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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

[*Opinions expressed in* THE JOURNAL OF ACCOUNTANCY *are not necessarily endorsed by the publishers nor by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors.*]

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EDITORIAL

The New Year

This issue of THE JOURNAL OF ACCOUNTANCY will reach readers as the bells ring out the old year and ring in the new, and all of us, whether poor or rich (if there be any rich) will regard the passing of 1933 in a spirit of resignation without grief and the advent of 1934 in a spirit of hope, let us pray, undaunted. Not for fifty years has there been in the history of America so dark an era as that through which we have passed. Nineteen hundred and thirty-three was, we all trust, the last of the years of the great depression following the war of the world and the wild orgy which succeeded. It was in a way the worst of the years because it was an accumulation of woe upon precedent woes. Had it been a lone year of hard times, we might have borne it more cheerfully, but with nerves frayed by experience and with patience well-nigh exhausted, no one was able to carry the load without groaning of the spirit. Now as we come into this brand-new year there is undoubtedly a feeling of something approaching assurance. Nearly everyone believes that we have seen the worst of it, and what ensues must be at least a little better than what we have gone through. Without placing too much faith upon the inspired prognostications of returning prosperity, there is still a possibility of looking forward with less of dread and dismay than has been our lot during the past four years. For no apparent reason there is abroad in the land a revivified will to carry on. Every business man knows something of this renewed hopefulness. Stocks of merchandise are at their lowest point. We

have lost the extravagant notions of 1929. We believe, most of us, that there is a norm of business to which we may rightfully adjust ourselves. We do not think that we shall see again in any near day such vast possibilities of the rapid and often unjust acquisition of wealth as that which we thought reasonable in the days of the great boom. We must, however, eat and clothe ourselves and travel and conduct the business of life. All these things involve the employment of men and the utilization of material and the transactions of trade—and these things of themselves will make sufficient demands to involve all of us in the march of progress.

Ready to Weigh Anchor

It has been said in these pages and in many other places that the real nadir of depression was passed while we knew it not in 1932. Since that time we have been wallowing in a slough of despond and we have been hesitant, uncertain, wavering; but nevertheless there has been an upward tendency in all the principal activities. We long to go forward, and that is the happiest augury for the days which are ahead. We have given up repining and we talk very little about the good old times when it was easy to make money and easy to spend it. We are now concerned not much with the past but almost entirely with the future. We are, in a word, ready to start. But we are being held back by uncertainty, not about ourselves or our abilities or the natural momentum of our business life. It is, rather, an uncertainty which is artificial and not truly a part of us. We are ready to start, but how shall we start and what shall we use as the medium of exchange in this new year? To what port shall we lay our course? We are enveloped in a fog, or perhaps it would be better to say in a smoke from the fires of experiment. Everything around us is obscure. We can not see even the horizon, and so we dare not get under way. We are beclouded with what is called emergency legislation and the extraordinary powers vested in our administration. Theorists are seeking to interpret the chart. The ship lies at anchor inside the harbor-mouth ready to sail, and as soon as there is a better visibility and we can see the sky and can learn the condition of the sea outside the bar we shall set sail and up-anchor on a thousand voyages, all of us, we hope, helping to build up the commerce of the world in general and of our own nation in particular.

American Institute Benevolent Fund, Inc.

Action by the American Institute of Accountants followed swiftly upon the suggestion, to which reference was made in the July, 1933, issue of THE JOURNAL OF ACCOUNTANCY, that a benevolent fund be created for the purpose of relieving members of the Institute who may be in financial distress. At the banquet of the Institute at the time of its annual meeting in New Orleans in October, Edward E. Gore, of Illinois, made an effective plea for the support of such a fund and subsequently a few subscriptions were received. It was considered desirable, however, that the entire membership should have an opportunity to contribute to this worthy cause and a letter was sent to all members and associates explaining the purpose and asking for small donations to be used for current necessities. It was explained that it was the intention to establish a permanent and substantial fund, but that the present was not the most propitious time to ask for donations of large amount. In the letter explaining the purposes of the fund an interesting illustration of the way in which such a fund could operate was given. We quote the following extract from that letter:

"A member who had reached advanced years was discharged from an advisory position which he had had every reason to believe was permanent, and he and his wife were left without resources sufficient to support them for more than a few months. When the condition had become desperate an opening occurred in one of the most desirable institutions in the country where this accountant and his wife could be admitted and spend the rest of their lives in peace and freedom from care. It was, however, necessary that a sum of $700.00 should be available to obtain admission. There was no time to lose and one of the members of the Institute personally advanced the money that was required in order that this opportunity might not pass without action. The member and his wife who were left destitute are now comfortably housed and will receive every care and attention so long as they both may live."

It was decided by the executive committee of the Institute that the new organization should be chartered in the state of New York under the title American Institute Benevolent Fund, Inc. The incorporators were: William B. Campbell, Will-A Clader, Allan Davies, P. W. R. Glover, James Hall, Frederick H. Hurdman, Arthur W. Teele. A charter has been received and the fund is in active operation. Many subscriptions have come in

and there has been universal approval of the plan, even in some cases by men who were unable at the moment to make any monetary contribution. This addition to the Institute's activities is one of the most gratifying examples of the usefulness of organization. In all probability when there shall have been a resumption of business activity it will be possible to build up a sum in the principal of the fund which will produce sufficient annual income to take care of the most urgent cases which will arise. Naturally, the demand for assistance will be less in prosperous times, but even at the peak of prosperity misfortune may befall a practitioner and his family, and it is eminently appropriate that there should be some source of financial relief available in such cases.

Responsibility of Auditors

Canadian and British accounting magazines have been commenting upon a recent case in the province of Ontario, which is of general interest to accountants everywhere. We quote the following from the report appearing in the *Canadian Chartered Accountant* for October, 1933, under the heading, "Responsibility of Auditors." The case was the *County of Renfrew* v. *Lockhart and Meehan:*

"What degree of skill must be exercised by persons who are not chartered accountants or professional auditors but who accept the responsibility of auditing accounts? A partial answer to this question was furnished recently by the judgment of Mr. Justice Wright in the above unreported case. The defendants, who were not chartered accountants or professional auditors, although they had some experience in auditing, were employed by the plaintiff to audit the accounts of the county treasurer. Commencing in 1925 the treasurer's accounts had been short every year until his ultimate exposure, but he had managed rather skilfully to cover up his defalcations during that time. The defendants did not discover these shortages when making their annual audits and this action was brought against them for damages for their alleged negligence.

"One of the principal charges was in connection with the shortages in the bank account. The judge found that at the end of December, 1929, the cashbook showed a balance of $64,966.94, whereas the real balance in the bank was merely $4,966.94—a shortage of $60,000. The defendants, however, were put off by a falsified bank book which was produced for their inspection and which showed a balance of $64,966.94, corresponding with the balance shown by the cashbook. In the judge's view the true

balance would have been discovered if the defendants had added up the different items in the debit and credit column of the bank book or had compared the items in the cashbook with the items in the bank book. Were the defendants negligent in not adopting either of these courses of action? The court held that while they were somewhat lax in the performance of their duty, their laxity did not amount to negligence, and that while their obligation was to perform their duty in a reasonably skilful and careful manner, yet their limited experience as auditors should be taken into account in determining the degree of skill that should be expected of them. Even if negligence on the part of the auditors had been proved, the court observed that a further point would have to be considered. Had the plaintiff shown that the losses sustained by it were the result of the defendants' failure to report the defalcations? It has been held in our courts (*Canadian Woodmen of the World* v. *Hooper*) that auditors are not responsible for the loss flowing from the misconduct of a defaulting employee, but only for the loss resulting from their failure to report the true state of facts. On the evidence in this case the judge concluded that even assuming negligence on the part of the defendants, the plaintiff had not made out a case as there was nothing in the evidence to show that had the auditors reported the defalcations at an earlier period, the services of the treasurer would have been dispensed with. In the result, therefore, the action was dismissed, but in view of all the circumstances, and in particular the laxity of the defendants, the judge allowed them only three-quarters of their costs.

"An appeal from the above judgment was heard on 21st September by five judges of the court of appeal for Ontario, and was dismissed with costs, two judges dissenting."

Value Not Always Received

In the course of comments upon the same case in the *Incorporated Accountants Journal,* London, November, 1933, it was said:

"The important aspect of this case is that the court took into consideration the limited experience of the auditors which in effect means that if a municipality chooses to appoint auditors who are not properly qualified, they do so at their own risk. As one of the judges of the court of appeal remarked, the county council 'got about the sort of audit for which they paid; they were about equal.' The moral is that auditors should be selected for their competence and not for the smallness of their fee."

In general it may be said that the opinion voiced by the judge of the court of appeal is true enough. People do usually receive about what they pay for; but it is not always true. In a case

such as the present, it seems to us that, whatever the county council paid, the service for which it paid was less valuable than the compensation. This does not mean that any particular blame attaches to incompetent persons who are deputed to perform a service outside the range of their experience and knowledge. It is quite common to find fraternal societies and many other organizations which subject their accounts to two or three men for audit when no one of the selected auditors is experienced in the science of accounts. In some cases it is known that treasurers have been appointed, with or without assistants, to audit their own accounts. Of course this is the height of folly. No argument is necessary to demonstrate the fallacy of incompetence. But there is another and more important aspect of the opinion of the judge whose remarks we have quoted, and that is one which is of direct concern to the profession of public accountancy.

Low Fees Are Costly Everybody knows that in all vocations there are men better fitted than other men to perform certain tasks, and as a rule the less efficient the man may be the less fee he demands. Consequently, there is a natural inclination on the part of many people to buy in the cheapest market, whether the goods for sale are merchandise or personal services, and it is not always true that the man who buys the cheapest article gets "about what he pays for." He often gets nothing, and he has to pay something. Then, again, at the other extreme, every one knows that there are professional men who charge utterly exorbitant fees and render no service of peculiar value. Here again the buyer does not get value for what he pays. What the learned judge had in mind, no doubt, was the perfectly incontestible truth that cheapness may be the most expensive thing in the world. So in the broad practice of accountancy the clients who stick to the accountants who ask the lowest fees are not wise, and it may be equally true that those who pay the highest fees are not wise. Indeed, the whole question of price is not one that should be considered first in the selection of professional advisors. If people could only be educated to the knowledge that price is a secondary consideration there would be far less difficulty. In that ideal day for which we all yearn there will be no question at all about compensation, but the work will be assigned to the men who are considered best qualified and they will be trusted to render fair and accurate bills for services.

