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## Accountant and the investor

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## THE ACCOUNTANT AND THE INVESTOR

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When I was invited to be one of the lecturers in this series, I hesitated on account of a conflict of feelings. I was gratified by an invitation to lecture at an institution which means so much as Northwestern has come to mean in the field of business education, but I felt that ethics should be practiced rather than preached; and I was dismayed at the thought of contributing one of several lectures on the ethics of a single profession. When, however, Professor Custis suggested that I talk on the ethical obligations of the accountant to the investor my doubts were resolved, because the suggestion offered an opportunity to discuss before a sympathetic audience some of those phases of accounting practice which make it, to me, the most attractive of the professions which are closely allied with business; and an opportunity, also, to discuss some questions possessing a broader interest.

### The Investor's Interest in Accountant's Work

Before discussing the ethical questions which arise between the accountant and the investor, it seems desirable to consider briefly the nature of the investor's interest in the work of the accountant and the conditions under which that work is ordinarily done. Accountancy today has become an important profession, the work of which varies greatly in character and purpose. Its work may, perhaps, be divided into three broad classes: first, the constructive work, such as the formulation and installation of systems of accounting; second, the detailed auditing of cash and other transactions; and third, the preparation and verification of financial statements. It is with this third class of work that the investor is more particularly concerned.

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As published on pp. 26-54, *The Ethical Problems of Modern Accountancy*, Lectures Delivered in 1932, William A. Vawter Foundation of Business Ethics, Northwestern University School of Commerce, New York: The Ronald Press Company, 1933.

Investors are interested in the reports of accountants on the affairs of businesses in which they already are, or contemplate becoming, security holders. If they already hold securities of a corporation carrying on a business, they are concerned with the annual reports presented by the directors to keep them informed of the progress of the enterprise. These reports contain, among other things, annual accounts, which may be certified by accountants. If investors are only potentially interested in any securities, they may turn either to the annual reports or, if the securities are newly created, to the "offering" or prospectus issued by the banking house sponsoring them. This prospectus is likely to contain financial statements made by or on the authority of accountants.

### Annual Reports and Prospectuses

It is interesting to note that the development of the work of the accountant in relation to annual reports and prospectuses dates from the last great period of depression which, beginning in 1893, came to an end with the sound money victory of 1896. My own experience in Wall Street began just as that period ended; and the memory of the disastrous losses shown year after year in the middle 90's, and of the successes subsequently achieved around the end of the century by the same companies, enables me to take heart of grace even in this distressing time.

The practice of having annual accounts audited, which began to make headway in the late 90's, has grown so that today about 80 or 90 per cent of all industrial companies whose securities are listed on the New York Exchange publish audited accounts.

In the early days of my experience, representations in prospectuses as to earnings and assets were usually based on information furnished to the bankers by the officers of the company, and were made by the issuing house itself. Later, it became more and more customary for the issuing houses to secure confirmation of the accounts by accountants, but they continued to make the representations themselves. More recently the practice has developed (which has long been customary and is now compulsory in England) of publishing the results of the accountants' investigations in the form of a report from the accountants themselves, embodied in the prospectus. Some concerns, however, still cling to the old procedure and rely on accountants' reports only to support their own representations should those representations later be challenged.

With the rapid development of this field of accountancy, it is not to be expected that standards either of practice or of ethics should be uniform throughout the profession or uniformly satisfactory. It is in times of depression such as we are now passing through, that reforms are most easily initiated, and it is timely, therefore, to consider now what standards of ethics the profession of accountancy can fairly be asked to accept and adhere to.

### The Accountant's Responsibility

It will be well, next, to consider the nature of the accountant's responsibility in respect of financial statements which are embodied either in a prospectus or in the annual report of a corporation. As a preliminary to a consideration of this question, I should like to emphasize the fact that the accounts of a corporation carrying on a complex modern business are not, and cannot be, statements of absolute fact. They are necessarily based largely on conventions, on estimates, and on opinions. I shall return later to a further discussion of this point, but think it desirable to mention it early in my address, as I have found from experience that it is by no means always fully appreciated even by people who might be supposed to be well versed in financial affairs.

