a large debt structure and a comparatively small amount of equity capital.

Under the Revenue Act of 1916 (39 Stat. 768 (1916) at Sec. 12(a) Third), a deduction for interest on indebtedness was allowed to the extent of the entire amount of paid-up capital stock plus one-half of the interest-bearing indebtedness. In practical effect, the 1916 Act limited the recognized amount of corporate indebtedness to twice the amount of the equity investment.

be: To what extent may a corporation's operating funds be represented by debt as against a contribution to capital—or how thin may it be?

No decided case or ruling has ever attempted to determine the proportions. We are thus confronted with the question of the status of "thin" corporations—that is, cases wherein the stockholders' stock capital as such is but a small percentage when related to the stockholders' loans.

There is nothing in the Code to prevent the "thin" corporation (i.e., much debt and little capital) from being fully recognized as to capital and debt, but we know from experience that when the crucial moment arrives we must reckon with the courts' application of what it considers the "intent of Congress" whether or not that intent is spelled out in so many words in the Internal Revenue Code, as well as the "intent of the parties."

No attempt is here made to deal with the cases involving types of securities or other forms of alleged indebtedness which lay themselves open to argument as to whether they represent debts or capital. This answer must be confined to cases where the basic record clearly involves indebtedness, however represented, arising in the manner envisaged by the question.

The element of a disproportionately large debt structure compared to a merely nominal stock investment, as indicative of the tax consequences, was first suggested, though not found present in the cases at bar, in the companion cases of *John Kelley Co.* v. *Commissioner*[2] and *Talbot Mills* v. *Commissioner*,[3] decided by the Supreme Court in January, 1946, with its oft-quoted dictum:

> As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

The factor of a disproportionately large debt structure, which the Supreme Court found missing in the *John Kelley* and *Talbot Mills* cases, had been present in several cases decided by the lower courts before and shortly after the cited Supreme Court decisions, but no particular attention had been given to this feature by the courts. From 1947 on, however, the ratio of indebtedness to equity capital became a subject of careful scrutiny by the Tax Court and the Appellate Courts. In *Swoby Corporation*,[4] the Tax Court issued its warning when it said, referring to the Supreme Court decision cited:

> That Court takes occasion to issue what we cannot but view as a warning when it notes that "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." (321 US at 526). The necessity excluded there we cannot now avoid.

Citing for the first time the previously quoted dictum from the Supreme Court decision in the *Kelley* and *Talbot Mills* cases, the Tax Court opinion said:

> . . . Dealing with property having a stipulated value of at least $250,200, the financing selected was to create a clearly "nominal" figure of $200 in the common stock and "an obviously excessive debt structure" of $250,000 in the debenture. This evokes a factor evidently regarded as significant by the Supreme Court, which, unlike either the *Talbot Mills* or *Kelley Co.* cases, tends to justify the respondent's treatment.

It is clear, however, that the courts will no longer treat as debt, for all tax purposes, that which is unquestionably, from a technical point of view, a debt when the circumstances of its creation are not normal and the ratios thereof to equity capital are so out of line with what would be a reasonable financial setup as to make the over-all picture unrealistic. This conclusion necessarily envisages cases in which the creditors are also the stockholders. There should be no argument about cases where the creditors are complete outsiders, unless the circumstances are such as to indicate that the creditors are the real owners and that stockholders of record are really dummies.

The cases heretofore decided have involved either the nature of the loss to the creditor-stockholder—i.e., a bad debt or a stock loss—or the question of the deducti-

[2] 1 TC 457 (1943), *rev'd* 146 F. (2d) 466 (CCA-7, 1944), *rev'd* 326 US 521, 34 AFTR 314 (1946).
[3] 3 TC 95 (1944), *aff'd* 146 F. 809 (2d) (CCA-1, 1944), *aff'd* 326 U.S. 34 AFTR 314 (1946).
[4] 9 TC 887 (1947).

bility of interest. The effect of repayment of the debt (under Section 115(g)) has not been involved. Obviously, however, if a debt (otherwise qualifying as such) is treated as a capital investment for stockholder-creditor loss purposes, one should expect this theory to carry through to the other aspects.

It may be concluded, therefore, that the use of the very "thin" corporation involves grave risks in view of the present trend, and that a conservative approach, wherein only a reasonable part of the operating capital of a corporation is represented by investments in stock, is advisable. It is better to seek half a loaf and be sure of it than to try to go all the way with only nominal equity capital and to wind up with no part of the loaf. How much should be represented by equity and how much by debt is something that will depend on the facts of each case, such as the nature of the business operation, the extent to which monies put into the corporation will be permanently invested in fixed assets, and many other factors. It would, of course, also be desirable, if possible, to have the debt held by the stockholders in ratios that varied substantially from their stockholding ratios. Sometimes that may not be possible and obviously the problem is more acute when the debt and stockholding ratios must be the same. So, to sum up my answer, I would say (considering all tax results) that the capital may be furnished in part by debt but not to what is obviously an unreasonable and unrealistic extent. No decided case says that—as a flat proposition; but if one does otherwise the risk of unexpected tax consequences is great.

21. *Do you believe that Section 102 will be a serious threat to many corporations in 1950?*

MR. MELVOIN: Section 102 as a serious threat to many corporations in 1950 is rather unlikely.

(1) The indicated increases in tax rates is causing both large and small corporations to be more generous in disbursements of dividends in 1950, obviously for the purpose of taking advantage of the present relatively low rates.

(2) With the passage of the National Emergency and Defense Act of 1950, the need for additional facilities and capital requirements is evident. Hence, "reasonableness" of accumulations or retentions of earnings should be more readily demonstrable.

(3) The bugaboo of 102 penalties ought to be examined in the light of the number of deficiencies that have actually been proposed in the past and the number of litigated cases involving this section. On the basis of studies made as recently as 1948, it appears that the average number of deficiency letters issued from 1939 to 1947 was less than 100 per annum. Of 97 cases that were litigated up to 1948, less than half were actually favorable to the government. It thus becomes evident that public corporations with consistent dividend policies have little to fear from this section. As for small business, the political sentiment favoring small business is such that it undoubtedly has an influence on the tolerant policy demonstrated by the Treasury Department.

22. *A closely-held corporation desires to retain as much of its current earnings as possible for possible future needs. What steps should it take to protect itself from the application of Section 102?*

MR. MESSERSMITH: Section 102, as all of you know, imposes a surtax on corporations which are formed or availed of for the purpose of preventing the imposition of the surtax upon their shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed. The statute contains two standards for determining that the interdicted purpose is present; if the corporation is a mere holding or investment company, that fact shall be prima facie evidence of such purpose; and if the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business, that fact shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

It is assumed that our corporation here

is an operating company and not a "mere holding or investment company." Therefore, if the applicability of Section 102 were to be raised by an examining Revenue Agent, it would be necessary to show that the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business and to prove "by the clear preponderance of the evidence" that there was no purpose to prevent the imposition of surtax upon the shareholders.

The question of presence or absence of the frowned-upon purpose seems to be largely one of intent, not of the corporation as a taxpayer but rather of the stockholders and directors (who in a closely-held corporation would normally be the same persons). Ordinarily the question of intent is not an accounting matter but if a positive showing is made of the need of retention of earnings, it may be possible to rebut thereby any contention that the interdicted purpose was present. The important questions, therefore, seem to be why the earnings were retained in the business and whether such purposes come within the reasonable needs of the business.

Assuming that the corporation has not violated the principles of Section 102, it could fortify itself against attack under that section by providing a written record, prepared during the closing period of the year, of the needs of the business, both present and prospective. An important means of providing such a record is the minutes of the directors' meetings when the dividend policy of the corporation is being considered; there should be recorded the discussion and conclusions reached as to the sound business reasons underlying the decisions as to accumulation or distribution of earnings. Financial statements, operating reports, and interdepartmental memoranda bearing on the subject should be retained. In many cases, material which appears in trade journals, financial columns, business publications, etc., influences the thinking of directors, and it would seem well to retain clippings of such articles tending to illuminate the position taken with respect to the payment of dividends.

If there is under consideration a particular problem or project, it is well to obtain and preserve correspondence or reports containing written opinions of outside experts who had been especially retained by the corporation, and whose recommendations influenced the decision to restrict dividends.

What constitutes "reasonable needs of the business" must in each case necessarily rest upon its peculiar facts. Because of the ramifications and innumerable differences in business enterprises, any discussion on the subject must be in general terms. The matter may be summarized by saying that whenever earnings are accumulated in substantial proportion to the year's profits, there should be a concurrent accumulation of evidence substantiating the reasons therefor. In this connection, it might be well to avoid having the record too formal or studied, in order that the impression will not be given at a later date that the record was made solely with an eye to being used as future evidence. After all, the record should be only a record of the facts, judgments, and estimates at the time it was compiled; no more and no less.

23. *What is meant by the term "collapsible corporation" and what are its tax advantages?*

Mr. Bergen: A collapsible corporation is a temporary corporation set-up for the purpose of converting ordinary income into capital gains. It is a device popular in the motion picture industry and has been used in the building construction industry as well as in other fields.

An illustration will serve to answer this question. The production of a motion picture will be used in the example, but the example would be equally applicable to the construction of a building or other similar project. A, a motion picture producer, wishes to produce a motion picture. For this purpose, he organizes a new corporation to which he contributes $200,000, the capital necessary to produce the picture. Upon completion of the film, it has a fair market value of $500,000. If the corporation were to sell the picture, it clearly would have ordinary income, and any dividend distribution of the income to shareholder A would also be taxable. In order to have the income taxed only once at capital gain rates, the corporation is liquidated or collapsed and the film is distributed to A. A then pays a capital gains tax on $300,000, which is the difference between the amount of the capital he contributed to the corporation and the fair market value of the motion picture at the time of liquidation. The film now has a stepped-up tax cost of $500,000, in the hands of A. The motion picture is thereupon released, and A's $500,000 tax cost is amortized against the income of the film as it is received. If the income therefrom does not exceed $500,000, there is no additional tax, and the entire gain from the motion picture is taxed as capital gain at a maximum rate of 25 per cent.

It is understood that litigation is pending as to the tax consequences in this situation. Assuming that the courts will uphold this device, it was obviously a loophole in the tax law. However, the loophole has been at least partially closed by Section 213 of the Revenue Act of 1950. Under this Section, gain realized from sale, exchange, or liquidation of stock in a collapsible corporation is treated as ordinary income in the case of a shareholder who owns more than 10 per cent in value of the stock if the gain realized from the sale, exchange, or liquidation of the stock during the year is more than 75 per cent attributable to property produced by the corporation and if the gain is realized within three years after the production of the property. The amendment applies only to gains after December 31, 1949.

24. *In the case of employees' stock options, under what circumstances will compensation income be realized by the employee, and when is it taxable?*

MR. KILPATRICK: It is not possible to answer these two questions categorically and comprehensively. There has been a great deal of litigation on this subject, and the leading case in the Supreme Court[1] has left a number of questions unanswered. For a discussion of the cases, see:

"Employee Stock Options and the Smith Case," by Victor E. Ferrall, 1 *Tax Law Rev.* 225.
"Stock Options," by Hilary H. Sax, 23 *Taxes* 505.
"Stock Options," by George G. Tyler, 24 *Taxes* 611.
"Tax Consequences of Employees' Stock Option Plans," by Milton Ross, 26 *Taxes*, 137.

Prior to the *Smith* decision, as the Tax Court itself admitted on several occasions,[2] the results in many of the decided cases could not be reconciled as to conclusions of fact or conclusions of law. However, the Tax Court seemed to have agreed upon these general rules:

(1) If the granting of the option was not *intended* as compensation, no taxable income would result from either the receipt or the exercise of the option.[2]

(2) If *intended* as compensation, the employee would be taxed upon the exercise (not the *receipt*) of the option, his income being measured by the excess of the value of the stock over the option price. And this was the holding even in cases where the market value of the stock substantially exceeded the option price at the time the option was granted.[3] The theory here apparently was that, until the employee actually exercised his option, the corporation had nothing to deduct by way of compensation, as contrasted with the delivery of other kinds of property as compensation, and therefore the employee could not be taxed—a non sequitur, in my opinion.

In the *Smith* case, the Supreme Court adhered to the test of intent. In that case, the option was held to be of no value when granted, so the court had no occasion to decide whether the mere granting of an option to buy at less than the value of the stock would subject the employee to a tax. However, by way of dictum, it said:

> In certain aspects an option may be spoken of as "property" in the hands of the option holder. . . . When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered.

In that case, it was admitted that the option was granted as compensation and,

[1] *Commissioner* v. *John H. Smith,* 324 U.S. 177 (1945).
[2] E.g., *Geeseman* v. *Comm.*, 38 B.T.A. 258, 262, and *est. of Connolly,* 45 B.T.A. 374, 376.
[3] *Connolly Estate* v. *Comm.* supra; *affirmed* 135 (2d) 64.

since the option was then valueless, the court concluded that the compensation intended must have been what would result from the anticipated increase in the value of the stock—a form of "delayed compensation."