A Good Time for Reformation

It seems probable that this winter there will be less of the intense activity which in former days was the terror of the accounting profession. The volume of business which will come to accountants' offices can not be expected to be as great as that which was encountered in normal years, but whether the number of engagements be large or small the same principle will be involved. The seasonal nature of much accounting practice is almost as troublesome in bad times as in good, because it makes it necessary to employ, during whatever may be the busiest season, a considerably greater number of men than that required during the rest of the year. Consequently there is a lack of continuity which is a severe handicap. When employees are not needed for the full twelve months they naturally become dissatisfied with a profession which offers only part-time employment. Men who are available are, in a great many cases, less qualified than would be desired, and the burden thrown upon the permanent staff is increased by the extra attention needed to supervise temporary assistants. This fact revives the old question of the date of the closing of books, and it seems that this is a good time in which to encourage reform. Countless corporations and other companies have passed out of existence or are being entirely reorganized, and accountants should seize this opportunity to urge the adoption of the natural business year rather than the calendar year for fiscal computation. There is no necessity to argue advantages of terminating the fiscal year at a period when inventories are lowest. Every accountant is familiar with the points at issue. When business is thriving there is a great deal of resistance to any change in arrangements because corporation officers and directors are disinclined to undertake anything which is not absolutely necessary. At present, however, few companies are working at full pressure and there is excellent opportunity to introduce reforms which will be helpful when the full measure of business shall have been attained. The accountants themselves can do more than any other group of men to arouse interest in the merits of this reform. It is, of course, to their own advantage to have the work spread over the entire year, but the question can be raised without laying undue stress upon selfish considerations. Every company which has a natural business year differing from the calendar year will derive benefit from adopting the most convenient period for the closing of books. The labors of the

taxing authorities will be relieved. Indeed, there is nothing to be said in favor of the common adoption of the calendar year except the spirit of inertia which militates against any change. This is the time when accountants can adduce their arguments and secure better results than ever before. A new company or a reorganized company can have no valid objection to the natural business year, and the companies which are continuing in their former status can not justify adherence to an inconvenient plan because of having no time to attend to it.

Questions in Ethics

The board of examiners of the American Institute of Accountants has introduced into the auditing examination a question based upon the code of ethics of the Institute. The board apparently felt that a man who is competent to be an auditor must be familiar with the principles which govern the reputable practice of the profession. The first of these questions appeared in the examinations of November, 1933. It required the candidate to explain the rule against advertisement of professional ability. Some of the members of the board expressed the opinion that this question was too elementary, but the answers are instructive, nevertheless. One candidate wrote, "For an accountant to advertise professional attainments would be disclosing information which should not be made public." Comment upon this answer would be entirely superfluous. Another candidate wrote, ". . . by frowning upon blatant display of qualifications in the hope of winning favoritism and clients at the expense of their less noisome but probably more proficient fellow practitioners." "Noisome," as Polonius might have said, is good, very good. Another candidate wrote, "If an accountant solicits business, advertises, underbids, etc., he will not only cut his fellow accountant's throat but will reduce himself from a professional standing to the standing of a cut-rate drug store or to that of the oldest profession known." Another candidate, who probably knew what he was trying to say but disguised his knowledge admirably, wrote, "If advertising were adhered to it would tend to alleviate the professional qualifications." The best answer of all, however, is probably this, "It looks like hell for an accountant to advertise how smart he is." The examiner, who reported this answer added his own comment: "A bully statement of fact."

The Position of Accountants Under the Securities Act *

By George O. May

I have been asked to discuss tonight the securities act of 1933 from the point of view of the accountant. Few, if any, measures have ever been passed possessing so much importance to the profession, and it is not possible within the limits of a single address to consider all the questions of interest to us which it raises. I propose to limit my discussion mainly to two points: the liability arising under section 11 of the act, and the powers to define accounting terms and make regulations granted to the federal trade commission by section 19 of the act. As I shall point out later, section 19 may afford a means of mitigating to some extent the harshness of section 11.

No one who has watched closely the developments of the past ten years can wonder that a securities law should be enacted, or even be greatly surprised at the form which it has taken. Nor would it occasion surprise if more recent revelations should prove to have made it difficult to bring about modifications in the act or perhaps have created a demand for still more drastic measures. But to say that legislation was natural, and perhaps inevitable, is not to approve all its provisions; and while the act possesses many merits, the wisdom of some of its provisions (notably those provisions relating to the liability of underwriters, directors, officers and experts) is open to serious question in the minds of those genuinely interested in the protection of investors.

It is a commonplace that extreme measures defeat their own purpose; but people are seldom willing to give practical effect to this commonplace. Fifteen years ago, we adopted a constitutional amendment designed to put an end to admittedly great evils. When legislation enacted in pursuance of that amendment proved ineffective, we passed more severe measures; but as the law became more drastic, its enforcement became more and more impossible. Yesterday, we took the final step to reverse the well-intentioned but unwise action of fifteen years ago. We all realize, however, that it will take years to eradicate the evils which that unwise action brought into existence. Surely there is a lesson here for those who seek to regulate the issue of securities.

* An address before the Illinois Society of Certified Public Accountants at Chicago, Illinois, December 6, 1933.

Many who originally supported the prohibition movement, including, as I particularly recall, a bishop of the church, finally became convinced that it should be repealed on the simple ground that it placed the distribution of liquor in the worst possible hands. In the same way, a too drastic securities law will place the distribution of securities in the worst possible hands.

I can not believe that a law is just, or can long be maintained in effect, which deliberately contemplates the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not to be measured by injury resulting from falsity in such statement. Yet, under the securities act as it stands, once a material misstatement or omission is proved, it is no defense to show that the plaintiff had no knowledge of the statement in question or of the document in which it was contained, or that the fall in the value of the security which he has purchased is due, not to the misstatement or omission complained of, but to quite different causes, such as the natural progress of invention, or even fire or earthquake. The securities act not only abandons the old rule that the burden of proof is on the plaintiff, but the doctrine of contributory negligence and the seemingly sound theory that there should be some relation between the injury caused and the sum to be recovered.

It is frequently suggested that the act follows closely the English law; but as one who has followed the development of the English law for nearly forty years I am bound to say that whether this statement be regarded as praise or censure, it is unfounded. None of the departures from ordinary legal principles to which I have referred finds its counterpart in the English law. The right of rescission is enforceable only against the issuer, and before the purchaser can recover from a director or other person concerned in the issue he must show that he relied on the prospectus, and then can recover only for injury due to the untrue statement which he proves.

Finally, as indicating the difference in temper of the English law, let me read a section which deals not with this specific question, but with the liability of directors and officers to the corporation for negligence or breach of trust:

"If in any proceeding for negligence, default, breach of duty, or breach of trust against a person to whom this section applies it

appears to the court hearing the case that that person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit." (Companies act, sec. 372 (1).)

The answer of congress to those who urged that the English law should not be followed because it was too severe and tended to check the flow of capital into industry, was that of the son of Solomon, who, refusing to listen to the elders, and following the advice of the young men, said: "My father hath chastised you with whips, but I will chastise you with scorpions." And you will remember that the answer was, "What portion have we in David? . . . to your tents, O Israel," and the biblical narrative concludes with the statement, "So Israel rebelled from the house of David unto this day." So, too, there is reason to fear that responsible people will refuse to accept the unfair liability imposed on them by congress under this act, and will continue to refuse until juster provisions are enacted. If they do so, their action can only be regarded as the course dictated by common prudence, and not as indicating factious opposition to the main purpose of the act.

If we limit our consideration of the liability provisions of the act to their effect on accountants, their punitive character becomes even more apparent. As between an innocent but negligent vendor and an innocent but negligent purchaser, there may be some consideration of public policy in favor of requiring the vendor to return what he has received if his representations are proved to be false in fact, although he believed them to be true. This consideration may be particularly applicable where the purchaser is a small investor who has neither the ability nor the resources for determining the truth which are at the command of the vendor. It is difficult to see, however, upon what principle of justice the accountant or other expert whose good faith is not challenged, but who is held to have failed to live up to the high standard of care required of him, can fairly be called upon to do more than make good the injury attributable to such failure for the benefit of a purchaser who perhaps did not even know of his existence at the time of the purchase, and took no pains whatever to investigate the security he purchased.

But even though we feel the provisions to be unjust, we can not expect them to be modified merely because they are unacceptable to accountants. The hope of securing amendment lies in demonstrating that they are not in the interest of the general public, or of the investing public in particular; and this seems to me to be so clearly the case that there should not be any great difficulty in demonstrating it to open-minded people possessing some general familiarity with business. I believe anyone who will take the trouble to consider carefully the work of the accountant in connection with new issues, and the practical consequences of these new provisions will be forced to the conclusion that in the public interest these provisions should be substantially modified.

The services of the accountant in connection with a new issue, are, broadly, to report upon statements relating to the financial position and operations of the issuer. The first important point to be noted is, that while the statements in question rest on a basis of fact, the facts in the case of any considerable business enterprise are both complex and incomplete, so that any report upon them is predominantly an expression of judgment and opinion. To illustrate—the most important single figure will usually be the profits for a particular year. Only the slightest consideration is necessary to bring realization of the fact that the transactions of the year are inextricably interrelated with those of earlier and subsequent years, and that how much profit is fairly attributable to a particular year is ultimately a matter of convention and judgment.

The function of the accountant, therefore, is to express an honest and informed judgment regarding the financial position and operating results of the issuer according to some acceptable standard of accounting conventions. It is not merely a fact-finding function.

We may now consider how this function is in practice discharged. While the work of accountants today involves the use of a large staff, it is obviously impracticable for the accountant even with a large staff to examine all the transactions of even a moderate-sized corporation. His procedure is, therefore, a varied one —in some cases, he will make a fairly complete independent check; in other cases, he will make tests; in still other cases, he must rely on the records of the corporation, satisfying himself that they are so kept and checked as to justify such reliance as a reasonable business procedure.

In considering, therefore, what degree of responsibility may wisely and rightfully be imposed on the accountant, one must start from the premises that (a) his work is in part in the nature of confirmation of facts, and in part an expression of judgment; (b) his procedure is necessarily to a large extent one of testing—he can not scrutinize every transaction; (c) his work is necessarily carried on largely through subordinates.

It is clear that the accountant may incur liability under the act without being guilty of either moral culpability or recklessness, if a court holds that (a) facts within his knowledge were presented in such a way as to mislead; or (b) the tests which he made were not sufficiently extensive to justify him in forming a belief; or (c) he was not justified in forming a belief on the evidence which he examined without probing deeper. Furthermore, he will presumably be liable for any misstatement which may be attributable to the failure of his assistants to take steps which they should have taken, even though he instructed them to take such steps and believed, and had a right to believe, that they had done so.

Surely, if any liability is to be so founded, it should at least be restricted to the damage shown to have been caused by the default proved against him or his assistants.

It is unnecessary for me to spend much time in pointing out how far beyond such a standard of liability the act goes. The point has already been fully discussed in the pamphlet entitled *Accountants and the Securities Act*, which has been circulated to its members by the American Institute of Accountants, and in addresses to accounting bodies made by the chief of the securities division of the federal trade commission, the honorable Baldwin B. Bane, on September 19, and on October 30, by Commissioner James M. Landis. The discussion of the question by the former concluded with the statement:

"Thus both theoretically and practically there is no probability of one's liability exceeding the aggregate amount at which the securities were offered to the public."