The character of the accountant's responsibility in respect of accounts embodied in a prospectus or in an annual report rests naturally on the nature and purpose of those documents. The prospectus is a document issued by a vendor of securities, and is frankly designed to induce investors to purchase securities. An annual report is a document addressed by the directors to shareholders, reporting on their administration of the affairs of the company for the year and the financial results thereof.

A number of differences between the two cases at once suggest themselves. The banker, who is offering securities, is not expected himself to be informed regarding the financial status and past earnings of a corporation. He must make his representation on the authority of others. He may conceivably rely on the representations of the officials of the company, but obviously this course involves a certain danger, since they are interested parties. Therefore, he is likely to have recourse, instead, to the accountant, who can furnish a disinterested report. In such a case, the full responsibility is put squarely on the shoulders of the accountant.

In the case of the annual report, however, the primary responsibility for the financial statements submitted to shareholders rests with the officers and directors, and the function of the accountant is to advise the shareholders whether, in his opinion, the statements so submitted fairly present the position of the company and the results of its operations. The investor has the right to assume that the figures, let us say of earnings, presented by an accountant in a prospectus represent the accountant's own best judgment of the results for the period which they cover. In the case of similar figures appearing in the annual report of a corporation, not quite the same assumption can properly be made. In that case, the figures should represent the best judgment of the officers and the directors — a judgment, however, which the auditor either concurs in or regards as being within the reasonable limits of a legitimate difference of opinion, unless the contrary is indicated by his certificate.

#### Differences of Opinion

Every balance sheet is, as judicial authorities have recognized, necessarily a matter of estimate and opinion, and in some cases the limits of a reasonable difference of opinion may be fairly wide. I do not wish to make too much of the point, but the investing public generally fails to appreciate that there is any distinction at all, and therefore it is essential to mention that a distinction does exist, and that it must exist. Often, perhaps usually, the accounts presented in an annual report are the results of discussion between the officers or directors of the corporation and its independent auditors, and represent their combined judgment. But the representatives of the corporation, on the one hand, and the accountant, on the other, may not entirely agree, and in such a case the accountant can properly accept the judgment of the corporation's representatives if he is satisfied that it is honestly formed and inherently reasonable.

Suppose, for instance, the question to be what provision for depreciation is required; and suppose that the directors, if left to themselves, would consider a provision of \$50,000 as adequate, while the auditor would favor the provision of from \$80,000 to \$100,000. The directors may agree to provide \$70,000 if thereby they can secure the auditor's unqualified certificate to the accounts. For the purposes of an annual report, the auditor would be quite justified in accepting this solution, perhaps saying in his certificate that the provision made is reasonable. But if he were preparing figures for a prospectus, the sole

responsibility for which would be his, he would be bound to give expression to his own final judgment, though in reaching that judgment he would naturally give full consideration to the views of the company's representatives.

### Annual Report Essentially Historical

Another, and perhaps more important distinction between the prospectus and the annual report is that the annual report is essentially historical in its character, whereas the prospectus, even when it deals with events in the past, does so solely for the bearing that they have on the prospects for the future. For, obviously, the intending investor has no interest in what has happened in the past merely because it has happened; he is interested only to the extent that the past is a guide to the probable future.

I should like to emphasize this point particularly, because in recent years there has, to my mind, grown up a tendency to attach an altogether exaggerated importance to the earnings reported annually by corporations as an index of future earning capacity and, consequently, of the value of the business. This tendency has, I think incidentally had the effect of magnifying the swings in the market prices of stocks. In passing, I might express the opinion that the habit of valuing stocks at ten, twelve or any other number of times the annual earnings applicable thereto, and using for the purpose of the calculation the earnings of a single year, has tended to bring about excessive valuations for stocks in periods of great prosperity and correspondingly inadequate values in times of depression such as we are now passing through.

Perhaps I can sum up the position by saying that the investor should be entitled to regard an accountant's statement in a prospectus as a little more objective and more clearly indicative of earning capacity than a statement made in an annual report primarily by the directors but with the concurrence and approval of the auditor.

### The Accountant and the Prospectus

I should like, now, to consider in more detail the position of the accountant in relation to the prospectus and the annual report of a corporation. I will take the prospectus first because, as I have already pointed out, the accountant assumes the greater responsibility in respect of such a document.