Although, as stated, the Supreme Court said nothing to change the test of *intent,* the Commissioner of Internal Revenue has apparently taken the position that the *Smith* case did change the law in this respect. TD 5507, 1946-1 CB 18, provided in effect that, in the case of every such option granted subsequent to the date of the *Smith* decision, the employee would be taxed on the "spread" at the time of exercise of the option, without reference to the intent of the parties. This amounts to a *conclusive* presumption that compensation was intended, a presumption without authority of law, in the writer's opinion. As to such options granted prior to the *Smith* decision, IT 3795, 1946-1 CB 15, was promulgated the same day. In this ruling, the Commissioner took the position that an option granted prior to the *Smith* decision would not result in a tax on the employee when exercised (or transferred) if:

(a) There was no substantial "spread" at the time the option was granted;

(b) The employee, under the old regulations, would not "otherwise clearly realize income by way of compensation" through such transfer or exercise of the option; *provided, however,*

(c) The employer and employee, on or before July 1, 1946, file written consents with the Commissioner to treat the option and its exercise as noncompensatory for purposes of (1) basis and (2) corporate deduction.

In short, while the case law clearly supports the propositions (1) that the *grant* of the option may result in taxable income to the extent of its value, and (2) that whether or not the *granting or exercise* of the option will result in taxable income depends upon whether the intent was to compensate for personal services, the Treasury's official position is (1) that no tax results, regardless of intent or value, at the time the option is granted, and (2) that, without regard to intent, there is a tax on the employee when the option is exercised.

These Treasury rulings have not yet been tested. If one may rely upon the language of the Court in the *Smith* case, they appear to be unsound in the two respects just mentioned.

If the *Smith* case may be relied upon, the next question is: How may the intent of such a transaction be determined? As already stated, it is difficult, if not impossible to reconcile the decisions as to this conclusion of fact. Some of them seem to distinguish between an option given a new employee to induce him to take the job and one given an old and valued employee. Others seem to find, even in the latter situation, some ground for holding that, if the option is granted to give the employee an opportunity to enter the proprietorship class, as an incentive to increase his efficiency, it is not compensatory, while others take the practical view that, if granted to the employee because he is an employee, compensation is necessarily involved. For a good discussion of the facts which have been given weight, one way or the other, on this question of intent, see Mr. Sax's article, above cited, in 23 *Taxes* 505 at pp. 507, et seq.

Among other questions left unanswered by the *Smith* decision are the following:

(a) Suppose the value of the option, when granted, can be proved and is proved, and the employee pays tax on it. The stock thereafter declines in value below the option price, and the option expires without being exercised. May the employee deduct a loss?

(b) Suppose the same case, except the stock increases in value and is then exercised. Apparently, under the *Smith* opinion, whether or not there would be taxable income when it is exercised will depend upon what was *intended* to be compensation at the time the option was granted, but this is none too clear. There is room for argument, though not much room, that, if the option had value when given, that value measures the taxable compensation, and any subsequent increase in value, realized upon sale of the option or of the stock, will represent capital gain. However, the implication is that the trial court might properly find the intention to be that *both* the value of the option and the subsequent increase in value between the time it was granted and exercised were intended as compensation.

(c) If the option had value when given, and the intent was that that value only represented compensation, should this value be added to the price paid upon acquisition of the stock, to determine its basis?

(d) Suppose the employee, by exercising the option in one year, acquires the unconditional right to receive the stock in a later year. When is he in receipt of taxable income? If not until the later year, is the income measured by the value of the stock in the earlier year or in the later year? If in the earlier year, may this value be discounted for the delay in delivery? If measured by the value in the earlier year, and the value is less in the later year, is there a deductible loss in the later year? The court, in an opinion on a motion for rehearing in the *Smith* case (324 US 695), expressly refused to pass on such questions.

To sum up:

(1) Any grant of an option by an employer to an employee, regardless of the "spread" and regardless of intent, will be treated by the Bureau, upon exercise (and not before), as resulting in taxable compensation to the extent that the value exceeds the option price.

(2) While the courts may continue to respect the "intent" test, the employee has a heavy burden to establish that the granting of the option was not intended as compensation for personal services.

Section 220 of the Revenue Act of 1950 would change these rules in the following respects:

No tax on the employee (except on capital gain) and no deduction by the employer either at the time the option is granted or the time it is exercised if:

(a) The option price is 85 per cent or more of the market value at the time granted;

(b) The option is, by its terms, nontransferable except by death;

(c) The employee holds less than 10 per cent of the stock when the option is granted;

(d) The stock is not sold within two years after the option is granted or within six months after the option is exercised;

(e) The option is exercised while the purchaser is an employee, or within three months after leaving the employment; and

(f) The option was granted, modified, extended or renewed after February 26, 1945, and exercised after 1949.

These rules are furthermore qualified by a special provision applicable when the option price is less than 95 per cent of fair market value when the option is granted. In that event, the "spread" is taxed as ordinary income when the stock is sold, or given away, or the stockholder dies.

25. *In the case of a sale and lease-back of real property, will a loss on the sale be allowed as a deduction? What if there is an option to repurchase the property?*

MR. BERGEN: A sale and lease-back is a transaction in which an owner of real estate sells it but remains in possession under a long-term lease. An example will illustrate the problem: A corporation owning land and buildings having a total tax cost of $1,000,000 requires additional working capital for its rapidly expanding business. The company can borrow as much as $500,000 at an interest rate of 3 per cent, giving a mortgage on the property to secure the loan. If it did so, its balance-sheet would show the $500,000 indebtedness, and there would be serious restrictions on dividend payments and borrowing, etc., which is undesirable to the company. Furthermore, the company will require more than $500,000 of working capital. As an alternative to the loan, it is suggested that a company sell the land and buildings to an insurance company or charitable foundation for $700,000 and simultaneously with the sale enter into a 25-year lease with the purchaser, the rental over the period of the lease to equal the $700,000 purchase price, plus interest which would yield the purchaser 4 per cent over the 25-year term. At the end of the 25-year period, the company is to have an option to renew the lease at a nominal rental, or in the alternative to repurchase the property for a nominal amount.

It is suggested that under this arrangement the rental payments would be deductible by the corporation which would in effect enable the corporation to take a depreciation deduction on land which would otherwise be unobtainable and, in addition, the corporation would obtain a deductible loss of $300,000 on the sale under Section 117(j) of the Internal Revenue Code.

While such a suggestion might be sound from an economics point of view, there are serious doubts as to the deductibility of the loss. A loss might be disallowed either because the transaction was not in reality a sale, but a loan,[1] or because the term of the lease plus the option to renew exceeded 30 years and, therefore, the lease was the equivalent of a fee under Section 29.112(b)(1) of Regulations 111. The lease being a fee, the arrangement in substance would constitute an exchange of "property of a like kind" which would result in no deductible loss.

Although not within the scope of this question, it should be pointed out that it is also very questionable whether a rent deduction would be allowed if the above suggestion is followed.[2]

Some changes in the suggested transaction might result in the desired tax results, however. Thus, if there could be a bona fide arm's-length sale for business reasons at a price reasonably equal to the fair-market value of the property and no strings retained by the seller except an option to repurchase at the fair-market value of the property or to renew the lease on terms which are reasonable, a loss should be allowed. This is borne out by the only court decision on the subject, namely, *Standard Envelope Co.*, 15 TC, No. 8, July 31, 1950, CCH Dec. 17,779. In that case, the Tax Court allowed a loss deduction against excess-profits tax income resulting from the sale and lease-back of land and buildings. The sale was made to a purchaser located by a real estate agent at a price approximately equal to the value placed on the property by two independent appraisers prior to the transaction. The seller retained possession of the leased property for one year with a right to lease the same for a term of 24 years and there was no repurchase or renewal option in the agreement. The court found that the sale was a bona fide arm's-length transaction; that the seller in good faith believed that the sales price represented the fair-market value of the property; that the rental agreed upon was a fair rental for the property; and that there were business reasons for the transaction. The court refused to be swayed by the fact that the seller admittedly had given consideration to the tax consequences of the transaction.

A sale lease-back transaction is one concerning which only the most conservative tax advice should be given, particularly in view of the uncertainties involved, the dearth of authority on the subject and the unlikelihood of being able to obtain a prospective ruling or closing agreement before entering into such transaction.

It will be interesting to observe whether charities which have been purchasers of many properties involved in sale and lease-back arrangements will continue to be as enthusiastic in the light of Supplement U. of the Revenue Act of 1950 under which the rents received by charities as a result of certain types of sale and lease-back arrangements are no longer fully exempt from income tax.

26. *Is an accrual basis taxpayer required to accrue income which is unearned in the year of receipt, or may the accrual of such income be deferred to the year in which earned?*

MR. COOPER: On the basis of Section 41 of the Internal Revenue Code, the Commissioner has successfully contended that advance fees and commissions received without restriction as to use, enjoyment, or disposition, constitute taxable income when received or accrued, notwithstanding that all or a part of such fees or commis-

[1] See *Helvering* v. *F. & L. Lazerus & Co.*, 308 US 252 (1939). The transaction takes on the form of a loan in that the price was not determined on the basis of the fair market value of the property but rather the negotiation had as its primary purpose the repayment of the sales price plus interest to the purchaser. Furthermore, the option given to the seller to renew the lease for a long period was for only a nominal rental and gave the transaction the appearance of a retention of ownership by the seller. An option to repurchase at a nominal figure would look even more like a loan secured by title in the "purchaser."

[2] *Cf. Brown* v. *Comm.* 180 F. (2d) 926, CCA, 3, 1950.

sions may not be earned until sometime following the year of receipt. This concept of taxation is in conflict with sound accounting principle, which requires unearned income, even though received, to be deferred until such time or times as it may be earned.

Consistent with the tax concept of reporting advance fees and commissions in the year received, the Tax Court has held[1] that a public warehouse company keeping its books and filing its returns on the accrual basis could not, during the first two years of its existence, exclude from income that portion of the storage fees which were set aside in a reserve account in order to meet its contractual liability to remove, without cost to the customers, goods from its warehouse at the end of the storage period.

In a prior case[2] also involving a warehouse and similar facts, except that the practice of excluding from income the estimated cost of removing the goods had been followed with unvarying consistency for more than 25 years, the Tax Court concluded that the taxpayer was within its statutory rights in excluding such estimated cost.

The Court distinguished the two cases on the ground that in one the warehouse had claimed the deduction in conformity with a long-established practice, whereas in the other, such established practice, on a long-time basis, was lacking. This distinction is not persuasive. It rests on the fortuitous circumstance that in one case the taxpayer's treatment was accepted by the Examining Agent years ago, thereby permitting that taxpayer to establish a consistent practice, whereas in the other the treatment was not accepted, thereby preventing that new taxpayer from establishing a consistent practice.

The distinction drawn by the Tax Court becomes still less persuasive upon a reading of its opinion in the earlier warehouse case.[3] The opinion in that case is apparently based on two factual determinations: (1) that as a matter of consistent accounting practice over a period of more than 25 years, an amount equal to the estimated cost of removing the goods had been excluded from income, and such practice should not now be disturbed; and (2) that the taxpayer had incurred in the year of receipt a definite and fixed liability to its customers to perform the service of removing the goods from storage at the end of the storage period, and while the exact cost of performing that service could not perhaps be determined in the taxable year, it could be reasonably estimated.

Since a reasonable estimate could have been made in both cases, it must be concluded that the only point of distinction between the two is that one taxpayer was permitted many years ago to establish the practice, while the other taxpayer, having no prior existence and wishing now to establish the practice, is advised that he may not do so.

The rule that advance fees and commissions must be taken into taxable income in the year of receipt even though not yet earned has been applied in a number of other cases. Thus, advance fees on advertising contracts[4] and on promotional contracts[5] to be performed after the year of receipt were held to be taxable when received and not when earned. Similarly tax liability was incurred in the year of receipt with respect to advance tuition,[6] fees from the sale of automobile service coupon books,[7] and from the sale of transportation tickets and tokens,[8] and fees for furnishing health and sport facilities.[9]

However, this rule of taxability in the year of receipt has been rejected where the amount received did not constitute income. In a recent case,[10] amounts received by the taxpayer, a manufacturer of concentrated extract known as "7-Up," from bottlers, to be used solely for advertising purposes, was held to be a trust fund, with the administration of such fund vested in the taxpayer as agent for the bottlers. As custodian of the fund and agent for

[1] *Capital Warehouse, Co. Inc.*, 9 TC., 966 *affirmed* (CCA-8; 1948) 171 F. (2d) 395.
[2] *Towers Warehouse, Inc.*, TC Memo Decision (1947).
[3] *Towers Warehouse, Inc.*, supra.
[4] *E. V. Elliott Co.*, 45 BTA 82.
[5] *Clay Sewer Pipe Assn., Inc.*, 1 TC 529, affirmed (CCA, 3; 1943), 139 F. (2d) 130.
[6] *Northern Illinois College of Optometry*, TC Memo Dec (1943).
[7] *South Tacoma Motor Co.*, 3 TC 411.
[8] *East Penn Transportation Co.*, TC Memo Decision (1947).
[9] *Your Health Club, Inc.*, 4 TC 385.
[10] *The 7-Up Co.*, 14 TC No. 115.

the bottlers, the taxpayer was obligated to expend such fund for advertising and any divergence for corporate or other purposes could have been enjoined by the bottlers. On these facts the amounts received were held not to be taxable to the recipient.