Commissioner Landis, taking what he seemed to regard as a more hopeful view, said:

"It should be observed that each person whose liability on the registration statement has been established is responsible in damages to any purchaser of the security, whether such person shall have purchased from him or from some other person. Theoreti-

cally this means that each person so liable can be held to a liability equivalent to that of the total offering price of the issue. Practically, of course, no such large liability exists. Several factors will operate to keep the liability within much smaller bounds. For one thing, the value of a carefully floated issue can hardly be assumed to reach zero. For another, every purchaser would hardly be likely to bring suit. Again, the issue of liability—generally, a complicated question of fact—would be retriable in every suit, and it beggars the imagination to assume that every jury faced with such an issue would come to the same conclusion. Furthermore, each person liable has a right of contribution against every other person liable, unless the one suing is guilty of fraud and the other is not. So that even eliminating the other practical factors that I have mentioned, it would be necessary for every other person liable on the registration statement to be insolvent, in order that one of them would be affixed with the large theoretical responsibility."

These being the views entertained by persons who sought to reassure us so far as they honestly could, it is quite unnecessary to consider what has been said by those who sought to excite our fears. The liability is obviously one that no prudent business man would be justified in assuming. And certainly accountants have no right to be guiding investors if they are not practical business men as well as technically qualified accountants.

Let me emphasize again that in order to be subjected to such a liability it is not necessary that the accountant should have been fraudulent, or even reckless or incompetent. He may be held liable merely because of an error of judgment regarding the extent of the examination which he ought to make, or through honest error or oversight on the part of a competent and ordinarily reliable subordinate. And if he is held liable in an important case, the cost to him may easily equal the savings of his whole professional career.

I believe in the case of most accountants—certainly it is true in that of my own firm—the amount of fees received from work connected with new financing is a relatively small percentage of their total annual fees. Why should they jeopardize not only the earnings from their entire business, but their savings, in order to undertake work which brings in perhaps five or ten per cent. of their total income?

Every reputable accountant should be perfectly willing to assume a reasonable liability in respect of injury which can be shown to be attributable to acts or default on his part, and no one

would quarrel with the imposition of a liability of a punitive character in cases of fraud; but only the clearest and most urgent requirements of public policy could justify making accountants or other experts liable for damages which bear no relation either to the injuries they have caused or the compensation they have received. I am convinced that no such requirement exists—on the contrary, I believe that a wise regard for the public interest would rather limit the financial responsibility of professional men for errors of professional judgment. This, incidentally, is the policy embodied in the new legislation on the question of auditors in Germany, (Handelsgesetzbuch (Commercial code), 1931) under which the liability of the accountant can not exceed a fixed sum, unless fraud is shown.

It is not easy to see upon what theory of law the provision of the act is based. Clearly, it is not founded in the ordinary law of negligence; nor can it be brought within the doctrine of rescission. It seems to me to be justifiable only on the theory that any issue of securities in connection with which a material misstatement is found to exist is a conspiracy, even though the misstatement is due to oversight or even honest error. There is nothing in the history of accounting in recent years to warrant such an attitude towards the profession or that provision which puts on the accountant the burden of proving his innocence whenever a disgruntled purchaser of securities or striker makes charges against him.

In my judgment, it is always wise to use restraint in imposing financial liabilities upon professional men for errors of professional judgment. Such errors, particularly where they become publicly known, result in serious injury to the professional reputation of the persons making them, and it is quite unnecessary to add a personal liability in order to impress the professional man with the necessity of care and thoroughness in forming his professional judgments. The effect of imposing a pecuniary liability out of all proportion to the compensation paid for the opinion will inevitably be that those best qualified to express opinions will refuse to assume the risks involved in doing so.

In the present instance, the risks are multiplied by the vagueness and uncertainties of the obligations imposed. The act makes the accountant liable if the part of the registration statement for which he is responsible "contained an untrue statement of a material fact or omitted to state a material fact required to be

stated therein or necessary to make the statements therein not misleading, . . ." and, in providing that it shall be a valid defense that the accountant "had reasonable ground to believe and did believe, . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, . . ." it prescribes that the standard of reasonableness "shall be that required of a person occupying a fiduciary relationship."

What explanations are going to be necessary in order to comply with these requirements? Let me take a simple case. The insurance commissioners have on several occasions prescribed valuations for securities which were far in excess of current quoted prices therefor. If one were consulted by someone to whom one had a fiduciary relationship regarding a proposed investment in an insurance company, certainly he would not be content to explain that the securities were valued in accordance with the schedules of the insurance commissioners without pointing out that these valuations were substantially higher than those currently realizable on the market. Suppose, however, that in a balance-sheet forming part of a registration statement securities were taken on the basis of the commissioner's valuations—would it be sufficient to state that fact, or would the accountant be guilty of omission of a material fact if he failed to make any statement regarding the relation between such valuation and the quoted market prices? Again, many public utilities provide for depreciation on bases approved by state commissions, which many accountants regard as quite inadequate. Is the accountant safe if he states on what basis the depreciation provision has been made, without expressing his own convictions regarding the inadequacy of the provision?

In each of these cases it would seem that the accountant must be safe, on the ground that he is entitled to rely on legal authority whether his own judgment coincides with the view of the authorities or not. In many instances, however, the authority for the practice followed will be accepted custom, rather than specific authorization from a governmental body; and what is to be the position when the accountant disagrees with the custom?

Here let me draw attention to a point which perhaps has escaped your attention—that the position of the accountant under

the act differs from that of any other expert. Others may "report" and be liable only for the truth of the statements contained in their report; the accountant is called upon to certify, and is liable for the truth of the statements certified, not merely for the truth of the statements contained in his certificate. Under a strict interpretation of the law, the accountant would seem to be liable if part of a statement covered by his certificate is held to be untrue or misleading, even though he, in his certificate, disclaimed responsibility for that particular part of the statement. It may be said that such an interpretation would be unreasonable; but it is certainly no more unreasonable than the explicit provision that his liability is not to be measured by the injury caused by his act or default. Further, it may be merely the reflection of the not infrequent view that an auditor should give no certificate whatever unless he can vouch for the complete truthfulness of the statement certified.

The fallacious view is quite widely held that the work of the accountant is purely a fact-finding function, and that when his work is completed he is in a position (if it has been properly performed) to make findings of definite and incontrovertible facts. The special committee on coöperation with stock exchanges of the American Institute of Accountants, whose membership has included partners in several of the largest firms in the country, became convinced of the extreme importance of correcting this too common misapprehension, and in a report which it made to the New York stock exchange in September, 1932, it stressed this point as the first on which the stock exchange should concentrate in its effort to bring about more enlightened investment. It began its report with the following statements:

"It (the committee) believes that there are two major tasks to be accomplished—one is to educate the public in regard to the significance of accounts, their value and their unavoidable limitations, and the other is to make the accounts published by corporations more informative and authoritative.

"The nature of a balance-sheet or an income account is quite generally misunderstood, even by writers on financial and accounting subjects. Professor William Z. Ripley has spoken of a balance-sheet as an instantaneous photograph of the condition of a company on a given date. Such language is apt to prove doubly misleading to the average investor—first, because of the implication that the balance-sheet is wholly photographic in nature, whereas it is largely historical; and, secondly, because of the suggestion that it is possible to achieve something approaching

photographic accuracy in a balance-sheet which, in fact, is necessarily the reflection of opinions subject to a (possibly wide) margin of error."

It then proceeded to discuss the problem in some detail; and in concluding the report and making certain recommendations, it offered this comment:

". . . But even when all has been done that can be done, the limitations on the significance of even the best of accounts must be recognized, and the shorter the period covered by them the more pronounced usually are these limitations. Accounts are essentially continuous historical records; and as is true of history in general, correct interpretations and sound forecasts for the future can not be reached upon a hurried survey of temporary conditions, but only by longer retrospect and a careful distinction between permanent tendencies and transitory influences."

I was extremely glad to note that Commissioner Landis, in his address to which I have referred, recognized the point which I have been trying to emphasize, in the following paragraph:

"Much also depends upon the method of expression, for what should appropriately be expressed as inferences or deductions from facts, and hence as opinions, are too often expressed as facts themselves and hence for the purposes of legal liability, whether at common law or under the act, become facts. It has been said, and very rightly in my humble opinion, that most of accounting is after all a matter of opinion. But though this may be true, I have still to see the case of a prospective investor being offered a balance-sheet and having it carefully explained to him that this or that item is merely an opinion or deduction from a series of other opinions mixed in with a few acknowledged facts. Accounting, as distinguished from law, has generally been portrayed as an exact science, and its representations have been proffered to the unlearned as representations of fact and not of opinion. If it insists upon such fact representations, it is, of course, fair that it should be burdened with the responsibility attendant upon such a portrayal of its results."

I have read the entire paragraph because it seems to me to have a double importance. In the first place, it indicates an appreciation on the part of a member of the commission of the point that accounts are not statements of fact, and such recognition is fundamental to the development of any sound regulations relating to accounts and accountants. In the second place, it emphasizes the danger which accountants run in putting forward as facts what are really expressions of opinion.

That the danger is not exaggerated by the commissioner is apparent from a consideration of the Ultramares case. That case would apparently have been finally decided in favor of the accountants by the court of appeals of New York if the accountants concerned had not stated as a fact that the balance-sheet which they certified was in accord with the books of the company. Doubtless they thought this was a fact, and doubtless it was a fact in the sense in which they meant the language to be interpreted, that the balance-sheet was in accord with the general books. But Chief Justice Cardozo decided that a court might properly regard the language as implying an agreement between the balance-sheet and the books as a whole, and there were books which contradicted the general books. Obviously, upon such an interpretation, whether a balance-sheet agreed with the books must always be in reality a matter of opinion (if for no other reason because no accountant can be sure that he has seen all the books that exist), and obviously even if the statement was made as one of fact, no one was injured by it for no one would lend a nickel on the faith of a statement that a balance-sheet agrees with the books. Nevertheless, such is the mysterious nature of the law, this point was sufficient to result in an order for retrial.

In the last sentence which I quoted from Commissioner Landis, he seemed to imply, although he did not specifically say, that the portrayal of accounts as statements of fact had been made by accountants. I am not sure that this is so. Accountants may be subject to some blame for not having done as much as they might have done to resist the tendency of other people to regard accounts as exact statements of fact, but I think that they themselves have almost invariably put forth their reports as expressions of opinion. Both here and in England, the words "in our opinion" have for years been a standard phrase in accountants' certificates. As long ago as 1913, Dickinson, in his work *Accounting Practice and Procedure* commented on the phrase at length. His comment began with the statement: "Every balance sheet must be largely a matter of opinion," and ended with the sentence:

"So far from weakening the certificate, they (*i.e.*, the words 'in our opinion') may rather be considered as strengthening it, in that they imply that the signer has given his certificate, not with foolhardy assurance, but with a realization of the inherent impossibility of saying, absolutely, that one balance-sheet is correct and any other incorrect." (Arthur Lowes Dickinson, *Accounting Practice and Procedure*, pages 236, 237.)