When a banker contemplates an issue of securities of, let us say, an industrial company, he is likely to take steps to secure the report of an accountant on the financial position and past earnings of the business. In doing so, he has two purposes in mind: first, to decide whether the proposed issue is one that he cares to undertake; secondly, to ascertain what sort of a presentation of facts he is likely to be able to secure for the purpose of influencing the judgment of potential investors. Very commonly, he will ask the corporation proposing the issue to cause an examination to be made by accountants satisfactory to him. In such work, the accountant is retained at the request of one party, but is actually employed and paid by another, and the purpose of his work is ultimately to influence the attitude of third parties with whom he never comes into contact. It is apparent at once that he owes an obligation to each of three groups or parties, and that the interests of these groups are by no means identical.

Now, the most difficult ethical problems generally arise from conflicts of interests and conflicts of loyalties. The simplest case is that in which the personal interest of the accountant conflicts with the interest of his client; but obviously no one can claim to be a member of a profession, or expect to succeed in one, unless he is prepared, when necessary, to subordinate his own interest to that of his client.

### Conflicts of Interest

More difficult problems arise in cases such as the one I have just outlined, in which the accountant owes an obligation or a loyalty to more than one individual or group of individuals, and the interests of the different parties conflict. Naturally, the problem is not made any less delicate by the fact that the accountant is dealing with matters of opinion in relation to operations with which one of the parties (the corporation) through its officials should be more completely informed than he can be.

Frequently, the first stage of his work is an investigation and report to the issuing house upon representations previously made to it by the corporation, and upon his report the issuing house decides whether those representations have been borne out and whether the issue is one which it is willing to sponsor. During this stage, the corporation and the issuing house are on the opposite sides of the table. If this stage is successfully completed, and mutually satisfactory arrangements are agreed

upon by the corporation and the issuing house, the questions arise what is to be shown in the prospectus, and in what form, and from this point onwards the interests of the issuing house and those of the corporation seem to converge and are, broadly speaking, identical.

### The Obligation to the Investor

The accountant is apt to encounter difficult ethical problems at both stages of the procedure, but those encountered in the later stage are by far the more difficult and are the only ones with which we are concerned today. In the first stage, the issuing house is trading with the corporation and has an interest in stressing any weaknesses in the corporation's position in order to secure more favorable terms. The accountant is frequently under pressure from two parties advancing conflicting views on the question at issue, and owing a duty to each party. He has, however, the advantage of hearing fully the arguments on both sides, and reaching his decision with due regard thereto.

In the second stage — when the prospectus is being prepared — the banker and the corporation are, as I have said, united in presenting their views. The banker is sometimes found to be minimizing at this stage weaknesses which he had stressed in the first stage. The accountant must recognize that his paramount obligation is to the investor, to whom his report is in reality to be addressed; and that the investor is some one with whom the accountant in the nature of things is not in touch, and who is incapable of presenting arguments counter to those presented on behalf of the banker and the corporation. The problem is made the more difficult because the importance of the accountant's report often lies as much in what it implies as in what it says, and because the differences relate almost universally to questions not of right nor of wrong, but of judgment.

To illustrate my point — the fact that a corporation has made money in the past has absolutely no significance to the potential investor except for its bearing on the probable earnings of the future. Therefore, neither the issuing house nor the accountant has any ethical right to put forward a statement of past earnings if to their knowledge it is calculated to mislead the investor as to the reasonable prospects for the future. On the other hand, what has been accomplished in the past is usually the main factual basis for estimating future prospects, and it is certainly no part of the work of the accountant to make esti-



mates for the future; so that if he is to make any contribution at all to the knowledge of the investor, it must be in the form of a report on what has taken place in the past.

### Past Earnings and Changed Conditions

What position, then, ought the accountant to take if either general conditions or the conditions specifically affecting the business under consideration have changed since the profits proposed to be reported were earned? This is a question which has occasioned conscientious accountants much concern. Conditions are never exactly the same from one year to another, and investment must, as a practical matter, always be based on imperfect knowledge and approximations.