The principle applied in the case of the bottlers may be traced back to the cemetery associations which set aside amounts received for perpetual maintenance of cemetery lots and vaults. Where the facts indicate that such amounts are impressed with a trust either by virtue of a contract or local statutes and therefore may not be used for any other purpose by the association, it has been held[11] that there is no taxable income to the association. However, tax liability has been asserted where the facts indicated that the amounts received were not impressed with a trust expressed or implied.[12]

To be distinguished from advance fees and commissions for personal services to be rendered are deposits received from customers on executory contracts for future delivery of goods.[13] Until the sale is consummated upon delivery of the property or the passing of title, there is no closed transaction on which gain can be accrued.[14] The statute taxes gains from sales, not estimated gains from contracts to sell.[15] This principle was applied in determining that no gross income was realized from the receipt of deposits made by customers on contracts to sell and deliver coal in the future at retail prices prevailing at the time of sale.[16]

Also to be distinguished are deposits made by lessees to secure performance of their obligations under the terms of a lease. As in the case of deposits on executory contracts, the receipt of security deposits does not constitute a closed transaction on which gain is realized. This is for the reason that so long as the lessor is under obligation to return the deposit either upon termination of the lease or upon the happening of some other specified event, he is no more in receipt of gain than one who borrows money. As stated by one court,[17] because of the acknowledged liability to account for the deposit, there is no gain; just as there is none in borrowing. On the other hand, if the lease merely provides that the additional payment shall be applied in satisfaction of the last year's rent, such payments constitute rent paid in advance and must be taken into income in the year of receipt.[18]

Whether a given payment represents a security deposit or advance rental depends upon the intent of the parties to be ascertained from an examination of the lease as a whole. The fact that a refund may have to be made to the lessee in the event that the premises are destroyed by fire, is a circumstance which attends the ordinary receipt of rental in advance and may not be relied upon as establishing the status of the payment as a security deposit.[19] The requirement that the payment be refunded to the lessee upon termination of the lease would appear to furnish the most convincing evidence that such payment was intended to be a deposit and not an advance rental.

27. *What tax planning might be accomplished now by a corporation in anticipation of a new excess-profits tax?*

MR. MILLS: This problem at the present stage is very largely a guessing game, with the added strike against you that the Congress is committed to making the excess-profits tax retroactive. However, it can be approached from two angles:

(1) It may be assumed that in drafting the new excess-profits tax law the Congress will consider the form of the 1940–1945 statute, and in fact I think it a fair assumption that the general pattern of the old law will be re-enacted.

(2) In any event, income after 1950 will be subjected to a higher tax burden.

Considering the last point first, we have the same opportunity for tax planning that is presented whenever there is a certainty of increased tax rates. Every year, from November to January, our tax literature has articles on how to anticipate or to defer

[11] *The Parkview Memorial Association*, 34 BTA 406.
[12] *Springdale Cemetery Assn.*, 3 BTA 223.
[13] *Veenstra & Dehaan Co.*, 11 TC 964.
[14] *Burnet* v. *Logan*, 283 US 404 (0000).
[15] *Consolidated Utilities Co.* v. *Comm.*, (CCA, 5; 1936) 84 F. (2d) 548.
[16] *Veenstra & Dehaan Co.*, 11 TC 964, supra.
[17] *Clinton Hotel Realty Corp.* v. *Comm.* (CCA, 5; 1942) 128 F. (2d) 968.
[18] *Edwin V. DeGolia*, et ux, 40 BTA 845.
[19] *Hirsch Improvement Co.*, TC Memo Dec (1942).

the tax incidence of transactions, and I am not going to try to cover all of the opportunities for such planning. Advertising programs, repairs, compensation plans, pending sales of property, can be accelerated or deferred, depending on decision of the best fiscal period for the accrual. This kind of tax planning requires a very intimate knowledge of the corporation's affairs, since it is not the negative problem of consideration of the tax treatment of consummated transactions, but rather advice on the form and timing of uncompleted or contemplated transactions. Unless the accountant has this close contact and knowledge of his client's affairs, he must make the management aware of the problem, so that they can apply it to the specific circumstances.

In this planning you cannot only accelerate or defer consummation of transactions creating income, but you can also secure advantage from the many variations of tax-accounting rules from ordinarily accepted accounting principles. For example, if settlement of a pending federal tax controversy is deferred until next year, the entire interest assessment on the deficiency will be deductible from excess-profits net income. Similar consideration should be given to the tax accrual rules for settlement of state tax controversies, litigation, etc. LIFO taxpayers who have an opportunity to replace involuntarily liquidated inventory before 1951 should consider the effect on current and future income and also on income of years which may be part of a base period for excess-profits tax purposes.

On the matter of possible measures of normal profit for excess-profits tax purposes, the problem is to build up the finally determined amount of taxable income for prior years which may be in the base, and also the net worth of the taxpayer. Generally it is too late to revise previously consummated transactions, but at least reconsideration can be given to the vigor with which you should resist attempts of revenue agents to increase taxable incomes of prior years under examination. It may be fortunate that revenue agents usually set their sights on the year they are examining without considering the over-all tax effect on the corporation.

28. ***Under what conditions may a taxpayer deduct accelerated depreciation? Does the Bureau permit greater depreciation during the early years of useful life when the asset has its maximum utility value?***

MR. CALDWELL: Internal Revenue Code Section 23(1)(1) and the regulations thereunder prescribe that the depreciation deduction shall be a reasonable allowance for exhaustion, wear and tear, including a reasonable allowance for obsolescence. Internal Revenue Bureau Bulletin F sets forth acceptable estimated useful lives and rates of depreciation for various classes of property. The bulletin states that its data is set forth solely as a guide or starting point from which correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence.

The taxpayer must accept the responsibility for supporting claims for depreciation rates higher than those prescribed. Remember that Bulletin F rates are for new property and that ordinarily higher rates may be claimed for used property.

In order to obtain depreciation deductions at accelerated rates evidence must be submitted not only regarding increased usage, by two- or three-shift operation for example, and of unusual operating conditions, but also evidence to prove that such increased usage and abnormal conditions will result in an actual shortening of the useful life of the asset. Detailed records of the individual assets should be maintained and opinions from independent engineers, appraisers, and the vendors of the property should be obtained as fortification against the inevitable Bureau scrutiny.

Trial of some cases has resulted in the allowance of double normal depreciation in instances of combinations of extremes in number of hours of operation and unusually bad maintenance programs. In general, however, about one-third to one-half greater than normal rates is all that can be expected. Consideration of the obsolescence factor in setting normal rates usually operates against obtaining higher accelerated rates than these since ordinarily with normal maintenance machinery will actually run for a longer period than indicated by the prescribed normal rates.

By use of the declining-balance method, the Bureau permits deduction of greater depreciation charges during the early life of an asset. This method requires that accumulated depreciation be applied to reduce the cost basis so that each year a lesser amount of depreciation is allowable. It is like the old question, "How long does it take a frog to jump the length of a log if he jumps half the remaining distance each time." He never makes it.

The Bureau refuses to recognize the use of a rate greater than 150 per cent of normal in figuring depreciation under the declining-balance method. Under these conditions the initial benefit under the declining-balance method is often not worth the final detriment. It would be well to consult tables comparing this method with the straight-line method before adopting it.

The Bureau recognizes the use of the unit of production method, but usually only in cases of machinery or equipment used in operations connected with exhaustible assets, such as mining or quarrying. This method requires the deduction of estimated salvage value from initial cost and the division of this remaining value by the estimated units of raw material available.

29. *What are some of the possible tax consequences of the liquidation of a corporation in order to operate the business as a sole proprietorship or partnership?*

MR. HOPSON: We may briefly and generally say, in answer to this question, that complete liquidations of corporations receive tax law treatment as an exchange of stock held by the shareholders for assets of the corporation; that such exchange is taxable as a capital gain or loss measured by the difference between the fair market value of assets distributed and the basis of the stock in the hands of the shareholders; and that the distributed assets take on a new basis for subsequent disposition, depreciation, depletion, etc. A large variety of consequences has developed in corporate liquidations and time will not allow a discussion of all of them.

The corporation may have developed goodwill which has no cost basis but which may have a transferable value that is taxable as assets distributed.

Depreciable and depletable property may have current values materially different from the former bases. Such differences are factors in the liquidating gain or loss, and also in future allowances for depreciation and depletion. The same principle applies to inventories. Benefits may arise from deriving capital gain which may turn into ordinary deductions in the future.

The capital gain upon liquidation may unexpectedly be great enough to impair current working capital of the successors.

I recall one experience where a taxpayer could not use prospective individual losses because of a large capital gain due to a liquidation. The alternative computation without benefit of the losses would have resulted in a lower tax than the application of normal and surtax rates to the net income, that is, capital gain less ordinary losses. Steps were taken to minimize the losses.

The corporation may have had unused capital loss carry-overs and also net operating loss carry-overs that may not be availed of by the successor. In reverse, if the successor sustains a net operating loss in its first year of operation, it may not carry such loss back against prior years' profits of the corporation, but a proprietor or partners may be able to otherwise use the loss of the new business.

If the corporation had previously charged off bad debts without tax benefit, recoveries by the successor will be taxable whereas recoveries by the predecessor may have been tax-exempt.

The corporation may have been a dealer reporting sales of merchandise under the installment method. If so, the unrealized profit became taxable as ordinary income at the time of distribution of the installment obligations.

A corporation with a Section 102 problem usually solves it for the final period by liquidation since liquidating dividends represented by earnings and profits after 1913 are allowable credits against undistributed Section 102 net income. However, the liquidation may in some circumstances increase Section 102 danger in prior open years.

At this time, there is uncertainty regarding treatment of corporation income-tax deficiencies assessed after the liquidation against the transferees. The Tax Court has upheld the Commissioner in saying that the deficiency could not reduce the liquidating gain in the year of liquidation. But the majority of the Court went against the Commissioner in the *Switlik* case and said that the deficiency could be deducted by the transferee as an ordinary loss in the year of assessment. The Commissioner wanted it to be a capital loss in the year of assessment and has appealed. It will be interesting to see what the higher courts say.

There are other possible consequences involving unamortized debt discount and expense on continuing bonds, taxability of insurance proceeds on policies transferred for value, changes in fiscal years, group insurance, acceleration of income-tax payments, and new needs for estate planning.

30. *Is it safe from a tax standpoint to split up a corporate business into two or more corporations owned by the same stockholders?*

MR. KILPATRICK: It is possible to divide one corporation into two or more corporations owned by the same stockholders, without tax consequences to such stockholders. Unfortunately, however, the selection of the *form* of doing this may invite tax troubles.

At the outset, let us define two terms often used in connection with such transactions, namely, the "split-up" and the "spin-off":

A typical "split-up" occurs where Corporation A transfers its assets to newly created Corporations B and C in exchange for their stock, and thereafter A's holdings in B and C are distributed to A's stockholders and A is dissolved.

A "spin-off" occurs when Corporation A, having conveyed part of its assets to such a new corporation for its stock, distributes the stock of the new corporation among A's stockholders, *wihout surrender by them of their stock in A*.

Under existing law, the "split-up" results in no tax on the stockholder,[1] but the Bureau holds that the "spin-off" does result in the distribution of a taxable dividend by A, although the result in substance is the same in both cases, with the same stockholders owning, in the same proportions, the same business they owned before, except that it is divided into two legal entities instead of being contained in one.

Section 112(g) of the Revenue Act of 1932 and prior laws specifically exempted the "spin-off" from taxation. However, this provision was dropped in 1934 because a decision of the Board of Tax Appeals[2] indicated that the provision might be subject to abuse by permitting the assets of the old corporation so transferred to the new corporation to be immediately distributed by the new company as a liquidating dividend to the stockholders with no dividend tax liability. While the Supreme Court held to the contrary,[3] Section 112(g) has not been restored, so the "spin-off" is presumptively taxable, but the "split-up" is not.

Section 207 of the Revenue Bill of 1950, inserted by Senate amendment, would have restored Section 112(g), with certain safeguards to prevent abuse of the sort attempted unsuccessfully in the *Gregory case*. If this had been enacted into law, the "spin-off," like the "split-up," would be nontaxable, but the amendment was stricken out, without official explanation, in conference between the two Houses.