And while very little testimony was given on behalf of accountants before the committees which considered the securities act, the little which was given included this colloquy between the members of the senate committee on banking and currency and Colonel A. H. Carter, who was, I believe, the only accounting witness:

"Mr. Carter. I mean that that statement itself should have been the subject of an examination and audit by an independent accountant.

"Senator Gore. Before filing?

"Mr. Carter. Before filing.

"Senator Gore. Is that patterned after the English system?

"Mr. Carter. Yes, sir.

"Senator Reynolds. Together with an opinion.

"Mr. Carter. That is all they can give; that is all they can give. That is all anyone can give as to a balance-sheet.

"Senator Wagner. Well, basically, are not these facts that have got to be alleged rather than an opinion?

"Mr. Carter. Under the terms of the bill it has to be given under oath. I do not see that anyone can certify under oath that a balance-sheet giving many millions of dollars of assets is as a matter of fact correct. He can state his opinion based upon a thorough investigation."

But whatever they have been represented or supposed to be, accounts are not mere statements of fact, but represent the application to facts of judgment and accounting principles. Truth in accounts is not, therefore, a simple matter of correspondence between fact and statement—accounts are true if they result from the application of honest judgment and reasonable accounting principles to the relevant facts. The question that should really be put to the accountant is not whether the balance-sheet is true, but whether it is fair—fair in the accounting principles on which it is based; fair in the way in which those principles are applied to the facts, and fair in the way in which the results are presented. These are matters of opinion.

The act stresses the obligation to state every material fact necessary to make the registration statement not misleading, and among the material facts in relation to any accounts none is more material than the fact that the accounts themselves and the certificate required from the accountant in relation to those accounts are, and must of necessity be, expressions of opinion. Indeed, the act, in speaking of truth in accounts without some such qualification is itself apt to mislead investors, in the same way as was

Professor Ripley's reference to a balance-sheet as an "instantaneous photograph."

At this point, I should like to suggest that section 19 can be used to clarify and modify the provisions of section 11. Clearly, only action by congress can remove the fundamental and, as I feel, insuperable obstacles to the free acceptance of appointments under the act by accountants which have been created by the imposition of a liability bearing no relation either to the injury caused by the accountant or the compensation received by him. If, however, this major difficulty could be removed, the remaining problem could probably be solved by judicious use by the commission of the powers conferred on it under section 19.

Under that section, the commission has power for the purposes of the act to define accounting terms used therein and to prescribe the method to be followed in the preparation of accounts. It seems to me highly desirable that under the provisions of this section the commission should define what constitutes a "true" balance-sheet or a "true" profit-and-loss statement. Such definition would, I think, necessarily follow the general line that I have indicated. Accounts would be held to be true if they represented the application of honest judgment and acceptable methods of accounting to all the relevant facts which were known or ought to have been known to the person preparing or certifying them at the time of preparation or certification. I suggest, also, that the commission should supplement the definition by indicating that accounting principles would be deemed acceptable which are either (a) prescribed or approved by governmental authorities to which the issuer is subject; or (b) sanctioned by common practice, it being recognized that in many instances alternative methods are sanctioned; or (c) are inherently fair and appropriate. It should be emphasized that principles will not be regarded as reasonable unless they are mutually consistent and are consistently applied.

The point may be urged that what must be shown in order to avert liability is not that the balance-sheet or profit-and-loss account as a whole is true, but that the statements of fact contained in it are true. Balance-sheets and profit-and-loss accounts are not, of course, couched in the form of statements of fact; but a description with an amount set opposite it is fairly capable of being judged as a statement of fact. The common heading: "Land, buildings, plant and machinery, at cost," with a figure set

opposite, seems at first blush to be a simple statement of fact; but in practice, what is fairly to be regarded as cost will often be a difficult matter of opinion, and always the question remains whether any and if so what amplification of the heading is necessary to make the statement not misleading.

You may think that I am being technical; but may I remind you that our own accumulated savings may be at stake in this matter, and also that the highest court of Massachusetts held not many years ago that a statement was false and that its falsity gave rise to liability on the part of those signing it, on the sole ground that a reserve for depreciation had been shown under the heading "reserves" on one side of the balance-sheet instead of being deducted from the assets on the other. It was only after this decision that the law of Massachusetts was amended by the insertion of this proviso: ". . . provided, that if a report of condition as a whole states the condition of the corporation with substantial accuracy, in accordance with usual methods of keeping accounts, it shall not be deemed to be false."

I am convinced that to make the act practicable in its working it is essential that some general ruling as to what constitutes truth in accounts along the lines I have suggested shall be put forward by the commission. As I have indicated, such a statement would serve the double purpose—first, of tending to prevent the investing public from attaching undue significance to accounts; and, secondly, of preventing accountants from being harassed or penalized through unduly technical interpretations of the provisions of the law.

I would not have you think that in this discussion I have exhausted the points in the act which are of interest and importance to the profession. I should have liked to discuss at length the provision by which the burden of proof is thrown upon the defendant; the opportunities that the act offers to blackmailers; the absence of any provision by which those unwarrantably attacked can recover the costs of their defense; and other features which seem to me to require amendment if a just balance is to be struck. However, you will find them fully discussed elsewhere.

In conclusion, I desire to say that I am in full sympathy with the general purposes of the act, and that the criticisms which I have offered of some of its provisions are not merely inspired by a narrow self-interest but rest upon the profound conviction, which I expressed at the beginning of this address, that unduly drastic

measures defeat their own purpose and are not in the ultimate interest of those whom it is sought to protect. I should be extremely sorry if the effect of the securities act should be to place the distribution of securities and all the work attendant on such distribution in the least responsible hands.

I think, also, that we, as accountants, owe a duty to small investors in any discussion of the act to point out that the ordinary vicissitudes of business make commercial securities necessarily hazardous and unsuitable for the investment of small savings, and that even if a securities act diminishes the hazards in some respects, it can not change their essential character. A realistic view would recognize the necessity for some governmentally fostered system for the safe investment of small savings; a broad market, subject to requirements for frank disclosure with penalties not unduly drastic attaching thereto, for what may be termed "business investments"; and some medium, entirely divorced from the idea of investment, for the gratification of the seemingly ineradicable instinct for gambling.

Problems of Interstate Practice *

By Will-A. Clader

An inspector of licences arrested a man for poaching on posted preserves. The man arrested is a certified public accountant in the state of his residence, a member of the American Institute of Accountants and of the society of certified public accountants of his state, hence undoubtedly a qualified and reputable accountant. Why was he arrested? Because he was auditing the accounts of a client of four or five years' standing in a state whose accountancy law provides that the practice of public accountancy, as defined in the act, without a certificate of registration is a misdemeanor. The alleged culprit was not certified in that state. Only a river separated the city in which he was performing the engagement from the city in which was his office. But that river was a state boundary. The law of the state in which the engagement was being conducted says that nothing contained in it shall be considered as prohibiting certified public accountants or public accountants of other states from practising in the state in pursuance of any engagement originating from without the state.

This incident, and others to which I shall refer, came to my attention, together with much of the information and factual material used in this address, as chairman of the committee on state legislation of the American Institute of Accountants. However, my observations are entirely my own views and are not to be considered those of the committee, nor have they been passed upon by the Institute.

Let these specific cases not cause offense to any one here tonight. I state only the record.

In Arizona, Florida, Iowa, Tennessee, North Carolina and Virginia an accountant from another state who enters the state to perform an engagement which originated from without the state must register in the state in which the engagement is to be conducted. A registration fee is exacted in a few of these states.

In Florida, Iowa, Illinois and Virginia the non-resident accountant applying for registration must be a certified public accountant of the state of his domicile or place of business.

* An address delivered at a meeting of representatives of the state boards of examiners, held in conjunction with the annual meeting of the American Institute of Accountants at New Orleans, Louisiana, Oct. 16, 1933.

In Florida the accountant may fulfill only one specific engagement under a temporary certificate, valid for ninety days.

In the Illinois accountancy act of 1903, as amended in 1907, is a provision that the law shall not prevent a certified public accountant, who is the lawful holder of a certificate issued in compliance with the laws of another state, from practising as such within Illinois and styling himself a certified public accountant. The 1927 accountancy law of Illinois provides that nothing contained in the act shall be construed or taken as repealing or as in any way affecting in whole or in part the provisions of the 1903 act, as amended. The 1927 law provides further that nothing contained in it shall be considered as prohibiting certified public accountants or public accountants of other states from practising in Illinois in pursuance of any engagement originating without the state.

In response to an inquiry about the apparent conflict of the two laws, the committee on public accountants of the department of registration and education advised me as follows:

"The position of the department has always been that the 1903 law has no effect on the *right to practise* but merely on the use of a title, or, in other words, on the *right to practise as a C. P. A.* However, the 1927 law for the first time imposed certain restrictions on the *right to practise*, whether as a C. P. A. or otherwise. Therefore, in considering the *right to practise*, the 1927 law must be recognized; but, after that right shall have been established under the 1927 law, the further question as to how it shall be exercised—whether *as a C. P. A.* or otherwise, must be settled in the light of the 1903 law. As to foreign state C. P. A.'s, section 6 of the 1903 law does not grant a right, but merely specifically refrains from interfering with one already existing—namely, to practise *as a C. P. A.*, not *to practise*, since the 1903 law had no effect on such latter right. The question has been up many times, and the position set forth above is well settled so far as the department is concerned." (Words in italic are underscored in the original letter.)

The aforementioned committee also answered an inquiry as to what constitutes an engagement originating from without Illinois as follows:

"Although there has been no official ruling on the subject, it has always been the belief of the present members of the committee that an engagement 'originates' where the contract therefor is closed.

"Thus if an accountant having an office in St. Louis, Missouri, calls on a prospective client in East St. Louis, Illinois, and there makes a proposal which the client accepts, the engagement origi-

nates in Illinois. But if no contract is made at the time, and, therefore, the client writes the accountant offering him the engagement on certain conditions as to rates, etc., and the accountant from his office in St. Louis, writes a letter accepting the engagement, then the engagement has originated in Missouri because a contract arose upon the mailing of his letter of acceptance."

The Mississippi board has ruled that if a certified public accountant of another state conducts an examination of accounts and records in Mississippi as a part of an engagement originating outside the state for a non-resident client, it is permissible under the law; but that if the accounts and records examined are those of a firm or corporation domiciled or doing business in Mississippi, and the accountant is compensated by that firm or corporation, no matter where the engagement may have originated, the client is a Mississippi client and the accountant must qualify in that state.

The board has ruled that no public accountant, either resident or non-resident, who did not qualify on or before February 1, 1931, may do so now, and he is therefore prohibited from practice in Mississippi. This seems effectually to bar all non-resident public accountants, who had not registered, from performing engagements in that state.