I suggest that the auditor should always consider how far conditions at the time of issue differ from those obtaining during the period covered by his report, and particularly how far any changes are a matter of common knowledge. He may, for instance, properly certify accounts covering a period of five years even though in his judgment general business conditions are as a whole less favorable than the average during the period covered by his report. He might conceivably justify certifying profits earned during the boom period which culminated in 1929 after the collapse of that year, upon the ground that the change of conditions was a matter of common knowledge and that every one must judge for himself how far-reaching its effects would be. He, certainly would not be entitled to certify figures for a prospectus if to his knowledge, but not to the knowledge of the public, new conditions had arisen within the corporation itself which practically negated the possibility of a continuance of any such earnings in the future, or made earnings dependent upon entirely different considerations.

An accountant would not, for instance, be justified in giving a certificate which he knew to be desired for use in a prospectus in circumstances such as came to my notice (not in this country) recently. A corporation had conducted a very satisfactory and profitable general investment business for a number of years. Control of it was acquired by a financier of somewhat doubtful reputation, who proceeded at once to dispose of the investments previously held and to reinvest the proceeds in a series of companies controlled by himself. He also put out a prospectus in which he invited subscriptions to new securities of the investment company on the basis of the results obtained in the past

under conditions entirely different from those existing when the issue was made.

### Reliance on the Accountant

Obviously, problems of great nicety must constantly arise, and in order to solve them properly the accountant must possess good judgment and be willing and able to exercise that judgment objectively and dispassionately. The investor must rely on the judgment and ethical standards of the accountant, and, except in cases so flagrant as to be fraudulent, the community will be wiser to leave the penalty for failure to justify such confidence to be inflicted through the loss of standing in business which is likely to follow upon it, than to attempt to impose legal penalties.

To be willing to exercise his judgment objectively and dispassionately the accountant must be a man of high character, prepared to recognize and observe high ethical obligations even to his own immediate disadvantage. To be able to do so he must be free from any relation to the subject matter or to the parties in interest which might cloud his judgment or impair his loyalty to the investors, to whom his paramount duty is owed. As I have indicated, he necessarily stands in some business relation to the corporation creating the securities and the banking house undertaking their issue, but he should be careful to keep those relations on such a footing as to insure that his freedom of action and independence of judgment will not be affected.

It might be a counsel of perfection to suggest that no accounting firm should give a report or certificate if any member of the firm has any interest, however slight, in the corporation creating the securities to be sold. On the other hand, it would seem unnecessary to say that an accountant should regard himself as disqualified from giving any certificate or opinion if he has any substantial interest in the corporation whose securities are to be sold. Yet I have encountered at least one case in which this principle has been ignored by accountants carrying on a large business and claiming a good standing. As a practical rule, an accountant should run no risk of putting himself in a position where his interest might with any reason be thought to be large enough to affect his judgment, and it is the part of wisdom to resolve all doubts on such a question conservatively by declining the doubtful appointment.

Similarly, the accountant should be extremely careful not to put himself at any time in the position of accepting from the

issuing house any favor, or of buying securities from it on any terms more favorable than those offered to the general public. His compensation for services should be fixed, so as to make it as nearly as possible a matter of indifference to him whether the issue is or is not made, or whether if made it is or is not successful. Any agreement in advance whereby the compensation to be received is directly dependent on the success or failure of the financing, destroys the disinterestedness of the accountant and is wholly objectionable.

### Good Accounting and Matters of Opinion

These general considerations seem to me to offer little difficulty. The really difficult ethical problems of the accountant arise when differences of opinion develop between him and the officers of the corporation or the representatives of the issuing house, and when actual or potential weaknesses in the position of the issuing corporation are disclosed. Frequently, the facts of an industrial situation are uncertain, and the most correct accounting treatment of them is a matter of opinion. The officials of the corporation may represent the situation forcefully, and the accountant, while taking a different view, may believe them to be honest and may be conscious of the fact that their familiarity with the subject and knowledge of the details are necessarily greater than his own. He should, however, remember that as against their advantage of greater familiarity he possesses the important advantage of greater objectivity, and though he should always be open to conviction by sound reasoning, he should never allow his judgment to be overborne by the mere authority of interested parties.