31. *In view of the abolition of the 30% rule, is an employee's pension plan now practicable from a tax standpoint for the closely-held corporation?*

MR. CALDWELL: Prior to the decision in the *Volckenning* case, 13 TC No. 94, Nov. 10, 1949, the Commissioner had issued several rulings restricting the benefits that may accrue to stockholding and high-salaried participants. The 30 per cent rule was set forth in IT 3674 and provided in effect that a pension plan would not qualify if in the aggregate more than 30 per cent of the employer's contribution benefits stockholders, each of whom owns more than 10 per cent of the voting stock of the corporation.

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[1] IRC, Secs. 112(b)(3) and 112(g).
[2] *Gregory* v. *Comm.*, 27 BTA 223.
[3] *Gregory* v. *Helvering*, 293 US 465.

The Commissioner alleged in the *Volckenning* case that the plan was not for the exclusive benefit of employees as required by Code Section 165(a), and that contrary to Section 165(a)(4) it discriminated in favor of shareholders. All of the capital stock of the corporation was owned by Volckenning and his wife. During the years under review, 1943 and 1944, 58.3 and 53.2 per cent, respectively, of the contributions by the corporation were applicable to the purchase of annuities for the two stockholders.

The court held that IT 3674 was a general rule only, to be considered with all the facts and not applicable in this instance. Subsequently, the Commissioner acquiesced in the *Volckenning* decision and announced the revocation of rulings IT 3674, 3675, and 3676, but announced that in order to qualify under Code Section 165(a) the eligibility requirements of such a plan must not discriminate in favor of employees who are shareholders, and such a plan must not amount to a subterfuge for the distribution of profits to such shareholders. IT 4020, Aug. 7, 1950.

Clearly the abolition of the 30 per cent rule as a result of the *Volckenning* case is a long step toward making the adoption of an employees' pension plan practicable from the standpoint of the closely-held corporation. But, as a word of warning, note the continuing admonition of the Commissioner in IT 4020, and also that in the *Volckenning* case:

1. Salaries of shareholders which formed the basis for pension contributions were reasonable and relatively consistent.
2. A limitation of annual retirement payments discriminating *against* the shareholders was provided in the plan. The annuity was to represent 30 per cent of the annual salaries, with a maximum annual total of $2,400. The president's salary was $20,000.
3. Some payment of dividends was made.

Of course in all cases the salary or compensation paid directly to any individual plus any contribution on his behalf to a pension or profit-sharing plan must in the aggregate be reasonable (Sec. 23(p)(1)).

32. *Can the limitations of Section 24(c) be avoided by the issuance of notes to a controlling stockholder in payment of accrued salary?*

Mr. Mills: Section 24(c) provides for disallowance of unpaid expenses and interest accrued by an accrual-basis corporation and payable to a controlling stockholder, if the stockholder is on the cash basis and the item is not paid within two and one-half months after the close of the taxable year.

The controlling word in the section is "paid," and there has been considerable litigation as to what constitutes payment for these purposes. The Tax Court for some time considered that the word paid meant that it had to be paid in cash, but more recent litigation has developed a somewhat more liberal attitude with respect to payment either in the form of notes, or by credit on the corporation's books under circumstances in which constructive payment can be argued. It now seems fairly well established that payment of salaries or other expenses in the form of negotiable promissory notes will qualify as payments under Section 24(c). In a 1943 case the 6th circuit commented, "To construe the word 'Paid' to mean that the payment must be in cash, is to distort the statute." Subsequent decisions have removed an earlier tendency to confine the payment to short-term notes. However it is still advisable to make payment in the form of negotiable notes, without any agreement not to discount or dispose of the notes, and it is also important to be able to demonstrate that the corporation payor is solvent.

Since form is so important in such transactions, every effort should be made to arrange for payment in cash, even if the corporation has to borrow funds for the purpose, and liquidates the outside borrowings by reborrowing from the employee-stockholder.

33. *May premiums paid in the gray market to acquire steel be excluded in valuing the steel in the inventory at the close of the taxable year?*

Mr. Melvoin: Before venturing an opinion as to the inclusion of a premium paid for steel in the gray market, inquiry should be directed to the method adopted and consistently adhered to by the taxpayer in respect of valuing inventories.

The great majority of taxpayers compute inventories on cost, or cost or market whichever is lower, and on the presumption of "first-in, first-out."

If "cost" is the method pursued, including the use of "first-in, first-out," the last purchases if exceeding the quantity in the closing inventory would be identified as "gray" or premium steel. The regulations would therefore require that the valuation include the premium (Reg. 111, Sec. 29.22(c)-2; Sec. 29.22(c)-3). Accountants probably would disagree and suggest a lower figure.

Where the lower of cost or market method is used, the material content of finished or semifinished products embracing the premium steel may be valued consistent with the Regulations, at the market for similar goods, which presumably is lower when purchased from ordinary channels (Cf., *Bedford Mills* v. *US*, Ct. of Claims, 1933).

Likewise, raw materials would be subject to valuation at "market," meaning the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer under ordinary circumstances (Reg. 111, Sec. 29.22(c)-4). Herein, the premium is excluded.

If the taxpayer is on a LIFO basis, valuation would follow the usual practices under LIFO, namely, by identification with the opening inventory valuations, followed, if closing quantities are greater, by reference to the succeeding purchases. Thus, only under extraordinary circumstances occasioned by a steep increase in quantities, would the premium be included in an inventory valued under the elective method.

34. ***Assume that a corporation needs additional working capital and that stockholder A is willing to lend an additional $25,000 in return for noninterest bearing registered bonds of $30,000, maturing in five years. Will A realize interest income or a long-term capital gain of $5,000 upon redemption of the bonds at maturity? When does the corporation obtain the deduction?***

MR. MESSERSMITH: The question here presented concerns the treatment for federal income-tax purposes to be accorded to the excess of the amount paid by a corporation on maturity of its noninterest bearing bonds over the amount received by it on issuance of the bonds under the following facts:

A lends to a corporation, of which he is a stockholder, the sum of $25,000 in return for noninterest bearing registered bonds of $30,000, maturing in five years. Will A realize interest income or a long-term capital gain of $5,000 upon redemption of the bonds at maturity? When does the corporation obtain the deduction?

There appears to be no question but that the $5,000 excess is compensation for the use of the money. In *Fall River Electric Light Co.*, 23 BTA 168, the Board said, "Interest on indebtedness has a definite and well accepted meaning as 'the compensation allowed by law or fixed by the parties for use, or forbearance, or detention of money'." Also to similar effect, see *Kena, Inc.*, 44 BTA 217, and the cases cited therein. Therefore, it seems that the income of $5,000 to A is clearly in the nature of interest.

In considering the nature of the income, we might refer to Section 42(b) of the Internal Revenue Code. Section 42 relates to the period in which items of gross income are to be included, and subsection (b) thereof gives cash basis taxpayers the right of election to treat as income in each year the increase during the year in the redemption price of any noninterest bearing obligation (government, public, or private) issued at a discount and redeemable for fixed amounts increasing at stated intervals; if the election is not so exercised, a cash basis taxpayer would, of course, be required to report the entire increase as income in the year of receipt. This section deals only with the period in which the income is to be reported and does not define the nature of the income, whether ordinary income or capital gain. Section 42(b) was inserted in the Code as a relief measure, and the implication appears to be that the income there discussed would be ordinary income unless some other section of the Code provided otherwise. In this connection, Section 117(a) excepts from the definition of capital assets certain government obligations (federal, state, territorial, etc.) issued on a discount basis and payable without interest. As to these securities, the increase would unquestionably be ordinary income, but no light is shed in this subsection on the nature of the income resulting from corporate bonds issued at a discount.

It seems to be a reasonable conclusion, therefore, that upon redemption of the bonds A will realize ordinary income unless specific relief is found in the statute. We turn to Section 117(f) of the Code and find it there provided that "for the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), *with interest coupons or in registered form* (underscoring supplied), shall be considered as amounts received in exchange therefor." Under this provision gain or loss would be capital gain or capital loss (it is assumed that A is not a dealer in securities) if the obligation had been issued by a corporation with interest coupons or in registered form. The subsection is broad in its scope and apparently covers all obligations of the kinds indicated regardless of whether or not they are interest-bearing. This conclusion appears to be borne out by the decisions in the cases of *Edith K. Timken*, 6 TC 483, and *Otto G. Nobis* (Tax Court Memorandum Decision, Docket No. 983, entered December 31, 1943), wherein gain on retirement of registered noninterest-bearing notes and certificates of indebtedness was held to be capital gain.

It may be well to discuss briefly what the term "in registered form" means. In the *Timken* case it was held that the notes were in registered form because "since there were provisions for notice to the noteholders of record, it is plain that there was a record, or registry of the noteholders. The notes were numbered serially, which of itself to some extent indicates registration, as does the fact that each note bore a form for appointment of attorney to transfer on the books of the corporation." In *Victor B. Gilbert*, 6 TC 10, petitioner relied on the fact that the obligations "were at all times entered, noted, and carried in the books, records, and accounts of the obligor corporation" and that the obligations were recorded in the county register "in compliance with the statute"; the Court held that the foregoing did not comply with the statutory expression "in registered form" and cited with approval a definition from *Gerard* v. *Helvering*, 120 F. (2d) 235, as follows:

> . . . Since the bond had no coupons she cannot succeed unless it was "in registered form," a phrase whose meaning in this context is entirely plain. It refers to the common practice in the issuance of corporate bonds which allows the holder of one or more coupon bonds of a series the option to surrender them and have one bond "registered" upon the books of the obligor or of a transfer agent; or the holder may subscribe for such a bond in the first place. The purpose is to protect the holder by making invalid unregistered transfers, and the bond always so provides upon its face. The mere fact that the debtor keeps books of account upon which the debt appears is altogether immaterial; to construe the statute as the taxpayer asks would in effect make the payment of any corporate debt—"evidence of indebtedness"—a "retirement" of "capital assets," for almost all corporations keep books. It is scarcely necessary to labor the answer to so plain a misinterpretation.

It may be concluded, therefore, that A will realize a long-term capital gain upon redemption of the bonds at maturity, provided the bonds are "in registered form" within the statutory meaning of that term.

With respect to the time when the corporation obtains the deduction, the difference between the face amount of the bonds, $30,000, and the amount received, $25,000, appears to come within the general meaning of the term "discount," although the difference of $5,000 is compensation for the use of the money and might, therefore, be considered to be interest. Section 29.22(a)-17(3)(a) of Regulations 111 states "if bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." The regulation does not mention either the accrual or the cash basis, and presumably the rule would apply to taxpayers on either basis, provided that the $5,000 was held to be discount and not interest paid for the use of the money.

If the amount were to be held a payment of interest, a taxpayer on the accrual basis would obtain the deduction in the same manner as if it were discount. However, a taxpayer on the cash basis may deduct interest only in the year in which it is paid. Discounts on loans were held to be deductible as interest in *Edwin M. Klein*, 31 BTA 910, *affirmed* (CCA, 7; 1936), 84 F. (2d) 310, and *US* v. *Collier* (CCA, 5; 1939), 104 F. (2d) 420. In *John C. Cleaver*, 6 TC 452, *affirmed* (CCA, 7; 1946), 158 F. (2d) 342, it was held that a cash-basis taxpayer cannot deduct discount on a loan until he has paid it. The cases cited all deal with discount on loans as contrasted with discount on bonds but it does not appear to be definitely settled whether under the circumstances the corporation (if on the cash basis) would be entitled to amortize the "discount" ratably over the life of the bonds; however, I would strongly recommend that the discount be amortized currently.

In the foregoing, it has been assumed that stockholder A and the corporation do not stand in a relationship covered in Sections 24(b) and (c) of the Internal Revenue Code. If the elements of control and difference in methods of accounting, there mentioned, exist, the corporation might be denied the deduction for the discount applicable to all years except the year the bonds mature. In any event, there would be special problems to be faced, which are considered to be beyond the scope of this paper.

35. *What are the major tax problems involved in stock-purchase agreements among stockholders of a closely-held corporation?*

PROFESSOR SURREY: This question, concerning stockholder agreements for the purchase of the stock of a stockholder, generally deceased, and for the financing of such purchases, obviously relates to a broad area. It would be both rash and dangerous to do more than name a few of the tax mountains that rise above the mists overhanging the area. A prominent pinnacle is Section 115(g). If pursuant to the agreement the stock is purchased by the corporation, while normally a partial liquidation would result, there may be circumstances in which Section 115(g) could cause trouble. Thus, suppose the remaining stockholders are the beneficiaries of the estate of the decedent stockholder. In this connection, the recent amendment to Section 115(g) removes some of the dangers, provided that the stock is more than 50 per cent of the net estate. Further, Section 115(g) may produce a dividend to the remaining stockholders if there are any funds paid out by the corporation. Thus, if the remaining stockholders purchase the stock and then resell it to the corporation, Section 115(g) may well apply. And perhaps Section 115(a) might apply if the remaining stockholders are obligated to buy the stock, or are jointly obligated with the corporation, but the stock is actually purchased by the corporation.