The law in Louisiana is silent as to engagements by accountants from without the state. According to the language of the statute the board could require a non-resident accountant to register before he commenced an isolated engagement that originated from without the state. I understand that this is not generally demanded. The policy of the authorities in Louisiana is generally regarded as liberal and reasonable.

An accountant from without the state of Louisiana who is called on by a citizen of that state to perform accountancy work should be mindful of a court decision in Louisiana. A certified public accountant of Texas sued a client in a Louisiana court for compensation for services rendered under written and oral contracts. The defendant based its defense partly on the accountancy law of Louisiana which prohibits practice in that state as a certified public accountant by one who is not registered as a certified public accountant by the Louisiana state board of accountancy. The court considered it proved that the accountant had practised in Louisiana as a certified public accountant in violation of the Louisiana law. The contract in question, therefore, was unenforceable.

While applicants for recognition in Michigan must be residents of the state or have an office there, certified public accountants of other states are permitted to use their title while temporarily in Michigan on professional business incident to their lawful practice in the state of domicile.

I am informed that in a few instances non-certified public accountants near the border line sought to cross into Michigan to perform audit engagements such as a certified public accountant would be entitled to make. When such cases were reported to the board, the accountants were informed that they were not privileged to practise, whereupon they acquiesced in the decision.

In another instance, a certified public accountant came into Michigan on an engagement originating from without the state. While there he attempted to secure another client. He was notified by the board that such action was prohibited by the law. He was told that the board did not recognize the second engagement which he had made as coming within the purview of the law, and if he desired to carry it out the board would proceed against him.

Another case in Michigan is interesting. A firm of certified public accountants went into Michigan to perform an audit engagement which originated from without the state. The audit report was signed by the firm name, as is customary. This was called to the attention of the board. The board decided that while any individual member of the firm might come into Michigan and while the audit report might be made on the firm's stationery, the report must be made in the name of the individual accountant who conducted the audit.

Let us assume that officers of a concern in Detroit know an accountant of another state, and, desiring his services, write him to come there at their expense to see them. He goes. In the office of the concern the matter is discussed and the accountant is informed that he may proceed with the work. If he accepts, will he violate the law? The engagement did not originate from without the state, for the engagement originates where the contract is made and the contract is made where the offer is accepted, say my legal friends. Perhaps the accountant tells his friends to write him a letter to his office offering the engagement. Upon his return home he answers. The engagement therefore now is one that originated from without the state of Michigan and he may be free to proceed.

Another question arises, however. It seems that one of the accountant's partners is especially experienced in the character of the business of the concern in Detroit, so he goes there to conduct the engagement. His name is not included in the firm designation. When the report is completed, he finds that the firm name should not be signed to it. But for certain reasons the client wants the firm's name signed to the report, as is usual. What is the firm of accountants to do? We shall have to let the hypothetical gentleman answer the question himself.

The decision of the supreme court of South Carolina in the case of *James* v. *State board of examiners of public accountants, et al.*, is of interest. The plaintiff applied to the state board of examiners in South Carolina for a recognition certificate as a certified public accountant. He was a certified public accountant of Georgia. The board refused to issue the certificate, mainly for the reason that the plaintiff did not have an office within the state of South Carolina and that this was necessary under the regulations made by the board. It was further asserted that without a C. P. A. certificate of South Carolina the plaintiff was prohibited under the law from performing an engagement in that state as a certified public accountant. The statute of South Carolina does not contain any requirement that a non-resident certified public accountant, properly qualified in all other respects to practise the profession, must maintain an office in South Carolina in order to be eligible for a recognition certificate. The plaintiff petitioned the court for a mandamus to require and compel the board to issue him a certificate. The court said that it found nothing in the law which would justify it in holding that a non-resident certified public accountant, duly qualified in all respects to practise his profession in South Carolina, must actually maintain an office in that state in order to obtain a recognition certificate. The following remarks of the court are significant: "If the statutes had a requirement of that kind therein, it might result in a holding that the enactment contravened the provisions of the constitution of the United States, for the reason that it discriminated against citizens of the United States who happened not to be residents of this state."

The Arizona law approved this year provides that none of its provisions shall be considered as prohibiting an accountant of another state from entering the state in pursuance of any engagement originating from without the state, provided the accountant

registers with the board, giving all facts relevant to the engagement and limits his practice to the subjects covered in the declaration filed. The board requires that fifteen days' notice be given. A lawyer has expressed the opinion that the Arizona accountancy law of 1933 is invalid in so far as it attempts to regulate the doing of business or the engaging in a contract to do business by a public accountant. It will be observed that the clause respecting engagements originating from without the state is similar to the clause in the Illinois accountancy act of 1925, and in the Tennessee law, which were declared to be unconstitutional, although I understand that there was no judicial construction of this particular clause.

Of course, a state whose law restricts the practice of accountancy by its own citizens must provide some means of regulating the practice there of non-residents. However, I have in my possession letters which show unmistakably that many accountants in such states, unfortunately, regard the restrictive law as an excuse for excluding non-resident accountants regardless of their qualifications. In fact, some of these letters indicate that the local accountant desires more to exclude the well qualified accountant from another state than the unqualified one. In a word, many accountants are thinking first of their own protection against competition and, second, if at all, of the protection of the public against unqualified practitioners. Local accountants in these circumstances frequently complain of the quality of work done in their states by non-resident firms, but they do not seem to consider that some client has seen fit to engage such a firm apparently believing that its services will be satisfactory.

When applying for registration in Arizona and Tennessee to undertake a temporary engagement in the state, the accountant is required by the statute to give all facts relevant to the engagement and must limit his practice to the subjects covered in the declaration filed. Hence, in case the accountant stated in his declaration that he was engaged to prepare a registration statement to be filed with the federal trade commission under the securities act, and in the course of work discovers that a defalcation has occurred, the client's desire that the accountant prepare a report to the bonding company probably could not be met, without filing another application and declaration. But I doubt whether the accountant could, under the language of the statute, discuss his contemplated employment for that purpose. If this should

happen in Memphis, the accountant would have to say that he could not accept the engagement in the office of the client, but that if the client would accompany him across the river into Arkansas the arrangements could be made, as the engagement would then originate from without the state. The accountant would then telegraph his office to file another declaration, making sure he did so in Arkansas before recrossing the Mississippi. Suppose the following day the client informed the accountant that he had intended to prepare the 1933 return of capital-stock tax to the federal government, but that, as it required the consideration of many factors that would involve his taxes in the future, he desired the accountant to prepare it. Another trip across the river, another declaration. When the client is not near a state line, I presume the technique would be to have the client telegraph the accountant's office.

In a town on the southern border of Arizona the solution is simple and more pleasant. The accountant and client can walk across into Mexico for dinner with refreshments not yet legally obtainable in Arizona, and thus avoid breaking two laws. The accountant then has a legally acquired engagement and has partaken of legally acquired refreshments, both most enjoyable. The only danger of this procedure is that in the exuberance of the occasion and under the stimulation afforded, the accountant might insist upon performing the service for nothing.

The requirement that a declaration be filed with the board giving the details of the engagement seems to be in direct conflict with the fundamental principle that no accountant should disclose information of which he has become possessed through his relationship with his client, even if a provision regarding privileged communications is not in the accountancy act. I have known of engagements where the client did not want his name divulged, and the company to be examined did not want the fact known that the accounts were being examined.

If the engagement is in Iowa, it must be one incident to the professional practice of the certified public accountant in the state of his domicile, and he must file with the state board of accountancy and with the auditor of the state, at least five days before commencing work for the client, the written appointment of a registered practitioner of Iowa to act as agent, upon whom legal service may be made in all matters which may arise from such temporary engagement. Is the requirement in Iowa that an

agent be appointed a necessary protection, especially when the accountant from without the state is generally employed by non-residents of the state? The five days' advance notice might be an obstructive requirement and an interference with the performance of an engagement which might be urgent.

It is interesting also to find that the Iowa law requires that every person having been granted a certificate to practise accountancy shall give a bond for five thousand dollars to the auditor of state, before entering upon the discharge of his duties, for the faithful performance of them. The requirement of a bond does not appear complimentary to the standing of professional practitioners of accountancy. It seems to me that certified public accountants as a class should consider themselves sufficiently trustworthy to make it unnecessary voluntarily to bond themselves. The public at large might feel that the accountants thought themselves under suspicion and were trying to offer reassurance by such a requirement. I mention this matter of the bond requirement because probably it could be imposed on the non-resident accountants in the state on a temporary engagement.

Let us consider a concrete case of which I know. An accountant with offices in Pennsylvania was engaged in New York by clients there to make examinations of companies in four different states west of the Mississippi river which were involved in a contract with a New York corporation to buy from it certain properties, one of which was in Iowa. There was no time for registering as required in Iowa five days before commencing the engagement; neither did the owners of the property in Iowa, a Delaware corporation, want it made public information that an examination was being made for purpose of sale. In such an instance the requirement of the Iowa law acted as an interference with legitimate business. No citizen of the state of Iowa had any interest whatever in the transaction.

In one of the proposed amendments to the blue-sky laws of Indiana, a requirement was included that auditors eligible to act under the law must be certified public accountants qualified to practise as such under the C.P.A. law of that state and maintaining offices in Indiana. Such a law would have worked great injustice upon foreign corporations retaining competent certified public accountants of states other than the one in question as well as a great injustice upon those accountants.

In criticizing an accountancy law there is danger, which I am anxious to avoid, of offending friends in the state. Perhaps that is why accountancy laws have not often been publicly dissected and criticized. The accountants in a state generally think highly of their accountancy law. I have had occasion to write to many accountants lately in each state in the union. I have come to the conclusion from the letters I received that the best accountancy law of our country is of 53 varieties.

What is the compensation for the requirement that certified public accountants from other states must register if they are to perform an engagement in a restrictive state which originated from without that state? No matter how judiciously the requirement is administered, a hardship exists. It must be recognized that business does not go to the trouble and the added expense of bringing in an accountant from another state unless it very definitely wants the services of that accountant. There are occasions when state governments refuse to engage resident accountants to perform certain engagements, in order to avoid accusations that the auditors have political preferences, which might affect the examination or be used by the opposition to attack the report.

A few weeks ago I was in a city where resides an accountant who is an energetic advocate of preventing accountants of other states from entering his state to perform accountancy engagements. I called at his office and found on the door a note indicating that he was in a town outside the state on professional business. It was evident that he had no compunctions about entering other states to perform accountancy engagements.

The business structure of today calls for interstate practice of public accountancy. Business will see that its demands are met. It has no concern in the self-interest of any one practitioner or group of practitioners. To paraphrase an old saying, you must make public accountancy meet the demands of business, not business meet public accountancy. The latter otherwise will fall of its own weight. It seems to me that restriction or obstruction of interstate practice of accountancy is a manifestation of a fundamental lack of economic adjustment. It may be considered by business as a form of extortion, a means adopted by a class, by the threat of coercion, to compel an unwilling business to employ an accountant whom it may not want.