Perhaps I might illustrate the difficulties of the situations which arise by an actual case, where the differences of opinion became a matter of public record. In connection with an important recent issue, the accountants, after listening to the views of the management, felt compelled to formulate their conclusions on a basis different from that which management thought appropriate. In the prospectus it was explained that the earnings, as reported by the accountants employed in that connection, were based on amortization tables which differed "drastically" from those theretofore accepted by the corporation on the advice of accountants, and the following statement was made: "The management believes that the adjustment, which accounts in large measure for the variation between the figures shown above and the interim figures reported by the

corporation, is extremely conservative and in the light of subsequent experience, may prove to be excessive."

It is easy to realize how embarrassing the situation in this case must have been. The question was purely one of opinion, the correct answer to which only time could determine. The management was, as the prospectus indicated, very definite in the expression of its opinion, and had the support of other accountants. The financial issues at stake were important. No doubt the accountants engaged in connection with the prospectus could have framed a form of statement which would have conformed to the views of the management, and which would have left them in a position legally secure. But ethically they were bound to give effect to the judgment which, whether right or wrong, they had honestly and definitely formed.

### Disagreements with Clients

It is painful to have to disagree with those by whom one has been retained, and the person in whose interest one does so is unlikely ever to know what has been done, or to appreciate the stand that has been taken on his behalf. But in the long run, the willingness of an accountant to do what he conceives to be his duty to the unknown investor, even if by so doing he alienates a client and suffers a present loss of business, brings a rich reward both in self-respect and in a professional reputation which, in turn, brings a pecuniary benefit.

Fortunately, in recent years a clearer recognition on the part of issuing houses of their own true interests has tended to make such controversies less frequent and less acute. The wise issuing house today recognizes that the prospectus is the basis of its contract with the investor and that all questions of ethics apart, it is not even expedient to issue a prospectus in which material facts are unfairly or inaccurately stated, or suppressed. Such a course may help the sale of securities at the moment, but that is of little worth if it creates possible ground of action against the banker later, should the securities for any reason involve the investor in loss. It is to the interest of the issuing house to see that no pretext is afforded for a later claim for rescission or damages. Here, again, an illustration may be helpful.

A few years ago, in discussion of a proposed issue, the accountants insisted that the existence of certain litigation should be disclosed. The junior representatives of the issuing house strongly opposed this suggestion, saying that it would be

fatal to the issue, and the lawyers seemed disposed to agree with them. The matter was, however, taken by the accountants to the head of the firm, who instantly decided that the existence of the litigation must be disclosed so clearly as to preclude any possibility of a claim being made against his firm later in the event that the litigation should result adversely to the corporation. He further expressed the opinion that such frank disclosure would affect the issue favorably, not unfavorably; and subsequent events seemed to bear out his judgment, the issue being extremely successful.

### Care in Wording Certificate

I believe that every high-minded accountant has accepted the principle that, once his conclusions are reached, the report or certificate which he issues, and which is designed to influence action, must be so worded that not only will every statement made therein be literally true, but every influence which could legitimately be drawn from the language will be warranted by the facts. There is no place in accountants' certificates for what President Roosevelt once called "weasel words."

In England, it would appear that what has heretofore been regarded as a canon of ethics may sometimes be a legal obligation, enforcible, possibly, under the criminal law. As long as 1884, Lord Blackburn, in the House of Lords, in a civil case expressed admirably his view of the position of those concerned in the issue of a prospectus. "If," he said, "with intent to lead the plaintiff to act upon it, they put forth a statement which they know may bear two meanings, one of which is false to their knowledge, and thereby the plaintiff putting that meaning on it is misled, I do not think they can escape by saying he ought to have put the other. If they palter with him in a double sense, it may be that they lie like truth, but I think they lie, and it is a fraud. Indeed, as a question of casuistry, I am inclined to think the fraud is aggravated by a shabby attempt to get the benefit of a fraud without incurring the responsibility." Since that time, many an embittered victim of a disingenuous prospectus has no doubt echoed the outburst of Macbeth which Lord Blackburn had in mind:

"And be these juggling fiends no more believ'd,  
That palter with us in a double sense;  
That keep the word of promise to our ear  
And break it to our hope."

In the case against Lord Kysant, which attracted attention here as well as in England and which was recently decided adversely to him both on his trial and in the Court of Criminal Appeal, it was admitted by the Crown that every statement in the prospectus was literally true. Nevertheless, the Judge charged the jury that if they believed that when the language was used the defendant knew that it was calculated to induce investors to draw entirely false inferences and intended that it should have this effect, they should convict him of the charge, which was that he had issued a prospectus which he knew to be "false in a material particular" with intent to induce persons to subscribe for the debentures offered.