Another income-tax peak, this time as respects the corporation, if it is the purchaser, is Section 102. Does the use of surplus to purchase the stock indicate a previous unreasonable accumulation of earnings? Presumably, there may be corporate advantages in the arrangement, such as continued services of the officer-stockholder, which tie the accumulation to the business needs.

As respects the estate tax, one major problem is that of valuation—what effect does the agreement have on the value of the decedent's stock subject to the agreement. Related to this question, where the value under the agreement is less than the value would be in the absence of agreement, is the question whether the excess is a transfer from the decedent which is taxable under the estate tax. Essentially similar questions may arise under the gift tax.

These are only some of the major problems involved. Others may well arise, especially where insurance is used. Reference may be made to:

RAUM, "Stock Purchase Agreements Among Stockholders of Close Corporations," 8 NYU Tax Institute, 702 (1950).

YOUNG, "Income Tax Aspects of Stockholders' Agreements," 7 NYU Tax Institute, 621(1949).

NESS, "Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death," 49 Columbia Law Review, 746 (1949).

COHEN, "Restrictive Agreements for Purchase of Stock: Effect on Estate and Gift Tax Valuations," 5 NYU Tax Institute, 54 (1947).

36. *What are the tax consequences, both to the corporation and to the individual, of permitting executives to use company automobiles?*

MR. HOPSON: I assume that the question refers to nonbusiness use of the automobiles. Companies frequently assign cars to executives primarily for company business use with the understanding that the car may be taken home at night. No doubt, the cars are used personally on occasions.

I have observed that Revenue Agents rarely propose adjustments in such cases. It may be advantageous to the company for the car to be taken home by the executive rather than to provide a company garage for it. Also, certain executives may use the cars for business purposes in off-hours and in such cases, it is good business for him to keep it at hand. The Tax Court has held that inconsequential personal use may be disregarded.[1] I think that personal ownership by the executive of a family car may often be the deciding factor in sustaining deductions for the expense of the company automobile.

If personal use is consequential, adjustments may be proposed by the Commissioner. It seems that where automobile expenses are not necessary business expense to any degree, the items may be disallowed as deductions.[2] Revenue Agents usually prefer to disallow deductions in examination of company returns rather than to open up the executive's return and treat the expense as additional compensation. However, disposition of the question may result in deductions being allowed to the company as additional compensation to the executive, taxable to him.[1] If the company claims the deduction as compensation, the test of the aggregate compensation being reasonable may be applied. If the aggregate compensation is unreasonable, the deduction may be lost and the executive may also be taxed.

Where company automobiles are used partially for business and partially for personal use, taxpayers often are at a loss to furnish evidence regarding the portion of expense allocable to each use. In the absence of accurate facts as to how much the automobile was used in business, the Tax Court has followed *Cohan* v. *Commissioner*, 39 F. (2d) 540 in making approximate allocations.[2] In the *Cohan* case, the Court said, "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." Each taxpayer should decide whether executive's use of company cars warrants the necessity of preparing proof as to the portion of expense and depreciation allocable to business use.

[1] See *Rodgers Dairy Co.*, 14 TC 66 (1950 CCH Dec. 17, 453).

[2] See *Leadbetter*, 39 BTA 629—CCH Dec. 10, 625 and *Floyd, Inc.*, TC Memo, September, 1943.

Highlights of the American Institute of Accountants public relations program

by GEORGE E. PERRIN, CPA

When the expanded public relations program of the American Institute was getting under way three years ago, the public relations committee adopted a formal program statement which included the following description of what we wanted to do:

> To establish, through the communication of facts and ideas, a broader public understanding of the functions and responsibilities of the certified public accountant and his role in our complex modern economy, thus creating a more favorable climate of public opinion for the profession; gaining wide public support for the maintenance of high ethical and professional standards; and assuring full opportunity for the CPA to render maximum service to society.

I was a member of the committee which signed that report, but frankly, I don't think it helps very much to explain what public relations is all about. The sentiments are fine. The trouble is that they need to be translated into action before they mean anything.

During the last three years, we have made some real progress in practical down-to-earth public relations activities. I'd like to summarize a few of the major things which have been accomplished. But first I'd like to try once more to answer the question which people ask me over and over again: "Just what is public relations, anyway?"

Public relations covers a great many different ways of getting ideas into people's heads. Everthing certified public accountants do individually and through their state and national organizations is public relations. The uniform examination; the bulletins issued by the committees on accounting and auditing procedure, along with the services and publications of the research department; *The Journal of Accountancy;* our state, regional, and national meetings—all of them have an important effect on what the public thinks about certified public accountants.

Therefore the public relations committee and the public relations department of the Institute are concerned with almost all phases of Institute activities. But that raises another question: "If everthing we do is public relations, why have a special public relations committee and public relations department?"

There are several reasons:

To begin with, our public relations department is comparable to the advertising and sales departments of a business corporation. There are two essentials in every business: First, you have to have a good product; second, you have to have a market for it. In our case, the product we have to sell is the professional qualifications of the certified public accountant. It is a good product, and many of the Institute's activities are devoted to making it better. But we also have to sell it. We have all been up against the fact that too many businessmen do not know the difference between a certified public accountant and any other public accountant. For that matter, a lot of them don't know why they should use an independent accountant at all, and in a profession where the number of CPAs has nearly doubled in ten years, we can find ourselves in real trouble if we don't do the sales job successfully.

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In selling the services of the certified public accountant, we use a number of public relations techniques.

The first and most obvious is publicity. The Institute has always had a good press, but in recent years we've done a lot more about newspaper publicity than we ever did before. In addition to press releases about meetings and special activities, the public relations department now sends out individual releases every month to the home-town papers of all newly elected Institute members. We also send out home-town releases for those who attend regional conferences. Releases have already gone out for the members who are here at this meeting. Naturally, not all of them get printed—but these purely routine releases have resulted in literally hundreds of newspaper clippings during the past year. Every one of them reminds the reader that there is such a thing as a certified public accountant, and that he is a professional man who belongs to a professional organization.

As another part of this sales job, the public relations department has recently prepared more than a dozen articles on the general subject of "bigger profits through better accounting" which are being published in various trade magazines. Each article explains how full utilization of the services of the certified public accountant can put dollars and cents in the pocket of the average small businessman.

One of the special things we did during the last year was a series of three booklets for the National Association of Master Plumbers. We prepared the text, and the Plumbers' Association paid for printing, illustrations, and distributing the booklets to its 15,000 members. Each of these booklets explains in concrete, dollars-and-cents terms how a master plumber can save money by getting advice and assistance from a certified public accountant.

Other phases of the sales job include radio and television. Most of you are probably familiar with the two transcribed radio tax shows which were prepared by the Institute and broadcast by more than two hundred stations throughout the country last February and March. Each of them identified CPAs with tax practice.

Still another application of public relations techniques is the preparation and distribution of public information pamphlets: *Why CPA Standards Are Important to You, Small Business Has Big Problems, A Career in Public Accounting,* and *The CPA Examination: Gateway to a Profession.* The total distribution of these four pamphlets runs to more than 150,000 copies.

But all of this is only one part of the specialized activities which we group under the general head of public relations.

A second major area is legislation, and relations with other professions. Of course these are problems which must be dealt with by the top officers of the Institute, the executive committee, and two or three other committees. Nevertheless, the work of these officers and committees might be largely ineffective if it were not supported by the use of public relations activities. For example, the Institute has been engaged for several years in a successful effort to oppose enactment by Congress of a bill to make the Tax Court a Court of Record. Our success has been due in considerable measure to the widespread attention we have obtained for the Tax Settlement Board Bill through newspapers, magazines, radio, and a pattern speech prepared for delivery by members of the Institute before business organizations. Mr. Austin will discuss some of the public relations aspects of our dealings with legislation and the legal profession later in this program.

In cooperation with the Institute's committee on state legislation, the public relations committee and the public relations department have also provided legislative assistance to the various state societies through the preparation of a legislative kit with suggestions and material for handling legislative problems.

A third major aspect of the Institute's public relations concerns relations of the Institute headquarters with the members and the state societies. The legislative kit which I have just mentioned is only one of many examples of materials provided for the use of the state societies. Because most such material is in one way or another a matter of public relations, the Institute's state society service department has been closely integrated with the public relations department under the same director. For similar reasons, *The CPA*—our monthly bulletin for the membership—is now written and edited in the public relations department.

I could go into a lot more detail and give you statistics on a variety of other accomplishments, but I hope I have said enough to make it clear that what we mean by public relations is a very broad field, including many different activities, all of which are of direct practical importance to the members of the profession.

As a matter of fact, we have so far scarcely more than scratched the surface. As the Institute membership grows, I haven't the slightest doubt that our public relations activities will expand in new directions as well as along the lines we have already followed.

In all of this, however, there is one serious danger: The members may feel that if they have a good public relations program run by my committee and the Institute headquarters, they don't have to worry about public relations themselves. Just the opposite is true. A national public relations program can help create a better understanding and wider acceptance for the individual CPA, but what people think of him still depends on himself and no one else.

Let me put it this way: Newspaper stories, magazine articles, radio broadcasts, and pamphlets prepared by the Institute help to make more people understand what a certified public accountant is and what he does. But none of this material is any good unless it gets distributed down to the grass roots. The professional public relations experts we have on the staff in New York can prepare material and make suggestions, but in the long run good public relations for the profession depends upon the state societies, the chapters, and the individual members. The most important part of public relations is personal and local.

The Institute cannot possibly run a public relations program from New York which will reach out into every city and town in the country where certified public accountants are now practicing. We can furnish the material, but everybody has to work together to do a successful public relations job.

We are therefore devoting a major part of today's program to state society public relations. We have arranged for two speakers to cover, first, what can be done by the public relations committee of a state society with little or no professional assistance, and second, how these activities may be expanded and additional public relations functions undertaken by those societies which have a part- or full-time executive secretary.

Public relations for a state society

by NORMAN H. S. VINCENT, CPA

ONE OF THE very large insurance companies stated in a recent publication that ". . .Everybody is concerned about *public relations*—the butcher, the baker, the candlestick maker. *First*, because good public relations are important to the success of every business; *second*, because maintaining good relations with John Q. Buyer is essential to the success of every man who sells any product or service today."

What are we talking about when we refer to "public relations?"

I like the definition which runs like this: public relations is the *art* of simultaneously deserving and achieving public support and understanding. An *art*, according to Webster, is the systematic application of knowledge or skill in effecting a desired result. Therefore, public relations is the systematic application of knowledge or skill in effecting the desired result of simultaneously deserving and achieving public support and understanding.

As members of the accounting profession we should be and are, I believe, genuinely interested in "simultaneously deserving and achieving public support and understanding." Assuming that statement to be correct, what means are open to us to get ourselves and our story across to "the butcher, the baker and the candlestick maker?"

Here is what we have tried to do in Massachusetts.

For many years, one of the standing committees of the Massachusetts Society has been a committee on publicity, whose duty, according to the by-laws, it was "to undertake, on the behalf of the Society, publicity of an educational nature with a view to informing the business community of the value of the services which its members are qualified to render." At the last annual meeting of the Society, the name of the committee was changed to "committee on public relations," as it had seemed for some time to the officers of the Society that the designation "publicity" was not broad enough.

Each year the incoming president appointed a committee of two, three, or four members, and the work of these committees centered around obtaining space in local newspapers for reporting meetings held by the Society. In a few instances, the committees cooperated with the American Institute of Accountants in distributing pamphlets such as *Accounting and Your Pocketbook* and *What Does an Auditor's "Certificate" Mean?*

Following the distribution by the American Institute of Accountants of the handbook on *How To Have Good Public Relations*, the officers of the Massachusetts Society became more and more interested in expanding the work of the publicity committee. We consulted from time to time with the public relations staff and counsel of the Institute and, in the latter part of 1948, the executive committee of the Society authorized an expanded public relations program including the solicitation from members of funds to finance such a program.

In taking this step, the executive committee was of the opinion that a profession, in a broad sense, is what the public accepts as a profession and is no stronger than the public opinion which supports it.

It was the intent to have our program inform both general and key Massachusetts publics of the profession's objectives,

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standards, achievements, functions, and its contributions to the economic life of Massachusetts.

The Massachusetts Society, through its executive committee and its publicity committee, sought to develop a program to make the Society better known, to aid individual members in enjoying the fullest opportunities to perform their duties, to allow them to render maximum service to their clients and the public, and to establish an informed public opinion for the profession.

That probably sounds like a man-sized order for a group of public relations "greenhorns," and believe me, it was.

It was considered desirable and essential to the success of the program that we obtain the services of part-time local public relations counsel to guide and assist the committee in launching our ambitious program.

The selection and indoctrination of part-time counsel was the least satisfactory side of our public relations effort.

Our budget was quite modest and in two instances, counsel we had engaged were lured to other fields greener than ours and the committees was forced to seek other counsel. This was not an easy task, but we experimented with two other individuals without very much success. While the certified public accountants may know little about the operation of a public relations program, public relations men who are available for part-time counselling know little about the public accounting profession and, for that reason, in experimenting with part-time counsel, a reasonable period of indoctrination should be included in any plan.