The trend of the times can not be ignored. The national industrial recovery act is an indication of the tendency to minimize state lines in federal regulation of business, and that act will doubtless increase the volume of accountancy practice of an interstate character. The securities act contains a provision that an accountant is liable for an untrue statement of a material fact or omission to state a material fact necessary in order to make the statements not misleading. This liability in itself makes it necessary for one accounting organization to perform the engagement even though the companies to be audited are scattered in a number of states. No accountant will assume legal liability for work performed by another organization, which would be necessary if interstate practice in such instances were prevented, no matter how much confidence he may have in his fellow practitioners.

Interference with interstate practice in Oklahoma was destroyed by the court decision which declared the restrictive law in that state to be unconstitutional. The court concluded that the business of public accountancy was not such in its nature, and was not so related to the general welfare and good of the state, as to require regulation by the police power of the state and held that the Oklahoma regulatory act, so far as it prohibited uncertified accountants from holding themselves out as professional accountants for compensation, or engaging in the practice of that profession, is in conflict with the spirit and express provision of the constitution and void, in this, that it abridges the right of private property and infringes upon the right of contract in matters of purely private concern, bearing no perceptible relation to the general or public welfare, and thereby tends to create a monopoly in the profession of accountancy for the benefit of certified public accountants and denies to uncertified accountants the equal protection of the laws and the enjoyment of the gains of their own industry.

A search of the reported cases on the legality of state accountancy acts so worded as to require a licence as a condition precedent to the performance by an accountant of accountancy engagements for the public shows that the courts have held such acts to contravene the constitution of the several states. Such cases are: *Fraser* v. *Shelton*, 150 N. E. (Ill. 1926) 696; *Short* v. *Reidell*, 233 PAC (Okla. 1924) 684; *Lehmann* v. *State Board of Public Accountancy*, 94 So. (Ala. 1922) 94; *People* v. *Marlowe*, 203 N. Y. Supp. (1923) 474; *Henry* v. *State*, 260 S. W. (Texas 1924) 190.

If, therefore, care is taken by the accountant to do nothing which could be construed as practising or holding himself out as a "certified public accountant" in the states referred to, there is doubt whether in such states a penalty could constitutionally be imposed for failing to obtain a licence to practise. However, there has been in recent years a considerable growth in the demand for audits of municipalities, banks, building and loan associations and business corporations, under the provisions of state laws and the rulings of regulatory bodies, requiring that the audits be made by certified public accountants, and it would appear that the making of such an audit would constitute holding oneself out to be a certified public accountant, regardless of the circumstances of the engagement.

In the Illinois case the court held that it does not seem that the "business" of practising accountancy is so related to the interest of public welfare as to be a matter of such moment as to require the police power of the state to control and regulate it, that there is a wide difference between a law prohibiting the use of a term indicating that a person has been examined and certified as an accountant when such is not the fact and one which provides that no one who has not received a certificate as public accountant shall be allowed to practise public accountancy.

In the same case the court said that a statute could prohibit the use of the words "certified public accountant" or "public accountant" unless the statutory requirement was met. But to prohibit one who is not registered to practise public accountancy is an act that does not spring from a demand for the protection of the public welfare but is an unwarranted regulation of private business and of the right of the citizen to pursue the ordinary occupations of life.

The supreme court of Tennessee said that legislative prohibition of the right to practise accountancy, except after qualifying in the manner required by the statute, has been declared void as an arbitrary and unreasonable exercise of the police power of the state, by the courts of two states, Oklahoma and Illinois, with no cases ruling the contrary to be found. The court said further, "the decree, which the pleadings and conclusions reached in this cause authorize, is only that the provisions of said section 7095 (section 7 of the act of 1925) are ineffective to bar the complainant from the practice of accounting, without obtaining certificate and licence from the defendants, constituting the state board of ac-

countancy." The clause in section 7 which requires that accountants from other states register and file a declaration of the details of the engagement is, therefore, no longer enforced by the board.

The Tennessee decision emphasized that "restriction is designed for the protection of accountants certified and licensed, and not for the protection of the public in general."

I believe that the decision of the supreme court of the United States on March 21, 1932, in what is generally known as the Oklahoma ice case, in which the question of the extent to which business is charged with a public interest is deeply involved, will govern our problems if they reach that court.

It is plain that unless the supreme court takes ground much farther advanced than in the past in determining what operations are charged with a public interest, the interference with interstate accountancy practice by legislation is in a decidedly shaky position. The court said that nothing is more clearly settled than that it is beyond the power of a state "under the guise of protecting the public, arbitrarily to interfere with private business or prohibit lawful occupations or impose unreasonable and unnecessary restrictions upon them."

I am in sympathy with the statements made by Robert H. Montgomery in his address before the international congress of accountants in 1926, to the effect that accountancy legislation theretofore enacted had been based too largely upon the theory of protection to the public accountant. Even though that may not now be literally true, there is no doubt in my mind that it is the opinion of most of the legislators called upon to consider accountancy legislation and of the public generally. I believe Mr. Montgomery is correct in his statement that there is no urgent demand for protection coming from the business public. If the need for such protection does in fact exist, the business man apparently fails to recognize it.

I have always maintained, and I repeat it here, that the best protection of the accountant and perhaps the only effective one will be found in the character of the work which he does and the reputation which he is able to build up. The profession will rise in the public's estimation in direct ratio to the worth of the duties performed and the dignity with which it performs them, and the accountant who builds up a reputation for good work and proper professional conduct will not need to shut out accountants from

other states by law in order to obtain engagements in his own state. Restricting accountancy practice to the accountants who are actually resident in any one state is not necessarily in the public interest and, therefore, not to the advantage of the profession which it is supposed to assist. This, of course, is on the theory that what is opposed to the interest of the whole is opposed to the interest of the part.

California, New York, Pennsylvania and a number of other commercially important states have found no need in the public interest to require accountants from other states to register when undertaking a temporary engagement in the state, even if the engagement originated within the state. Progress in the accountancy profession under the present laws has not ceased but rather is continuing at an accelerating rate. It is not claimed that conditions in these states are perfect. There is very little in the universe that is perfect, unless we turn to the celestial realm, where, we like to believe, restrictions against entry are not too severe.

The American Institute of Accountants has definitely voiced its opinion in favor of free passage by accountants across state lines in pursuance of professional engagements. It addressed the state boards of accountancy and the state societies of certified public accountants on the question of interstate relationships affecting accountancy practice. It said that accountancy, unlike some other professions, is national rather than local in character; that it is desirable that the entire American business public recognize certified public accountants as accredited members of a unified profession, regardless of the part of the country where they happen to practise. It voiced the belief that nation-wide acceptance of certified public accountants as qualified professional practitioners should be the ideal of the profession as a whole. A few quotations from the pamphlet on "Interstate relationships in accountancy" sent to the state boards of accountancy seem appropriate:

"The Institute feels strongly that any tendency to limit the good standing and the privileges of a certified public accountant to the state in which his certificate was issued will retard the growth of the accountancy profession and handicap every accredited practitioner.

"Almost every public accountant must at some time cross state lines in pursuance of his practice, and it is to the best interests of the profession that he be permitted to do so with freedom and

without prejudice to his professional standing. Accountants in cities near state borders frequently experience difficulties when their practices spread into neighboring states, and most practitioners, wherever they may be, would benefit by solution of the same problems.

"In some states there is a tendency toward narrowing technical requirements to meet purely local conditions and erecting statutory barriers to the practice of outsiders, which, incidentally, sometimes also tend to confine local practitioners within their own borders by evoking retaliatory measures in other states."

I wish I had remembered that excellent pamphlet before I accepted the invitation to come to New Orleans to address you tonight on this subject, as it so concisely states what I want to say.

In a mail ballot an overwhelming majority of the members of the Institute advocated free passage across state borders and complete freedom in crossing state lines in pursuit of temporary engagements originating without the state. The record shows that the Institute is definitely committed to a policy of liberality in such circumstances.

The Institute has also advocated broad provisions for recognition of certificates of other states. At a meeting of representatives of state accountancy boards at Colorado Springs in October, 1930, the following resolution was unanimously adopted relative to the subject of interstate relationships in accountancy:

"*Resolved*, That the representatives of state accountancy boards here assembled express approval of the general principle that recognition of C. P. A. certificates of other states should be granted as freely as is compatible with maintenance of proper standards, and be it further

"*Resolved*, That copies of the memorandum presented at this meeting be sent all state and territorial boards of accountancy of the United States, and that the American Institute of Accountants be requested to ask each board for suggestions as to how the principle of recognition of C. P. A. certificates may be extended."

Accountants must consider public opinion of the motives actuating proponents of restriction requirements. It may be believed that, though screened behind the "public interest," apparently unreasonable requirements must be based on a desire for protection amounting almost to monopoly.

I feel sure that broad and generous provisions with regard to accountancy outside the state will in the long run benefit the profession everywhere. Fences erected around state borders may provoke retaliatory measures in other states and, if such a tend-

ency should become widespread, a substantial portion of the important work of the profession would be badly crippled. Accountancy practice is often necessarily of an interstate character and I do not believe competent practitioners should be harassed by technical restrictions merely because their work calls them from the state of their residence.

This is not of interest to the large firms only. It is of equal importance to innumerable small firms and individual practitioners. I know of an accountant whose services are sought by universities throughout the country, another by insurance companies in many states and another by public utilities whose engagements take him into a majority of the states in the union.

Assume, as an illustration of an absurdity that will never be perpetrated, that the certified public accountants of the District of Columbia should have a law enacted similar to those I have discussed. The public accountants of the country other than those in the district would not be permitted without inconvenience to represent their clients before the bureau of internal revenue in Washington. You may say that that is grotesque and silly. It is not essentially more absurd than the incident I cited at the beginning of my remarks or other attempts to impede the practice of accountancy not affected by a local interest.

I am the holder of a certified-public-accountant certificate of Delaware, the home of thousands of corporations, of which undoubtedly there are accounting offices in almost every state in the union. It would seem quite advantageous to me if the Delaware legislature passed a law requiring all Delaware corporations to be audited by certified public accountants of that state—but it would not help the profession.

As we are a federation of states, instead of a single political unit, there are legal obstacles to granting a national certificate on the English plan. In Canada each province holds its independent examination for accountants. The Canadian chartered accountant may, however, conduct his practice as such in any province throughout the dominion. It is necessary for us to achieve the same results without violating the constitution or the rights of the states.

The theory that the degree should be safeguarded but that the practice of accountancy should be unrestricted has been followed in the British Isles since the formation of the first Scottish institute. A special committee of the British board of trade re-

ported that "the committee has come to the conclusion that it is not desirable to restrict the practice of the profession of accountancy to persons whose names would be inscribed in a register established by law."

