Accounting Historians Notebook

Volume 18
Number 2 *Fall 1995*

Article 5

October 1995

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ACCOUNTING FIRM HISTORIES IN TEACHING AUDITING AND FINANCIAL ACCOUNTING

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While the history of accounting is a well-developed field with established journals and numerous books, few universities offer classes devoted to accounting history. Moreover, in most curricula little or no attention is paid to history in financial accounting, cost accounting, or auditing classes. Consequently, few students have much knowledge of the history of the profession including even its most recent history. For example, when discussing the subject of auditor liability with a class in 1994, I asked the students what the importance of the Laventhol and Horwath bankruptcy was. None of the students had heard of this firm or had any idea of what, if any, importance there was to the accounting profession of its demise. Slightly less surprising to me was that none of my students had heard of Main Hurdman (the ninth largest U.S. auditing firm prior to its 1987 merger with Peat Marwick). In addition, few students were aware that current accounting and auditing standards (e.g., Financial Accounting Standards Board and Auditing Standards Board Statements) had significant historical antecedents that could enable them to better understand the reasons for their development.

This article does not attempt to provide a complete remedy for the lack of historical awareness of accounting history by either students or professors. Instead it provides a few pedagogical examples of how the history of accounting can be incorporated into conventional lectures on financial accounting and auditing in a way that will both introduce students to a historical perspective on accounting and contribute to an improved understanding of the basic subject matter. A rich source of accounting history is found in the official or semi-official histories of large accounting firms. Beginning in 1951 and continuing until the early 1980s, several of the largest U.S. accounting firms (see references) published "official" histories of their firms. In addition, a managing partner of one firm, Arthur Andersen & Co., was interviewed extensively for a "semi-official" history of his firm (Spacek, 1985).

These official or semi-official sources provide useful information which can enable accounting teachers to use anecdotes from accounting history to illustrate important points. This article illustrates how this can be done mainly by using material from these "authorized" histories of accounting firms and some other sources to develop a number of "trivia" questions. Each of these questions is designed to provide historical perspectives on the profession and also to provide useful information on current topics in financial reporting and auditing.

Each question (Q) will be followed by the answer (A) and then by a brief teaching note (T) which discusses the relevance of the question and answer to current issues in accounting and auditing. The sources for the answers, most of them official or semi-official accounting firm histories, will be cited with the answers.

Q1. Which was the first large international accounting firm to hire significant numbers of women accounting professionals?

A1. Price Waterhouse. Faced with a shortage of personnel due to the draft into the military of many young male accountants during World War II, Price Waterhouse recruited a number of women. These new employees went through an eleven-week training course in auditing and accounting at Northwestern University (DeMond, 1951, pp. 293-294). Following the end of the war, the firm expected its female employees to resign; most of them did, but a few kept working as auditors until the early 1950's.

T1 It was not until the mid-1960s that most major CPA firms began to hire minorities or women in significant numbers. For example, an official history of a major firm from its inception through 1963 describes the valuable contributions of female secretaries to the firm, but also notes that "our firm has never employed women for its professional staff" (Arthur Andersen, 1984, p. 97). This lack of interest in employing women and minorities should not be presented as a specific condemnation of the accounting profession, since it was quite typical of most American institutions at the time.

Q2. Two brothers who lived in Cleveland founded an accounting firm in 1903, putting in a total capital contribution of $500. In 1906, one of the brothers decided that the accounting business was not likely to be a profitable venture and withdrew his contribution to start a commercial laundry. What was the name of the firm and which Big Six accounting firm continues to exist long after the withdrawal of one of its founders?

A2. Ernst & Young; the original firm was known as Ernst and Ernst and practiced under that name until the late 1970s (Ernst & Ernst, 1960, pp. 1-6).

T2. The AICPA's code of conduct allows firms to practice under the same name following the withdrawal of a partner. Ernst & Ernst continued to practice under the original name long after the withdrawal of one of the original partners from the firm. The firm history does not discuss whether the withdrawing partner's laundry business was a success.

Q3. Arthur Andersen, founder of the firm that bears his name, died in 1947. What was one of the first acts by the partners of the succeeding partnership?

A3. Arthur Andersen, Jr., son of the firm's founder, was eliminated from any participation in the new firm (Spacek, 1985, pp. 80-82). Of course, the succeeding partnership continues to practice under the original name to this date.

T3. The basic lesson of this question is the same as question two: an accounting firm may continue to practice under its original name long after the original partner or partners have left the firm.

Q4. What was the primary historical antecedent of the use of the "pooling of interests" method of preparing consolidated financial statements?

A4. In 1941, William Black, managing partner of Peat Marwick, developed the "pooling of interests" theory in response to the request of a client, Celanese Corporation, which wished to merge with Celluloid Corporation (Wise, 1982, pp. 49-50). Celanese did not want to use purchase accounting which would have required that the excess of the purchase price over Celluloid's book value be amortized against the future earnings of the combined entity. The use of "pooling" allowed the newly-combined entity to report larger profits than would have been reported if "purchase" accounting had been required. Subsequently, "pooling" accounting became a very popular method of treating business combinations. Because of the belief that the method was being abused, its use was curtailed, but not eliminated, by pronouncements of the Accounting Standards Board in the late 1960s.

T4. This Question could be used as a teaching device to suggest the relevance of positive accounting theory to the development of accounting standards. In this case, the accountant put forth a "theory" which, while not unreasonable, might appear to have been developed largely to serve a client's desire for more favorable accounting treatment.