For a substantial portion of last year our Society operated without benefit of local counsel, and in the committee's annual report, it recommended a continuance of that policy until such time as the Society operates an office with a full-time executive secretary. In Massachusetts, we are considering quite seriously opening a permanent office and it has been recommended that an executive secretary should have some training in public relations, as one of his important jobs would be the continuation of the program of the Society to create a better public understanding of the profession and to prevent or overcome attempts to lower the standards or restrict the activities of the accountancy profession.

There was unanimous agreement in committee that the program of the Society must be conceived in professional terms and have the following characteristics:

1. It must reflect the needs of the Society and the profession generally.
2. It will be a public relations program based on informational and educational approaches.
3. It will extend public information and public relations help and guidance to both the individual practitioner in less populated areas and the individuals and firms in metropolitan centers, with emphasis always on the position of a certified public accountant as a member of a major profession.
4. Publicity in newspapers, on the radio, and by way of other media will reflect both the Society and its members in a professional light as leaders of public thought in matters of accounting and financial reporting and as counselors in business policy.

What specific audiences or publics should we take cognizance of to make our program effective was a question put to the committee. We listed five, as follows:

1. Small business owners
2. Banks
3. Business management
4. Government financial and regulatory agencies and legislators
5. Media executives—i.e., editors, publishers, radio station executives, etc.

Should our program adopt a theme or themes? We decided in the affirmative and accepted the ten themes set forth by the American Institute plus one for the profession in Massachusetts. Let me restate the ten and give you our number eleven.

1. Accounting Is a Profession
2. The Accountant Serves the Public Interest
3. The Accountant Helps Management
4. Accounting Is Creative
5. Accounting Is Progressive

6. Accounting Is a Language for Business
7. The CPA Is Independent
8. The Accountant Has a Code of Ethics
9. Accountancy Is an Expanding Profession
10. The Accountant Is a Good Citizen
11. The Massachusetts certified accountant is a counselor to Massachusetts business and industry. The Massachusetts certified public accountant is directly interested in maintaining a prosperous and progressive economic level in Massachusetts. Through counseling and regard for the prosperity of the Commonwealth, he serves every citizen in Massachusetts as well as the Commonwealth's government.

So much for the background of our plan.

Let me review with you for a few minutes our accomplishments and failures in attempting to effectuate that policy.

To determine, if possible, how much or how little was known about certified public accountants in Massachusetts, the committee authorized our local counsel to conduct an attitude measurement survey. We utilized the services of graduate students of the Boston University School of Public Relations. The purpose of this survey was to establish a yardstick against which to measure the results of the first year of our expanded public relations program. It was planned to have a second survey made at the close of the year. The results of the beginning survey were neither startling nor too enlightening and a follow-up survey was not taken. Probably the results of surveys and forecasts during the 1948 presidential campaign left us all quite skeptical of the value of surveys in general. The principal point brought out by the survey was that very few, if any, of the people contacted had any information about certified public accountants, except as it had been obtained by personal contact.

It was this apparent deficiency in the written word about the profession in Massachusetts that we hoped to overcome through the publication of a pamphlet dealing with the certified public accountant in Massachusetts. This was a major project of the committee during the past year and numerous false starts were made by local counsel and the committee before a satisfactory booklet was completed with the able assistance of Institute counsel and after drawing freely on the few available similar publications of other state societies.

To emphasize the wide variety of activities which may comprise a public relations program for a state society, I will enumerate some of the other activities in which our committee became interested.

In February and March of both 1949 and 1950, we participated with the Institute in distributing transcribed radio shows on income taxes. We received excellent cooperation from a number of broadcasting stations in Massachusetts. As the subject of taxes is of such widespread interest, this type of public relations effort is, I believe, quite worthwhile.

When our state society adopted a resolution in support of the Institute's position and endeavors relative to HR293 (the Mills Bill), the public relations committee distributed copies of the resolution to all Massachusetts senators and representatives in Congress, to the National Association of Manufacturers, to the Associated Industries of Massachusetts, the New England Council, the Massachusetts Federation of Taxpayers Associations, Tax Executive Institute, and to 150 chambers of commerce in Massachusetts.

Through the courtesy of the American Institute, several pamphlets published by the Institute were adapted for distribution by the Massachusetts Society. Among such pamphlets were *Small Business Has Big Problems* and *Why C.P.A. Standards Are Important to You.*

Several thousand copies of the small business pamphlet were mailed to the members of the Smaller Business Association of New England, to a selected list of other businessmen (manufacturers with twenty-five or more employees) and to presidents and managers of national banks and trust companies in Massachusetts.

Several copies of the pamphlet *Why C.P.A. Standards Are Important to You* were mailed to each member of the Massachusetts Society accompanied by a letter requesting that the members read the pamphlet carefully and then pass copies along personally to their state senators and representatives. The purpose of this distribution was to help combat a bill entered in the State Senate by the public accountants, the passage of which bill was being opposed by the State Society.

As a further service to the members and to the Society's committee on state legislation, the public relations committee prepared a list of state senators and representatives, arranged geographically by counties, and mailed one to each member of the Society with the request that the office of the Society be informed of personal contacts between Society members and members of the legislature, to prepare the Society to take the offensive against legislation adversely affecting our profession. Members were also urged in the letter, to get to know their senators and representatives and to be better known by them.

All members of the Massachusetts legislature received a letter from the president of the Massachusetts Society in which was enclosed a copy of the Institute booklet *The C.P.A. Examination: Gateway to a Profession*. Our committee felt that this was a most interesting and valuable background booklet.

In addition to the special projects enumerated there was, of course, the routine publicity through the newspapers. One member of our public relations committee, with good newspaper connections, assumed responsibility for press releases of all types and the efforts of our committee along this line were rewarded with a very substantial amount of publicity relating to meetings, awards, appointments, etc., in the principal newspapers of the state.

Through the medium of a public relations column in our state society bulletin the committee has kept the members informed of progress and has urged the individual members to participate in the public relations activity in every way available to them. I am happy to report that our members gave their wholehearted support and participated actively when called upon.

I would like to refer again briefly to the matter of part-time local public relations counsel. There is no question in my mind that if the right individual could be obtained, a substantial load would be removed from the shoulders of the public relations committee and probably a better public relations job would be done. I wish to emphasize, however, that finding a suitable individual is a difficult and time-consuming task, and a step in any state public relations program which should not be taken lightly or hurriedly. It could very well be that some member of a state society would know of an excellent part-time local counsel available at a cost which would fit into the public relations budget.

While our committee recognized that publicity was only a small part of any public relations program, it was important that we should receive good newspaper publicity in various sections of the state, and we did receive such publicity through the efforts of one member of our committee who was willing to work to achieve the desired results.

In conclusion, I would like to say that what we have done in Massachusetts has not been held up here this afternoon as a perfect example of what either should or should not be done under certain circumstances in connection with the development of a public relations program for a state society of certified public accountants. We all know that like causes do not always produce like results.

It is reported that the famous dancer, Isadora Duncan, once wrote to George Bernard Shaw and proposed marriage with him, so that they might have a family of children who would be endowed with her beauty and his brains. He wrote back that he found the proposition most attractive but had to decline because of one dreadful thought—they might have his beauty and her brains.

A state public relations program

by CLIFFORD C. BEASLEY

It has been my observation that the most successful public relations programs are those which have the greatest variety of techniques. It isn't difficult to think of some individual you have known in your experiences who, in performing his daily tasks, is never obnoxious through boisterousness; his quiet manner is reassuring, his suggestions are cumulative, brief, and to the point; and, when decisions are to be made, his advice is often sought. The same description might well apply to a good public relations program.

The secretariat of the Florida Institute of Accountants was established in January, 1948. It should be pointed out that the membership of our group is comparatively small—less than 500. This point is established for the reason that there prevails the impression that small societies cannot successfully execute a full-fledged program of public relations. This conclusion is in error.

Human relations is the fundamental ingredient of public relations. The stimulation of favorable acceptance of one's profession by a second party is not necessarily dependent on numerical strength. Large or small, the success of a program ultimately depends on interested participation by those to whom the benefits will accrue. The size of the organization will merely dictate the limitation of tools which may be used in the application of public relations techniques.

During our first month of operation, a meeting of the executive committee of the Florida Institute of Accountants was held with all committee chairmen invited to attend. In this meeting an effort was made to determine what was considered by the membership to be the most important problems facing the profession in our state. The next step was to determine the causes of these problems. It soon became obvious that the major weakness of the profession was lack of understanding by the public of the distinction between certified public accountant services and the services offered by the prevailing multitudes of self-ordained specialists dealing in records, figures, and accounts. Further, though the membership had consistently grown through the years, there had been no concerted effort to make it easy for the public to acquire information relative to the public accounting profession.

Suffice it to say that we did the elementary thing at this point. A short-range program was developed for each committee and for each chapter, emphasizing the certified public accountants' responsibility to the public. We interpreted this responsibility as a privilege assessed to the profession by our state government in the form of statutory requirements for tests of proficiency, maintenance of standards, and the enforcement of penalties in the event public responsibility was not honored. Obviously such a program demanded effective participation on the part of the various committees. We made certain in this initial step that there was simultaneous activity on the part of the membership in every area of the state. Within a few months we had succeeded in creating a limited curiosity on the part of the public as to whether or not the CPA in Florida was complying with the statutory provisions of the Florida Accountancy Act. Having established this question in the public mind, we had in turn opened the door for pouring out information as to just what the CPA has to offer and how his

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services are distinguished from those whose services are sometimes camouflaged in varying types of descriptive titles.

It becomes evident that the machinery of public relations had then to move into high gear. We hammered at one theme—public responsibility. We ran the gamut of outlets in telling the CPA story. Our scrapbook relates personal interviews with Institute officers; vocational guidance outlines for high school students with follow-up speeches by CPAs; a statewide committee of educators with representation from every college and university in Florida; civic club speeches by CPAs in every corner of the state; the formation of an Estate Planning Council with attorneys, CLUs and CPAs. There were bulletins specifically prepared for informing legislators. There was a statement of policy as to legislation placed in the hands of every member. There were tax institutes in three sections of the state; radio speeches in cooperation with local chambers of commerce. Institutional advertising programs were underwritten and carried out by local chapters. Our two annual statewide membership meetings featured representatives of large and small business, along with outstanding educators in the business field. Members were urged—and sometimes pushed—into assignments of civic responsibility such as Community Chest, Salvation Army, Chambers of Commerce, Quarterback Clubs, civic clubs, tax study groups, health and welfare associations, university and college trusteeships, and many others.

Bear in mind that this initial effort is what might be termed a "splash program." It was for the sole purpose of focusing attention on the profession, and establishing a few liaison contacts, which later could be utilized in disseminating the constant factual information necessary to inform the public adequately. The splash effort was necessary because of pending legislative problems. The long-range plan of public relations was from this point moved into gear more carefully and perhaps a bit less obviously. It would be well to examine in more detail a few of the techniques used, and possibly some of the results.

Public relations has been glorified considerably in many quarters. In too many minds public relations and the high-pressure press agent are synonomous. Nothing could be more incompatible. In planning for public relations, favorable stories in the newspapers and time on the air should be anticipated only in terms of "a dividend resulting from a sound investment of service." Honesty of motive and truth in the story to be told must always be the foundation stone upon which a program of public relations is built.

Hence, the first approach to planning is to look at one's own house, to make sure it is in order, before asking public acceptance. A check list includes making sure that the administration of the state accountancy law cannot be discredited. Insist that the code of ethics adopted by the society is enforced. Make certain that educational opportunities are provided for those aspiring to entrance into the profession. Develop awareness and acceptance of responsibility for professional standards among the membership. Look under the professional carpets of those who will benefit from the program of public relations and recheck the collective reputation of the profession in order that it may go to the public with clean hands. Foremost in importance in executing a program is membership acceptance of responsibility. The committee system is still the keystone around which to build. Our best results have been obtained by careful selection of committees, an intermingling of old and new members in the appointments, the establishing of committee objectives and putting these in print. This must be followed up through what we term "pacing of committee activity." In this we attempt to establish permanent written records for each committee. Each committee is advised in advance that periodic reports are to be made, and every assistance possible is afforded the committee in carrying out its selected projects for the year. It should be emphasized that even though a committee has only one project for the year, if that one project is well executed and the objectives accomplished, one more stone has been removed from the professional pathway we are attempting to pave.

Another technique of considerable significance in applied public relations is the cooperation of the public accounting society with other organizations. In our state we have not had a major problem in our relations with attorneys. However, we did feel that there was a certain stigma attached to the committee for cooperation with bar associations having to cooperate with a bar committee described as the committee on unauthorized practice. Psychologically, it wasn't a healthy inference, and certainly such a description in the press left the wrong impression. Through proper contacts with the president of the Florida Bar Association, a committee for cooperation with accountants was and has subsequently each year been appointed. You would undoubtedly be interested to know that this year the Florida Bar Association has invited the Florida Institute of Accountants to join in planning and affording CPAs for several teams to conduct tax seminars for the professions throughout the state. As an applied technique in bringing about this relationship, we have gone simultaneously in the front and side doors. We have carefully gone over local and state lists of Bar Association officers. We have looked for business and personal relationships, and used these as liaison wherever possible.