In more than one state accountants in the past have not only failed to work out problems together but have aggravated them by working at cross purposes. In a very real sense we have no state lines at all. Commerce passes freely from state to state. Railroad trains never, and automobiles rarely, are stopped at the border. It is this practical harmony which has made us a great nation. Talk is always cheap and one section often complains of another. But the economic bonds which tie all parts of the country together are numerous and very powerful. If the accountants of the various states are to keep their place in the scheme of things, they must learn to discard isolationist, separatist methods better suited to stage-coach days than to those in which we live.

If a certified public accountant of another state comes within a certain state and performs an engagement in a manner injurious to the citizens of the state, or acts in a manner discreditable to the profession, the state board can report the matter to the board of the state in which the man is certified, to the end that his certificate may be revoked. Such a procedure would give reality to the claim of protecting the public; it would assist in the development and control of the profession, and it would increase the safety of business in the United States far more than technical restrictions would do.

Like all attempts to lay down laws for human conduct, more depends on the administration of an accountancy law than on its provisions. The administration of many of the laws has been in the hands of able, honest and unselfish men of broad vision. An important need, however, in the administration of the accountancy laws of all the states is the whole-hearted support and coöperation of the entire profession. This can be attained only by the avoidance of impediments against men recognized in their states of domicile as competent and reputable.

Of course, general equivalence of standards is the fundamental prerequisite for a really broad system of coöperation between the states, and it seems that if the question is ever to be settled an effort should be made to establish parity of state standards. That is a matter for the serious consideration of members of the

state boards of accountancy of the United States. Their task is to agree among themselves on uniform requirements as to preliminary education, professional practice, etc., which, when established, will permit all states to reciprocate freely with each other.

You will not find, I think, that the members of the profession are working according to a comprehensive and definite plan. You will not find that there exists a clearly formulated policy embracing and coördinating the many different matters with which the accountancy profession is concerned. There is no universal creed, which every one believes who has responsibility in public accountancy. Not only in the details of administration of the state accountancy laws, but in the decisions of policy as well, circumstances and personality, individual force and eccentricity, factionalism and favoritism, accident and improvisation, rather than logic and theory and formulæ, are often the deciding elements.

It seems to me that some men in the profession are striving to level it to place all certified public accountants upon a common plane. In these days anything is possible, but it is quite inappropriate that such activities should arise in a profession. In one sense all men are equal, but all accountants do not possess the same degree of skill. Legislation prescribes a minimum only, and it is inevitable that business shall exercise its privileges of selection.

With conditions as they are, it is a wholesome sign that conferences of state boards of examiners are held, that an interstate assembly of such men convenes yearly at the Institute's annual meeting. These meetings are all informal and unofficial. But such meetings can not fail to render more intelligent the work of the separate boards. The meeting of minds from many states on common problems is sure to aid in solving those problems, not in any narrow, local way, but for the benefit of all.

When a state requires registration by its own citizens, it is proper, of course, to consider whether it is unreasonable or not to require it of non-resident accountants called in to the state on temporary engagements. It is a hard question to answer to the satisfaction of all parties.

The future depends largely on the wisdom of accountants themselves. The menace consists of thoughtlessness, haste and intolerance. Considering the importance which the accountancy profession has assumed in the country's business affairs, the

greatest possible good judgment, poise and tolerance are necessary. It is a large question and it goes deep.

Accountants are intensely concerned with their own affairs, and many an accountant feels that his own state can settle its own problems. I urge more coöperation among the states. If a number of them would frequently exercise their powers jointly on the common problems, the profession would be better served.

Clear doctrine and rigid purposes that apply to a whole profession have to be paid for; their price is the suppression of individuality and the compromise of opinion. A community of men, who proceed by argument to leadership and consent, necessarily work out their policies as they go along. Events rather than theories, experience rather than doctrine, supply the reasons by which men are brought into line. The knowledge to do this or that particular thing may be lacking. We can not be certain that we shall choose the best of all possible policies.

I have no doubt that on the question of interstate practice the right decision for the state groups of accountants to take in their own interests is the right decision from the point of view of the profession in general. It is not a matter of state rights or whether or not to be nationalistic. It is a matter of reaching a wise decision on a question of great moment.

I know that this address has been too long. I know, too, that I have probably been too vehement in expressing what is, after all, only my own personal opinion. Men as able as I, and of whose sincerity I have no question, hold to the opposite view. I have recited a number of instances, actual and hypothetical, which seem to me to prove that restriction of interstate practice often leads to harmful and ridiculous results. I have tried to prove to your satisfaction, as I had already done to my own, that the interests of the business public are not well served by state barriers and that accountancy can not flourish if it does not follow in the course of business. I have suggested that restriction of interstate practice may not be upheld by the courts. I have recommended changes in state accountancy laws which will bring uniformity of standards and full coöperation and mutual recognition among the states.

As a profession we can not limp along, one short leg, one long. If states persist in closing the barrier to outsiders, others may be forced to do likewise in self-defense. Believe me, please, if that happens, we shall throttle our growing opportunities. We shall

renounce our ambition to become the accredited advisors to the nation in its financial affairs. We shall relegate ourselves to the obscure position of myopic clerks, struggling with our immediate neighbors for crumbs—for auditing work which is purely local in origin and purely local in effect. Bankers, credit men, stock exchanges, investment bankers, the federal government will pass us by. They will have to do so, because as certified public accountants we shall not be wholly free to do the work they require under conditions which circumstances may demand.

At this time, when the door to our opportunity is open wider than it has ever been before, I can not believe that we shall turn away from it. Enlightened selfishness fairly shouts at us, "Let liberality be your watchword."

Accountants and the Recovery Act*

By C. Oliver Wellington

The national industrial recovery act and its administration have a three-fold interest to professional accountants. First, as citizens we must follow closely any movement which so greatly affects business and the welfare of the nation; second, in our professional capacities we shall be called upon to help trade associations in developing uniform cost-accounting systems and in "policing" under the codes and trade-practice agreements; and, third, our advice will be sought by clients as to what they should do for their own best interests in reference to various activities and proposals under the act.

Recently, some one who was rather disgusted with the situation, stated that the initials N. R. A. stood for "Nuts Running America." While many of us are far from satisfied with the act, and particularly some features of the administration of the act, I believe a better meaning to us of the initials N. R. A. is "New Responsibilities for Accountants."

It will perhaps help to a clearer understanding of the present situation if we review briefly some of the events leading up to the passage of the recovery act. It was undoubtedly the intention of the administration and congress to improve the rather serious business and social condition of this country. Any discussion as to causes of the depression reminds me of the tale of the three men who were arguing as to which profession was the oldest. The doctor mentioned the story of a rib having been taken from Adam and turned into a woman, Eve, and asserted that this operation was the earliest example of professional work. The engineer, however, pointed out that the Good Book referred to the world having been made in six days out of chaos, and that this, the most wonderful engineering feat ever recorded, proved that the engineering profession was the oldest. But the banker settled the argument by merely asking the question, "Who created chaos?"

The bankers are blamed for much of the trouble which we have been through, and undoubtedly must share a considerable portion

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of responsibility, but some of it at least must be laid at the door of management engineers and cost accountants. Many of these men, in advising individual manufacturing clients, have pointed out that an increase in volume of production and sales beyond a certain point would very substantially increase the net profit. Many so-called "stop-loss charts" have been devised, showing a point at which the production has absorbed all the overhead or burden cost, and beyond which any production and sales at prices above direct material and labor represented clear profit. With such a chart it was very easy to demonstrate mathematically that the client was well advised to take an increased volume of business at any price greater than direct material and labor, as the regular business had already absorbed the total burden.

This type of argument appeared sound on the surface, but those making the argument and those applying it to actual business failed to reason out the effect of cutting prices to get the increased volume. There often was an immediate gain but in nearly every case it was merely temporary. Competitors who saw an increasing share of business going to the concern which cut prices promptly met the new prices, and usually went one step further, so that the final result was practically the same volume of business being done by all concerns in the industry but all of them selling at a loss instead of a profit.

Unfortunately this idea, that volume in itself is a cure-all, still prevails. The president of one of the large New York banks within a year stated that the farmers needed better prices in order to cure their ills, but that the manufacturers did not need better prices but merely increased volume. The facts coming under my observation, were quite the contrary. Manufacturing prices in general were then so low that an increase in volume would merely increase the total loss, and to save the manufacturing situation there must be a definite improvement in the price level.

Some years ago I was privileged to see a clear illustration of the results of the policy of attempting to get volume irrespective of price. An accounting firm was employed to develop a uniform cost-accounting plan for a group of paper mills, making similar products. One mill out of the group had made a slight profit in the depression year of 1921, when all the other mills showed losses. In response to inquiries to determine the cause, the treasurer said that the mill had four paper machines and, with the dropping off in business at the end of 1920 and the beginning of 1921, the com-

pany saw it would be impossible to get satisfactory business in sufficient volume to run the mill at full capacity. Accordingly, the management of this mill decided that it should become a two machine mill. The people in charge would forget that they had the other two machines. They would work out a careful budget of operating expenses based on running two machines and, computing costs on that basis, would refuse to take any business the price for which did not at least equal the cost.

The result of this policy was that, by considerable sales effort, they were able to obtain sufficient business to run the two machines most of the time, and they ended the year 1921 with a very slight profit. On the other hand, those mills that attempted to run all their paper machines full time all the year lost money, and those that tried the hardest to run full time lost the most money, in some cases running up into millions of dollars.

If all the mills in this industry had looked the situation in the face and refused to make sales below cost, while the carrying charges for unused capacity would undoubtedly have kept the profit near a minimum, there would have been no large losses. The policy they did follow of trying to run full time and pushing on to the market a greater tonnage than could be consumed under the then current business conditions left a heavy inventory hanging over the market, which had to be used up before prices could get back to a reasonably profitable basis. This policy of attempting to run full time not only caused large losses in 1921 but carried the losses forward and reduced the opportunity for profit in the two succeeding years.

Another cause of the bad business situation is the increase in the operation of the larger companies by "hired men," who have little or no ownership in the business. A man who is running a business which he owns is vitally interested in net results, but a man who is merely hired on a salary naturally attempts to make a showing in his particular job. For example, the sales manager properly considers it his job to get sales. If he succeeds and the company still loses a large amount of money, he can always blame the failure to earn net profits on the high costs in the factory.

In addition to the foregoing causes for the bad business situation, the great expansion in plant capacity during the war period caused many manufacturers to break into new markets in the hope of utilizing part of this capacity. This served to unsettle the price situation in industries which otherwise might have con-

tinued to operate at some profit. Improvement in the situation in many trades, which might have been made by coöperative action, was restrained or prevented by fear of action on the part of the government under the Sherman or Clayton acts.

The Sherman anti-trust act, as its name implies, was an attempt to prevent the large trusts from crushing the small individual competitor. It was never intended by congress to restrain business men in a trade from agreeing on reasonable trade practices to stop unfair competition, but unfortunately such ideas have been read into it by court decisions. The Clayton act, of a much later date, prohibits various means of restraining competition. The tendency of both these acts and decisions under them has been to prevent business men from joining together to improve trade conditions in their industry.