Unfortunately, the precise grounds on which the prospectus was held to come within the statute are not entirely clear. Two paragraphs were specified in the indictment — one, giving average profits for ten years, the other, which followed immediately, containing a statement of dividends which showed that dividends had been paid in all but one of the last seventeen years. On the trial, the Crown in stating its case and the Judge in summing up seemed to take the view that the statement of an average for ten years, when in fact all, or substantially all, of the profits were earned in the first four of the ten years and the operations in some of the later years resulted in losses, was a statement false in a material particular, even though the average was mathematically true. In sustaining the verdict, however, the Court of Appeal pointed to the statement of dividends paid as being the portion of the prospectus that was particularly deceptive, by reason of the false inferences it was likely and intended to create.

To justify a criminal conviction on the ground that a statement of dividends created a natural inference as to earnings, when there was, in fact, a separate paragraph dealing with earnings, might seem to be straining the law. Possibly, however, what the Court had in mind was that the statements made in successive paragraphs regarding earnings and dividends were together so misleading as to justify a jury finding a criminal intent. Fortunately, no accountant was chargeable with responsibility for the language used in the Royal Mail prospectus; and I think most accountants would refuse to certify an average alone where the figures for individual years were ascertainable.

This is not the place in which to pursue the particular question before the courts in the Kysant case. For the present it is sufficient to say that all questions of criminality or even civil liability apart, the ethical obligation of the accountant is clearly

to see that no statement is put forward which is a half truth or which he realizes will probably give rise to inferences which would, in fact, be ill-founded. Of course, he cannot be held responsible for every inference, however unwarranted, which the ignorant or careless investor may draw from the appearance of his name in a prospectus. Every accountant with any considerable practice has probably, after a company with which he has been associated has come to grief, been told in aggrieved tones: "I took it for granted that if your name was on the document it was all right; I didn't trouble to read just what you said." Such an attitude is wholly unreasonable; but if a statement carries a natural and almost irresistible inference, the accountant is ethically and perhaps legally as responsible for that inference as for the literal truths of the words he uses.

### Phraseology in Annual Reports

The question of phraseology assumes a different form when we come to consider accounts embodied in annual reports. As I have pointed out, the figures and the language of an accountant's report or certificate, given for use in a prospectus, are his own. Others may make suggestions, but the final decision is entirely in his hands. The annual accounts of a corporation, on the other hand, are those of its officers and directors, and the primary responsibility is shared between them. In this case, it is the accountant who makes suggestions and the directors who must make the final decisions. When they have done so, the accountant must consider what report he will make to the shareholders on the accounts which the directors have adopted.

Clearly, it is not desirable that he should insist on registering every difference of opinion, however slight, that may arise between the directors and himself. His power to render service to the shareholders, and his ability to influence directors towards sound decisions, will be impaired if he adopts a too pedantic or too captious attitude. But when he differs with the directors on a point which he deems really important, he should indicate his dissent and express it clearly.

There is probably considerable justice in the criticism that qualifications of accountants' reports are frequently inadequate to convey to the average shareholder the precise nature and extent of the accountants' reservation. Those versed in financial affairs regard any sort of a qualification as a danger signal and refuse to pass it until they are satisfied just what danger threatens. But it would be a distinct forward step if auditors

would aim to express their qualifications in clear, non-technical, as well as unambiguous language. This point may be elaborated by a future lecturer, as Mr. Hoxsey of the New York Stock Exchange is taking a keen and active interest in such questions.

### Fairness to Shareholders and to Future Investors

In relation to annual accounts, a conflict of interest which I have not heretofore mentioned may arise, as between those who are already shareholders and those who may become so. The auditor's primary ethical duty is clearly to existing shareholders, but since he knows his report is likely to influence others to become shareholders, he must recognize some obligation to that class of investors. At the same time, annual accounts are historical in their nature. They are not intended to be and cannot properly be regarded as designed to indicate earning capacity. And if accounts are fair as a historical record, no one can justly assert a grievance against the accountant on the score that they led him to draw inferences as to future earning prospects which the accountant with his greater knowledge might have known to be unwarranted.