In our relations with other organizations we have attentively been aware of small business, and through the State Retail Merchants Association, the State Chamber of Commerce, university extension divisions, and others, have had limited success in affording information to and on occasion assisting in developing information for small business groups.

In developing a relationship with bank groups, experience has dictated the necessity of not assuming that the banker necessarily knows the difference between a public accountant and a bookkeeper. Particularly is this true in smaller communities. Our approach to this has been joint meetings with banker groups, with the chapters of our association playing host. The program usually includes both a CPA and a banker. The subject is projected in such a manner as to indicate a positive interest in affording improved CPA services to the credit and trust departments of banks. The follow-up on this is the broadcasting of informational bulletins developed by the American Institute, the choice of bulletin dependent upon the most obvious needs. Suffice it to say that cooperation with other organizations offers unlimited possibilities. Reciprocity is the password. Therefore selection of organizations with whom cooperative relations will be maintained is of great importance.

In selecting such organizations it is often necessary for the CPA to offer a genuine service to the other group, in order to open up avenues for getting the CPAs' story told. An example of this is the Florida Institute of Accountants' relations with the Florida Municipal Finance Officers Association. In our state most municipal charters require that audits be secured on a bid basis. The Florida Municipal Finance Officers Association has been wise enough to recognize poor record keeping as one of the major problems of municipalities in Florida. We have a joint committee whose responsibility it is to prepare a manual on municipal accounting, same to be published and placed in the hands of finance officers and their elected governing bodies. Obviously our CPAs will render many hours of genuine work to this initial effort. But what are the possibilities? It will accomplish improved understanding of accounting procedures by city officials. It is hoped it may be the forerunner for the adoption of uniformity in municipal accounting procedures throughout the state. It offers an opportunity for CPAs to be called in for advice and do a subtle selling job on a local basis. Ultimately it has the potential of leading to required audits for municipalities by CPAs. This particular technique might well be termed "reciprocal public relations."

It would be well to move now to some consideration of what can be termed membership relations. In order for a program to succeed in accomplishing its collective objectives, care must be exercised in having the individual member participate in the interest of the profession and not for personal benefits. Likewise, the membership collectively must be kept informed of what is going on, credit given within the family for what is being accomplished, and a constant interpretation of the total program. Our most effective means for accomplishing this is a monthly *Newsletter*, usually five pages reporting from all parts of the state. It points up chapter activities, committee accomplishments, opportunities and hints as to what the individual may do, and makes references to individual work. The *Newsletter* is informal, on a "Bill and Joe" plane, and is mailed direct to each member.

A most helpful means of correlating state-wide activities is carried on through chapter participation and parallel committees. In this manner there is an understanding of what is contemplated state-wide, and it is helpful in having the proper interpretation on local levels. Each chapter is encouraged to program for a year in advance. A "report back" technique is very helpful in using member's services in public relations.

Once a chapter program has been mapped for the year, assignments made, and responsibilities accepted, the secretariat of the Florida Institute then moves in to assist the local officers and asks that reports be supplied to the central office as to results. Chapters are advised that these results are to be correlated with those from other chapters in order that the composite picture may be known. This has aroused local pride, places efforts and results on a competitive basis, and it has been found to be very helpful in the utilization of membership abilities.

Having followed quite closely, through the help of the American Institute public relations department, the problem of legislation throughout the country last year, it would undoubtedly be well to mention some of the efforts in this direction in Florida. Florida has quite a restrictive law. We are credited with having a desirable climate in which to reside, and we literally have the multitudes move in seasonally and permanently. Many of these, upon crossing the state-line, anoint themselves with all the self-delegated qualifications necessary to carry on a public accounting practice. There exist in our state two organizations of public bookkeepers—one apparently dedicated to the destruction of the public accounting law, the other affiliated with the national organization which sponsored the model bill that made an appearance in virtually every state having a legislature in session last year. Numerically these groups outnumber accountants at least five to one. For what it's worth, an attempt will be made to review some of the techniques of public relations with the Florida legislature.

In Florida there has developed an allergy on the part of legislators to "state boards" of any kind. This being the case, those whose purpose it is to water the public accounting profession have found a ready-made audience in telling their story that the Florida Board of accountancy maintained a "closed shop," that it was undemocratic, that the examination was of no significance since the Board selected in advance those to whom certificates would be issued, that the CPAs of the state were going to introduce legislation to make it unlawful to practice public bookkeeping, and many other untruths. The organized bookkeeper groups in Florida had over many years told their story so well that actually what the Florida Institute of Accountants found itself combating was not so much the legislation which the opposition was introducing, but the prejudiced attitude of the legislator toward the certified public accountant. In other words the public confidence, so necessary to any profession, was not to be found among the members of our legislature.

How to crack this legislative nut was in itself a major problem. Naturally, a tremendous responsibility had to be placed in a few hands. This responsibility fell on the shoulders of our committee on state legislation. First, we studied the vocational make-up of our legislature. This, as always, was overwhelmingly composed of attorneys. We developed a card file on every member of the legislature, listing such pertinent information as home and business address, address while at state capital, telephone number, marital status, civic and fraternal affiliations, hobbies, social habits, major business interests which might influence him, and types of legislation he was likely to sponsor in the legislature. We arranged for contacts with the President of the Senate and Speaker of the House, and in time got as much advance information as possible relative to committee appointments. As committee appointments are announced in advance of the legislature, efforts were then made to anticipate the "balance of power" group in each house, and there again be sure that every contact possible is made on local levels. Legislators are always more sensitive to the interests of constituents than to those whose votes are not cast in their district.

Various information was gathered for use in testimony before committees. Local committees were given definite assignments in contacting members of the legislature, with reports back to the committee on state legislation.

Here it might be well to point out one technique which was suggested by our advance appraisal of the legislature. The 1947 legislature had authorized an interim Joint Senate-House Tax Study Committee which was to study the tax structure of Florida, and make recommendations to the 1949 legislature. We found that the chairman of this committee was a friend of the public accounting profession. Aside from this he was tremendously interested in having the results of his committee work reflect his qualifications for further political ambitions in our state. A few well-chosen contacts, suggestions pointing up how helpful the certified public accountant could be in assisting his committee in their fiscal study, evolved into a plan of study by the legislative group in which the Florida Institute of Accountants, the Florida Bar Association, and the State Retail Merchants Association were invited to assist. Thirty-two CPAs gave their services at intervals over a period of several months. Each one of the CPAs found himself on a study team composed of one or more members of the legislature, one attorney, and one retail merchant. Hours and hours of personal contact in which the CPA dug out and explained budgetary figures to his respective team could not help but impress his team associates. The final report to the legislature with a covering statement on Florida Institute of Accountants letterhead, was the first piece of material placed on the desk of all members of the legislature, and the first information considered when the legislature convened. The Florida Institute of Accountants went into the 1949 legislature with approximately fifty legislative friends, many of whom had previously either been doubtful or definitely antagonistic. Not a word had been said in all the months of close cooperation about the CPA and his legislative problem. But the press in all of its stories definitely established the CPA as an asset to the legislature.

But what about when the legislature is in session? As previously stated, the committee on state legislation shoulders the responsibility for handling any and all problems. I was sent to our state capitol to watch the machinery in operation. First of all, I registered with the proper legislative committee, making a declaration of my interest and whom I represented. We feel that our interest in the legislature will at all times stand the light of day, and that it is better to be recorded with the proper committee designated by the legislature for this purpose. I made known to the Speaker of the House and the President of the Senate that I shall be available as representative of the CPAs of the state in the event there is any way in which the particular qualifications of our group may be helpful to him in his responsibilities during the session. Others we make it a point to know well are the Chief Clerk in each house, the readers, the chairman of the rules committee, and the secretaries to the chairmen of committees in which bills of interest to the profession might find themselves. Such contacts as these must not be overlooked for oftentimes they mean advance information concerning the calendar, the scheduling of hearings in committees, and exact recording of roll calls in advance of publication. Our approach to legislators while in session is not one of "pressure." We attempt to maintain the dignity expected of the profession in representing our cause.

During the legislative session the membership is kept advised weekly of just what is happening as regards legislation affecting the profession. The legislature convenes on Monday morning, usually adjourns Friday noon. A memorandum is dictated from the capitol to the secretary in the Florida Institute central office. She mimeographs and places the memo in the mails not later than Saturday morning. On Monday morning each member of the Florida Institute of Accountants has before him a resumé of happenings the previous week and what may be on the calendar for the current week. With this information before him, he is alert to the needs for support and knows that he may be contacted direct for whatever assistance the committee on state legislation feels is needed.

There are many more techniques of acquiring more successful legislative results. All that has been attempted here is to point up the importance of careful planning and understanding of legislative approaches. All CPAs rather gladly acknowledge a lack of "know-how" in overcoming legislation handicaps, but this must be faced up to and overcome.

The CPA's greatest opportunity for public relations as regards legislation is when the legislature is not in session. Much can be accomplished through participation of legislators on local chapter programs, and the maintaining of contacts with leaders in both houses in order that there will be continuity in their understanding of the CPA's problems.

Certainly time will not permit the enumeration of all the approaches and techniques applied in accomplishing favorable public relations. We have touched on only a few. Remember in the beginning of this paper it was indicated that a good press and radio are the result of good public relations. But lest the wrong impression be left, it should be explained that those responsible for a public relations program must understand the responsibility of newspapers and radio. They, too, have a public trust, and truth and integrity must be maintained in their reporting. Editors are grateful for information which is helpful to them in recognizing that which is credible. There are still more editors who do not understand the difference between a certified public accountant and a public bookkeeper, than there are those who do. Prepared copy in advance of conventions, personal conferences with editors and feature writers, advance explanations about subject matter to be handled on a given program, all are helpful to those disseminating the news to the public. Considerable time is given to cultivating an understanding and friendly press and radio.

Florida's program of public relations is less than three years old. Naturally, we have attempted to tell you the better things about it. Needless to say we have also had failures, made mistakes, and have yet a long way to go. The public accounting profession in Florida had for too long been looking at its feet. It is hoped that its public relations program will, in the future, cause it to throw back its head, look at the top of the hill, and make easier the paths which must be followed to reach the improved professional objectives.

Relations with the legal profession

by MAURICE AUSTIN, CPA

As every talk must start with an introduction, this will start with the not too world-shaking announcement that the state of the relations between our profession and the legal profession has, in recent years, occupied much attention and attracted great public notice. To this may be added the distinctly unnovel statement that, despite this, it still remains true that the two professions have infinitely more in common than in opposition; that in general, there is recognition in practice as well as in principle that the interests of the two professions, and of the public lie in harmonious cooperation between them and not in combat; that the areas of agreement are wide and those of difference narrow; and that such points of difference as do exist have been magnified out of all proportion to their importance.

The principal area of controversy, of course, concerns two professions' respective spheres of competence and practice in the field of federal income taxation. It is proposed herein to review briefly the origin and development and present status of that situation.

Preliminarily, it may be stated that this whole subject, involving as it does actually and potentially the status of certified public accountants in the entire field of tax practice, is among the most important problems which face the accounting profession and the American Institute of Accountants and has been regarded, and will continue to be regarded in that light by the administration of the Institute.

It is common knowledge, especially to any group of accountants, how the intimate dependence of the income tax on accounting concepts, techniques, and data naturally led to the performance of the bulk of the services in this field by the public accounting profession, and how the high level of competence evinced in this work over the years has continued to confirm the business world and the public at large in their reliance on certified public accountants for assistance in federal income taxes. It is equally well-known, unfortunate as this fact is, and I sincerely regard it as unfortunate, that the great majority of the legal profession for many years failed to recognize the importance to them, in their clients' interests, of adequate knowledge of income taxes. Beginning in the middle thirties, this condition received increasing attention from the organized bar, resulting eventually in two major forms of activity. One was a well-organized program of income-tax education among the bar at large, and in this activity many certified public accountants were asked to, and very willingly and happily did participate, feeling, as they did, that progress in that direction was in the interest of all concerned. The second activity, however, much to the disappointment of those very certified public accountants who were happy to participate in the education program, as well as many others, was a campaign to restrict the activities of certified public accountants—in the income-tax field.

A word of clarification as to this latter activity is in order. Every licensed profession is concerned with possible encroachments on its activities, and the activities or attempted activities in its field of the unqualified and unlicensed. The medical and dental professions are concerned with it. We, as certified public accountants, are concerned with it, both, as to violations of the law in so-called regulatory states and,

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in all states, as to efforts, made from time to time, to attack the integrity and standards of the certified public accountant's certificate. Naturally, therefore, the bar also is concerned with that problem, and to deal with that problem the organized bar associations have created, over the years, committees dealing with the unauthorized practice of the law. These committees have performed extremely laudable and valuable service, not only in their own interest, but in the interest of the public, in eliminating from the practice of the law the unlicensed and the incompetent.