Q5. This is a "mix them and match them" question, based on the relationship between well-known practicing accountants and their involvement in academic education.

Famous Accountant	Academic Attachment
1. Arthur Andersen (founder of you know what firm)	a. Chairman of the Accounting Department at University of Notre Dame.
2. Cletis Chizek (an original partner of what is now the 13th largest accounting firm in the U.S., Crowe, Chizek, and Co.)	b. Dean of the Business School at New York University
3. John R. Wildman (an early partner of the firm of Haskins and Sells, now Deloitte and Touche)	c. Accounting Professor at UCLA
4. George D. Bailey (one of the founding partners of Touche Ross, since merged into Deloitte and Touche)	d. Chairman of the Accounting Department at Northwestern University

A5. 1–d; 2–a; 3–b; 4–c. Arthur Andersen was a professor of accounting and an early department chair at Northwestern University. Chizek, a founding partner of what is now the 13th largest CPA firm in the United States, was accounting department chair at the University of Notre Dame in the 1940s. John R. Wildman was a partner in Deloitte Haskins and Sells and also accounting professor and department chair at New York University. Bailey taught at Harvard, the University of Michigan, and UCLA following his retirement from public accounting in 1958.

T5. The main point here is that the collaboration of academics and practitioners was once closer than is the case today. Practicing accountants were more directly involved in accounting education, and academic accountants were perhaps more interested in practical problems affecting the profession.

Q6. What was the most notorious "audit failure" of the 1930s and what consequences did it have for the profession?

A6. The McKesson-Robbins case. McKesson-Robbins, a publicly traded company, had fictitious receivables and inventory allegedly held by a Canadian subsidiary. The firm's auditors, Price Waterhouse, failed to confirm the receivables or observe the inventory. Once the fraud was discovered, actions by the SEC and the accounting profession led to the requirement that an audit usually involve direct confirmation of receivables with the debtors and auditor observation of inventory (DeMond, 1951, pp. 257-279).

T6. The obvious teaching point is simply that confirmation of receivables and observation of inventory are today considered normal audit procedures. A secondary point is that both government regulators and the profession itself are often reactive rather than proactive; i.e., without this highly-publicized audit failure, these two audit procedures, which we now take for granted, might not have become standard practice. An entire chapter of the official history of Price Waterhouse (DeMond, 1951) is devoted to this incident. This chapter could be used as interesting supplementary reading in an auditing course, since there is considerable similarity between the McKesson-Robbins case and recent accounting scandals such as ZZZZ Best and PharMor.

Q7. Which important client of a major accounting firm dismissed its auditor in the 1930s because the auditor refused to allow the client to use the equity method for its investment in another firm?

A7. The large chemical company, E. J. DuPont, which was one of Arthur Andersen's largest clients. DuPont accounted for its approximately 25% holding of General Motors stock using what is now called the equity method of accounting. After receiving a qualified opinion, DuPont fired Arthur

See HISTORIES on page 31

HISTORIES continued from page 8

Andersen, replacing them with Price Waterhouse (Spacek, 1985, pp. 60-63).

T7. There are at least three important points here: First, this might be viewed as a blatant example of the problem currently referred to as "opinion shopping," where a firm considers changing auditors to obtain a preferred treatment of a particular accounting issue. Second, the fact that at the time the equity method was not considered to be "GAAP," but now is an accepted practice, emphasizes how accounting standards change over time. Third, this illustrates that a CPA firm can lose an important client due to a disagreement over accounting principles without ultimately harming its practice. Indeed, in this case, it appears that the favorable publicity obtained by opposing a client's view on an accounting principle may have enhanced the auditor's reputation for independence.

Q8. When a partner or other employee of a CPA firm leaves his or her firm, important clients often follow. What is the most dramatic example of this?

A8. In 1947, George D. Bailey, an employee of Ernst & Ernst for 35 years and managing partner of its Detroit office for 25 years, left Ernst to begin his own practice. Several important clients, including Chrysler Corporation, followed him. These clients became an important nucleus of what later in 1947 became the "Big Eight" firm of Touche Ross (first known as Touche Ross, Bailey, and Smart) and since its 1989 merger, the "Big Six" firm Deloitte and Touche (Swanson, 1972, pp. 9-10, 14).

T8. Several teaching points might be made here. The "official" history of Touche Ross hints at dissension in Ernst & Ernst prior to Bailey's departure, suggesting that even in large CPA firms, personality differences can have important consequences. In addition, the defection of many important clients indicates that clients may be as interested in the expertise or reputation of the accountants they deal with as with the expertise or reputation of their accounting firm as an entity.

The accounting firm histories discussed in this article and cited in the references include much more useful material to teachers of accounting. For example, there is considerable historical information on the contrasting methods by which these firms expanded, the development of accounting standards, and how the general political and economic climate affected the development of the profession at various times. There are also shortcomings to this material which should be recognized. For example, only two of these official histories (DeMond, 1951, and Swanson 1972) discuss the legal liability problems of the profession and both tend to do so in a way that presents their firms in a positive light As might be expected from official histories of any organizations, public or private, positive developments are emphasized and negative aspects are downplayed (but not completely ignored). Despite some shortcomings, using these sources can both encourage students to become more interested in accounting history and also enable professors to enrich the traditional teaching of accounting with an historical perspective.

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