To illustrate this point — suppose a company to have been operating during a year on the basis of a sales contract covering the bulk of its output at a high price, which at the end of the year has expired and been replaced by a contract at a substantially lower price. An accountant would not be justified ethically in giving a certificate of the profits for the year for use in a prospectus, without referring to the expiration of the old contract and the making of the new one. It would, however, be no part of his duty to refer to the contract situation in his certificate to the annual accounts, though it might be a part of the ethical duty of the directors to do so in their report.

While every one experienced in corporation finance must recognize the impossibility of giving to annual accounts all the significance as indices of earning capacity which investors (and those who undertake to advise investors) too often attribute to them, neither directors nor auditors can completely ignore the fact that the history of the past is commonly regarded as some guide to the prospects for the future. The obligation of directors is, it would seem, greater if they have caused the securities of their company to be listed on a public exchange, for in doing so they have invited the public to trade in those securities. They have endeavored to secure for their shareholders the advantage



which a broader market sometimes affords; and both they and the shareholders should be willing to pay the fair price for this benefit.

### Liberal Standard of Disclosure

That fair price seems to me to be a sufficient disclosure of the affairs of the corporation to enable the public to deal in its securities with a reasonable degree of understanding. I have heard it argued that it is impossible to throw the full light of day on the affairs of a corporation, and that it is therefore unwise for a body like the New York Stock Exchange to exert its influence actively to secure more disclosure than corporations would otherwise undertake. The suggestion is, that as a result of such efforts the public is deceived because it is led to believe that it is trading in the full light of day, when it is only trading in the twilight. Personally, I have no sympathy with this point of view, but favor a liberal standard of disclosure. Inasmuch as Mr. Hoxsey has been one of the most persistent and effective campaigners in favor of publicity, I trust that he, when he comes to lecture to you, will discuss the question more fully than I can now attempt to do.

The difficult questions in this field revolve largely around two classes of items, frequently referred to as "non-recurring items" and "secret reserves." The term "non-recurring items" is applied to those items, whether of income or outgo, which although relating to the business and properly finding their way into the income account, are in character quite exceptional and not likely to be repeated at all regularly. Illustrations may be found in the case of recovery of insurance on the life of the president of the company, or a loss through fire of an important plant. "Secret reserves" is the term applied to amounts set aside out of income purely as a precaution and not in respect of any losses presently known or anticipated. The amounts so set aside may be used to meet totally unexpected losses in the future, or may be restored at a later date to the income account.

It is obvious that both classes of items require either to be eliminated or given special consideration in any study of the income account which is designed to determine the normal earning capacity of the business; but how these items should be treated in the regular annual reports of corporations is a question on which there is considerable divergence of opinion and practice. I think the minimum which a reasonable standard

of ethics calls for on the part of directors and auditors of companies whose securities are listed on exchanges, is that when any important non-recurring items are included in the income of the year, the fact that they are so included shall be clearly stated; and that where secret reserves are drawn upon to improve the profits of the year, this fact also shall be disclosed. I do not think there is room, thus far, for any serious disagreement. Differences, however, would arise on the further suggestion which I would make, that the amounts involved should in all cases be indicated.

### Original Establishment of Secret Reserves

There remains for consideration the attitude on the accountant toward the original establishment of secret reserves, the result of which is, of course, that the profits for the period in which they are established are understated. This is a particularly difficult problem because of the varied ways in which what are substantially secret reserves can be established. There is the simple case of a general reserve for contingencies; but there are more difficult cases, such as the undervaluation of inventories or securities, which have precisely the same effect.

One view of the question is that the directors should always submit accounts that represent as accurately as possible their best judgment of the true profits for the year, according to the general method of accounting adopted by the corporation. Others take the position that all businesses are subject to many hazards which cannot be accurately measured; that the attribution of profits to years is at best largely conventional; that business moves in cycles; and that a certain amount of deliberate understatement in good years is warranted and in the interests of shareholders.