In the course of their activities, they have come into contact with the functioning of various groups such as bankers, trust officers, life insurance underwriters, certified public accountants, and perhaps others. Recognizing the natural resentment which might be encountered by attempts to discuss this subject with these groups through a committee formed to eliminate the "Unauthorized Practice of the Law," and so named, a different machinery was created, under the aegis of the unauthorized practice committees, namely, the conference method. There were created national and state conferences with bankers, life insurance underwriters, and others, and, eventually, the conference method was adopted in connection with the common problems of lawyers and certified public accountants.

The National Conference of Lawyers and Certified Public Accountants was organized with equal representation from the American Bar Association and the American Institute of Accountants. Its progress in the early forties was slow and had only reached the point of agreement on some very broad generalities with which no one could quarrel, namely, that certified public accountants should not practice law and lawyers should not practice accounting, and recognizing that the preparation of income-tax returns was a proper function of both lawyers and certified public accountants.

However, shortly after that stage was reached, litigation was instituted by the New York County Lawyers Association in the well-known *Bercu* case. The initiation of the *Bercu* case led to certain misunderstandings, and created acrimony and bitternesss between the two groups, with the result that the conference group became completely inactive. It was not disbanded; it just didn't meet. The rational processes of the conference table were abandoned for the more active processes of public combat.

As the *Bercu* case wended its way through the courts, other developments occurred. In 1947 two bills were introduced in Congress. One was clearly a Bar Association project—the proposed Administrative Practitioners Act. In 1946 there had been enacted a very important piece of legislation, which was of no direct concern to certified public accountants, the Administrative Procedure Act, which dealt with the general problems of procedure in matters before administrative agencies. It was stated at that time that there would be future legislation dealing with the regulation of practitioners before the administrative agencies. The proposed Administrative Procedure Act, which grew out of this, was mainly a project of the American Bar Association's Administrative Law Section, which was concerned primarily with federal practice before these agencies. However, while the bill was in the drafting process, the unauthorized practice committee became interested and undertook to have provisions included which would deal with the aspects of administrative practice that concerned them. At that point the certified public accountants became interested, because the bill, as originally drafted, would have tended to have the effect, it was believed, of seriously restricting the right of practice of certified public accountants before federal agencies, including the Treasury Department. Testimony on this bill before the House Judiciary Committee widened, rather than narrowed, the differences between the two professions.

It so happened that in the same year there was introduced into Congress a bill whose major object was a long-needed codification and revision of the federal judiciary laws. However, included in the bill were provisions that would make the Tax Court a court of record, with the implications, at least as read into it, that that might have an important effect upon the existing rights of certified public accountants to practice before that body. Actually the federal judiciary revision was not a Bar Association project, but was the work of a committee of Congress created for revision and codification of the federal laws, and the proposal to change the status of the Tax Court originated in that committee.

Finally, at about this same time, the Attorney General of one of our states handed down an opinion that the preparation of tax returns constituted the practice of law and could be undertaken only by lawyers.

The coincidence in time of all these occurrences added fuel to the already existing fire, which, by now, was generating intense heat. However, before proceeding to the steps being taken to extinguish the fire, it may be well to trace the subsequent history of some of the foregoing elements of controversy.

The *Bercu* case involved the right of a certified public accountant to give advice, to a person with whom he had no other client relationships, as to the proper year in which he might deduct, for federal income-tax purposes, the amount paid in settlement of a local tax controversy. The lower court decision having held, for reasons dealt with presently, in favor of the accountant, was reversed in the Appellate Court and the reversal was sustained by the highest court of the State of New York. Accordingly, the decision rendered in the *Bercu* case is at present the law of the State of New York. The two decisions in that case adopted different approaches to the problem of attempting to define the respective spheres of lawyers and certified public accountants in the field of taxation, in which it was admitted that both had some sphere of operation. In the lower court decision, the approach was to determine where the function of a certified public accountant stops and that of the lawyer begins by looking to the nature of the question presented, i.e., whether it presents a question of law or not. The court held that if the question related solely to proper accounting practice under the federal tax laws that was within the area which in a certified public accountant might operate as part of the practice of his specialized calling as a certified public accountant, whereas, if the question involved or depended on solution of such questions of general law as domicile, marital status, and the like, retention of a lawyer was required. The Appellate Court's decision, which became the final one, adopted a different approach. It said, in effect, that the preparation of tax returns was a legitimate and recognized function of the practice of public accounting, and that in the conduct of that phase of his practice, the certified public accountant was entitled to deal with all incidental legal questions that might be involved. On the other hand, if an accountant undertook to render advice on questions involving the tax law to a person to whom he rendered no auditing or accounting services and whose return he did not prepare, he was practicing law. In other words, when a question got to the point that advice had to be sought, not from the regular accountant or tax return preparer, but from an independent adviser, the line had to be drawn and, at that point, a lawyer retained. The first approach looked to the nature of the question, while the second approach looked to the circumstances under which the question was asked. Clearly, the *Bercu* case is the law in New York. Whether it is the law elsewhere is perhaps another question, but there is no doubt that it will be given great weight in any other tribunal in which the question arises.

As to the proposed Administrative Practitioners' Act, there were Congressional committee hearings in which the American Institute of Accountants, several of the state societies, the American Bar Association, and many other groups interested in administrative practice, were heard. This occurred toward the end of the 1947 session, and the bill went over to the next year. Neither that bill nor any other bill dealing with the regulation of practitioners before administrative agencies has passed, despite a number of changes subsequently made, under conditions presently to be described, which effectively removed the objections of certified public accountants to the point at which they were willing to endorse the bill as modified. The principal present obstacle to passage is objection from other sources.

In the case of the judiciary revision bill, following advice from the draftsmen of the legislation that there was no intention to change the present practice status of certified public accountants before the Tax Court, and at the request of the American Institute of Accountants, there was readily included in the bill the provision of present law to the effect that no qualified person could be denied admission to practice before the Tax Court by reason of his failure to be a member of any particular profession or calling.

In this form the bill went over to the Senate at the next session. Meanwhile, the bar associations took exception to the idea that Congress should tell any court of the United States who might or might not practice before that court, that traditionally being within the province of the court, and, particularly, that the court should be told that it would have to admit non-lawyers who could demonstrate their qualifications. Hearings were held in 1948 before a Sub-Committee of the Senate Committee on the Judiciary in 1948. Representations were made to Congress, not only by certified public accountants but by many businessmen as well—all based on the idea, not that certified public accountants felt competent as a class to try cases in the Tax Court, but rather that the settlement of many cases with the Treasury Department included the filing of petitions with the Tax Court as a necessary step in the settlement process, and that it was against the public interest to require that a lawyer necessarily had to be retained in every case at that stage of the proceedings. As the result of all this, and in order to assure passage of the judiciary revision bill, the Tax Court provisions were dropped out, and the status of the Tax Court was brought up again in a separate bill in 1949. At that time, the position urged before Congress was, that since this bill, even with a so-called "grandfather clause" which would insure the continued right of practice of those non-lawyers already enrolled to practice, but not dealing at all with the future enrollment of non-lawyers, tended to affect existing settlement processes, and since there had been introduced into Congress the Tax Settlement Board Bill which proposed to revise radically the procedure for settlement of tax controversies, the whole matter should be held in abeyance until the proper Congressional committees would have an opportunity to hold hearings on the entire matter of tax settlement procedure, and deal with the entire matter at one time and not piecemeal.

While all this was going on and continuing to engender heat, the *Bercu* case was reaching its final stages. Well before the final decision in the *Bercu* case, intimations and more than intimations had been received from many high-placed members of the bar that it might be in order to suspend hostilities and resume rational discussions. This obviously was the feeling of the responsible members of both professions.

Starting with these small beginnings, informal, unofficial discussions were inaugurated with a view to exploring the possibility of resumption of the conference-table method. These efforts were fruitful and both professions are indebted to the eminent members of the Bar Association who made them possible.

The informal discussions occurred in the spring of 1949 and were attended by representatives from our organization and representatives from various sections of the American Bar Association. One of the immediate fruits, which was a clear earnest of good intention on both sides, was an agreement on revisions of the Administrative Practitioners' Bill to eliminate the features objectionable to certified public accountants, to an extent that the latter support the bill and thus enable the Bar Association to proceed with what it regarded as a major project for improvement of administrative practice.

By the summer of 1949, these discussions had reached the stage of agreement that the activities of the National Conference could be resumed. The National Conference reconvened in December of 1949, had another meeting in April of 1950, with subcommittee meetings in between. At the April meeting, the conferees, after extended debate, reached a unanimous agreement on a joint statement of principles, subject, of course, to ratification by the governing bodies of both organizations. After much debate, that statement was adopted, without change, by the council of the American Institute of Accountants. On the Bar Association's side certain objections have been raised, relating to a single paragraph. It is hoped that these differences are sufficiently narrow to be resolved. At present the matter still rests with the Conference to be discussed at its next meeting.

While the contents of the statement cannot be discussed, because it was agreed that details would not be published until there was ratification on both sides, a few words are in order as to the general objectives of the statement and what, it is anticipated, it would accomplish. The statement recognizes what has been at all times clear: that the only sound basis for division of functions is protection of the interests of the taxpayers and the public. It does not seek to define, in detail, who may do what and how. The objective has been rather to take this whole subject out of the public combat arena and bring it back to the conference table. Fundamental to this would be the recognition on both sides of the fact that there are wide areas in the field with which one profession or the other, as the case may be, may deal without recourse to the other, and that, at the same time, particular income-tax questions may be of such nature or involve such issues that the person dealing with it should, in the interests of the client, advise the retention of a member of the other profession. To put it simply, that would involve recognition by lawyers that there are many tax questions with which certified public accountants can deal adequately without resort to attorneys, or for which the retention of certified public accountants should be advised, and recognition by certified public accountants that many tax questions are of such nature or can involve such procedural problems that the retention of a lawyer should be advised.

There is also involved the implicit thought that even if one were to assume that certain changes in existing practice were desirable, it is not possible to legislate, overnight, changes in business community behavior and professional practice well founded in experience, and that the only rational process of change is one of the education of the members of both professions over a period of years to the end that each stay within the bounds of their own professional competence and jurisdiction.

The general thought is, if such a statement can be adopted, defining such areas as can be agreed upon by the more responsible and objective members in both professions, and by dealing more generally with those areas which are more troublesome, progress would be made thereafter by an evolutionary case-by-case approach. It is hoped that similar conferences would be established, at the local and state levels, which would deal with cases as they might arise, and, if they couldn't reach agreement at that level, could obtain advisory guidance, if they desired, from the National Conference.

There is, perhaps, implicit also, although this has not been discussed at all, the idea that the organizations of each profession should undertake education within their own ranks as to their proper sphere of activities in taxation, the point at which the certified public accountant should call in the lawyer and the lawyer call in the certified public accountant, with the basic objective that neither should try to take on more than he is professionally competent to handle, or hesitate, out of pride or greed, to call in necessary outside talent whenever the interest of the client calls for it. While the dividing line in the middle ground cannot be defined precisely now, it is hoped that over a period of years such a process of education would result in the dividing line defining itself much more clearly than is now possible.

There are a number of difficulties entailed. One of them is the problem of procuring acceptance by the local organizations of anything that is agreed to on a national level. It is hoped that if agreement on a joint statement is reached, it will have been reached after a complete exposure thereof to the local unauthorized practice committees. Another difficulty is created by the preparation of tax returns and tax practice by persons who are neither lawyers nor certified public accountants. In any case in which, in a laudable endeavor to restrict such practice by an irresponsible or incompetent person in that category, a local bar association should seek to do so by having a court declare the preparation of the return to be unauthorized practice of law, then immediately, without any thought of justifying the activities of a particular individual, the certified public accountants are necessarily concerned, because the establishment of such a principle could affect them. Obviously, if the Treasury Department, under authority of law, should undertake to license and regulate the preparation of tax returns, that would take the entire matter out of the unauthorized practice area. This problem still remains unsolved.

Throughout, the basic effort of the organized public accounting profession has been to stress the public interest aspects of our position, to make all efforts to keep clearly before the public, the business world and the legislatures, the expert status which certified public accountants believe they have in this field, and to participate actively in tax legislation, tax forums, and the like. In the interests of better understanding it is sought to engage in as many cooperative projects with the bar groups as possible—not only in tax projects as such, but also in programs of wider scope, such as one recently suggested and seriously considered, for an inter-profession symposium or seminar, in which there would be explored and discussed the various ways in which all the professions can be of aid and assistance to the others.

Clearly, this problem will not be solved by any single magic formula. This problem may well be with us for many years, and the way in which it will be resolved and settled may well depend upon the attention given to the old cliché involving eternal vigilance.