The question is partly a practical and partly an ethical one, and my own judgment is that directors would usually be well advised to follow their own judgment in regard to the establishment of precautionary reserves, but to disclose to shareholders the fact that the reserves have been made. Whether they should give general publicity to the amount of the reserves established is a matter of judgment. Their ethical obligation is probably discharged if they tell shareholders explicitly that reserves have been made, and give them the opportunity to make further inquiries if they so desire. Drawing on reserves to supplement current profits is, as I have indicated, an entirely different matter, and should be fully disclosed.

So far as the accountant is concerned, I do not think that in the present state of public opinion and general practice he can be charged with an ethical duty to insist on the disclosure even of the fact that a secret reserve has been created, if he believes that the action was taken in good faith and if the amount involved is not so large that ignoring it completely distorts the earnings picture. Cases occasionally arise in which the accountant may be convinced that earnings are being deliberately understated in order that one group, often referred to colloquially as the "insiders," may profit at the expense of the general body of shareholders. There can be no question of his ethical obligation to the shareholders as a whole in such a situation. His position at such times would be greatly strengthened if he were elected by the shareholders and directly responsible to them, instead of being appointed by and responsible to the officers or directors as is the common case in our country.

#### Ethical Obligations of Accountancy Make It a Profession

I hope that this discussion of the ethical obligations of the accountant to the investor will be sufficient to convince you that the high-minded accountant who undertakes to practice in this field assumes high ethical obligations, and it is the assumption of such obligations that makes what might otherwise be a business, a profession. Of all the group of professions which are closely allied with business, there is none in which the practitioner is under a greater ethical obligation to persons who are not his immediate clients; and it is for this reason that I believe accounting ought, and can be made, to take an outstanding position in this group.

I would not have you think that because the investor is not his immediate client the accountant owes nothing to the investor except legal duties and ethical obligations. This is not, of course, the fact. It is to the investor that he owes his entire practice in the field of financial auditing, and it is only because the investor exists, and attaches weight to an accountant's report, that the banker employs the accountant's services in this field. And the continued success of the accountant is dependent on his retaining the confidence of the investing public. An enlightened self-interest, therefore, as well as self-respect calls for the maintenance of a proper ethical standard by the practitioner.

The young accountant may find it hard to take the first stand for the principles that have been suggested for his obser-

vance, but he will find that this is essentially a case in which "it is the first step that costs." Perhaps, therefore, in bringing this discussion to a close I may indulge in a personal reminiscence which bears on this point and which, as it happens, relates also to the question of showing average profits which arose in the Kysant case.

### A Practical Illustration

A good many years ago — as a matter of fact, in 1899 — owing to the death of one of the senior partners I was called upon to settle with a New York banker the form of a certificate for use in connection with a prospectus. As the issue was to be made on both sides of the Atlantic, it was planned to print the accountants' certificate in the prospectus as was and is customary in England.

The profits of the company showed a fairly steady decline over a period of ten years except that in 1898, owing to the Spanish-American War, they rose considerably to a point higher than the average of the ten years. The banker desired the certificate to show only the average for the ten years and the profits for the last year. I demurred to this suggestion on two grounds: first, that it was contrary to the practice of my firm to show only averages where the profits for separate years were readily ascertainable; and secondly, that the information proposed to be given would create a natural but erroneous impression as to the trend of profits.

The discussion became difficult, and it was indicated to me that if we adhered to the position I had taken there would be no possibility of similar differences with that particular banker in the future. However, I refused to modify the stand I had taken and was supported by the senior partner, with the result that no certificate was printed in the prospectus, but a statement was made by the banker on his own responsibility. I felt that I was right, but I could not fail to be conscious of the fact that my first important interview with a banker had not been a success and promised to result in the loss of an important client.

There was, however, a sequel. Some six months later, the same banker was contemplating the purchase of a business and desired a full and reliable report on its operations. His lawyers approached us, saying that while the banker still thought we were entirely wrong in the stand we had taken six months earlier, he believed that we had taken it in perfect good faith and that the incident should not, therefore, be a bar to friendly

relations between us. They thereupon gave us instructions to make the investigation, and further intimated that the banker desired that I personally take charge of it.

This sequel made the whole incident one of the most helpful of my experience, and I hope it may also be of service in encouraging those of you who may be about to start practice, or are in the early days of practice, to take a firm stand for sound ethical principles, which I am sure will ultimately tend to bring you professional success as well as a consciousness of professional integrity.