In considering the national industrial recovery act, it is very important to bear in mind that this is a political law. While it is true that all laws are political, this one is especially so. Moreover, it is an attempt to serve two purposes in one act.

The country was faced with a large number of men out of work and very low rates of wages being paid to those who were at work in many industries; and it seemed essential, if we were to live through this coming winter without serious social disturbances, to develop a plan for unemployment relief. On the other hand, most businesses had for a year, or two years, been operating at a loss, and business was properly clamoring for some relief or some change in the situation whereby it could, on the average, operate at a profit. The first purpose, unemployment relief, led to the introduction of the Black thirty-hour bill, and the second purpose to agitation for the repeal of the Sherman and Clayton acts, in order to allow business to stop by itself some of the unrestrained competition which these laws not only encouraged but required. The recovery act, therefore, attempts to carry out both purposes: to give unemployment relief through shorter hours and generally higher wages, and on the other hand to give employers the opportunity of combining through trade associations to stop ruthless competition and endeavor to restore each industry to a profitable basis.

The recovery act has gone a long way in the right direction in suspending temporarily the action of the Sherman and Clayton acts, not only allowing business men to develop proper trade practice agreements for a whole industry, but providing, through

the licensing section of the recovery act, for the assistance of the government in enforcing these trade practice agreements. With proper administration, this act can go far in correcting some of the competitive evils that have grown in intensity since the world war.

The way of presenting the movement to the general public, however, can be adversely criticized on account of the fact that the administration has put the cart before the horse—it has attempted to put results ahead of causes. The administration has stressed shorter hours, higher wages and greatly increased costs of production, at the same time requesting business men not to increase selling prices. Considering the fact that most businesses have been operating for two years at substantial losses, we may wonder where the administration expected the business men to find the money with which to pay these increased costs.

The business man who fails to be carried away by "ballyhoo" and insists on keeping his business going, is really rendering the greatest service to the country, as his failure would throw more people out of work. It is not the spectacular addition of employees here and there that improves the whole situation, but a more general and widespread increase of employment which comes only with an improvement in business conditions.

Fundamentally the emphasis must be on profits. No business man will enter into a transaction, buy materials or employ labor unless he believes by so doing he will make a profit. He may be incorrect in his judgment, and the result of the operation may show a loss rather than a profit, but at the outset he hoped for and planned to make a profit. I realize that during temporarily depressed conditions a man may consciously transact business at a loss in order to keep a nucleus of his organization together pending the restoration of more normal conditions, but such an expedient can only be undertaken during a temporary depression and for a comparatively short duration of time.

Granting that the stimulating force for business and an increase of business is the hope of making profits, we see that the way to improve conditions is to help and encourage the making of profits. A manufacturer does not discharge employees on whose labor he makes a profit, but on the contrary will add to his payroll and keep on adding as long as he can make and sell goods at a profit. On the other hand, if he can not sell goods at a profit, he will either discharge workmen or reduce wages, or both, to reduce cost

so that the goods that are made can be sold at a profit. If he can not carry this process, plus a saving in expenses, to the point where he does make a profit, he will eventually have to go out of business, throwing all his employees out of work.

The efforts of the administration, therefore, should be devoted to helping to change trade conditions from a point where transactions result in losses to a point where transactions result in gains, as every gain, no matter how small, builds up a fund out of which further expenditures can be made, further transactions undertaken and more labor employed. We need not worry about excessive profits, as the normal forces of competition will keep these down in practically every instance; and a large share of really excess profits can properly be taken by the government through taxes.

It is perhaps unnecessary for me to point out that the continuation of the capitalistic system is dependent upon the operation of businesses at a profit. We know that any one concern can operate at a loss for only a comparatively short period before it must cease entirely, but perhaps we do not realize fully that the welfare of the nation is affected by the profit or loss of individual concerns. It is only through the accumulation of profits of thousands of businesses, at a very large total of profits in excess of losses, that the nation as a whole can continue. The business man who makes a profit, not only helps himself but helps the nation. On the other hand, the man who makes losses, not only hurts himself but does double damage, as he also makes it more difficult for his competitors to transact business at a profit.

There are three general causes for selling below cost: (1) ignorance of costs, (2) the desire to attract profitable business through the offer of one or more outstanding articles below cost, and (3) an intention to make low prices so as to drive competitors out of business, in the hope of recouping the losses through higher prices after the competitors are gone.

Whichever one of these three causes may be controlling in a certain case, the result is economically bad for the nation. From the standpoint of the good of the whole country, it is much more reasonable to prohibit by law the selling below cost than to restrain so-called "profiteering." High profits in themselves are good for the whole nation rather than bad, and these high profits can very fairly and properly be made the means of raising part of the heavy taxes that are required at the present time and will

undoubtedly be required for the next ten years. The excess-profits taxes, that we formerly had, yielded large sums to the United States treasury up to 1920, and an excess-profits tax at the present time at a much higher rate than 5 per cent. would undoubtedly be popular.

Considering these fundamentals which will prevail as long as we have a capitalistic system and allow any freedom of action to the individual man, we can see that the greatest force for good in the recovery act is the encouragement given trade groups to govern themselves, eliminate unfair and unjust competitive practices, and put the whole industry on a profitable basis. The repeal of the Sherman and Clayton acts would have been of considerable help in this same direction; but the N. R. A. movement, if properly directed, can go further, through its authority to compel all members of an industry to conform to a reasonable code of fair competition. Competition is not eliminated, but it is put on a higher plane, whereby the industry as a whole makes some return on the capital invested. It is this feature of the N. R. A. movement which is most hopeful and valuable, and it is the one that must be emphasized and helped by all intelligent business and professional men.

Another feature of the administration of the recovery act which seems open to considerable opposition, is the handling of the labor situation. Although it is always true that there are increases in strikes when a country begins to recover from a depression, the wave of rather serious strikes which we have seen recently has undoubtedly been stimulated by the false ideas which the recovery administration has spread or at least has allowed to be spread.

While in most cases business men are willing to work in close coöperation with the present heads of organized labor, the history of labor unions in this country and others gives little assurance that, when the unions once have full control, the present leaders will not be deposed in favor of those much more radical, who can be elected to office by promising all kinds of impossible things. Few intelligent executives object to high wages and good working conditions, but they do object to unreasonable operating rules set by the union, which unfairly increase costs.

During recent years the federal trade commission has held numerous trade-practice conferences at which business men have joined together to work out plans for the good as a whole industry, especially in restraining unfair competition through unsound

methods of doing business. There were 52 conferences held by the commission in the period from October, 1928, to January, 1932. Under the laws in force prior to the recovery act, however, neither the federal trade commission nor the trade associations could go very far in correcting a bad price situation. In general, the federal trade commission considered as an unfair trade practice, "the selling of goods below cost with the intent and with the effect of injuring a competitor, or where the effect may be substantially to lessen competition or tend to create a monopoly or unreasonably restrain trade." Selling below cost in itself was not an unfair trade practice but, to make it unfair, a definite intent or effect had to be proven.

Under the recovery act, many of the codes already filed go much further than the federal trade commission practice conferences and make it an unfair trade practice to sell below cost. In stating this general policy, there is a great diversity of ideas and especially of wording. The administration so far has not attempted to establish any standard wording on this subject, but appears to be interested primarily in having each group agree within itself. Some of the code provisions refer to "reasonable cost," others to "cost to the seller," "base price having regard to cost of manufacturing," "current weighted average cost of production," and still others to a "reasonable cost of production and distribution." One code refers to "cost as determined without any subterfuge in accordance with sound accounting practice." Several provide for no sales below cost, several mention a return on the capital invested as one item of cost, and some refer similarly to the use of plant facilities as an item of cost. Some provide for a cost determined on an average basis or an "average weighted cost," and some also provide that no sales shall be made below cost plus a reasonable profit. The attitude of the administration appears to be rather generally opposed to any provision requiring a profit above cost and to any determination of costs on an average basis, but the theory of prohibiting sales below the individual cost of each business unit seems to have substantial support.

With this development of codes and trade practice agreements under the codes it is especially important to know what is cost. There is here a great responsibility and opportunity for accountants to work with individual clients, trade associations and the federal administration to guide along sound lines the thoughts and the wording of any agreement. It seems to me that it is especially

important that any reference to cost must be to a total delivered cost. Any consideration of cost which is limited to "cost at the plant," "manufacturing cost" or some similar phrase will defeat the purposes of the agreements, which are, fundamentally, to put the business as a whole on a profitable basis and to prevent one company from injuring not only itself but the whole industry by selling below its cost. Cost should be the total cost delivered to the customer, and no item of cost or expense should be allowed to be overlooked.

After an agreement is designed to cover total cost, there is still much work to be done. The total cost means little in actual practice unless a company is making merely one product. If, as in the average case, there are several products, it is necessary for the industry to agree upon the best method of allocation of the costs and expenses to the different products made and sold. I can not emphasize too strongly that no one method of allocation can be arbitrarily used to fit all expenses in one company or one industry and, especially, that no general plan can be applied to several industries. It is essential that each trade develop a uniform cost accounting plan which is sound in principle and practical in operation, so that under it cost elements will be handled by each company in the same way, costs can be compared, and "policing" of costs and selling prices can be conducted in a practical manner. It is not necessary nor desirable that any two trades have exactly the same cost-accounting plan, but the way in which costs are built up should be so clearly defined that it will be possible to reconcile the costs of two or more industries, especially those which may compete with each other.

This emphasis on uniform costs obviously does not apply to uniform books, sheets, cards or other records, but only to the classification of accounts, the resulting uniform analyses of expenses and in general to the principles and methods of building up the costs.

It is hardly necessary to point out that determination of cost on a proper basis for an industry will be of great value to that industry in its contacts with labor, the government and the general public. Facts when known give a sound basis for correcting any injustices there may be, and, on the other hand, if a condition is reasonable, it will be proven so by the cost figures.

In helping trade associations to work out uniform cost-accounting plans, there are certain questions of principle on which there

may be some difference of opinion. Shall there, for example, be included in costs, or in the cost calculations, any provision for a return on the capital used or on the plant facilities? Shall the cost as developed be actual cost or shall it be normal cost; and if the latter, shall we use as a normal a fair average of production for the industry or some other basis? Shall there be a separate classification for administrative expenses, or shall such expenses be analyzed and those that are primarily manufacturing be included with manufacturing costs, and those that are primarily selling be included with the selling costs? Shall depreciation be included on the basis of replacement values of the plant assets or on cost of the assets or some combination of the two? Shall depreciation be at uniform rates for all plants in an industry? How shall we reconcile the different practices of different concerns as to handling expenses for repairs, upkeep, etc.?

These questions are not intended to be an exhaustive list of what must be considered. They merely illustrate the kind of questions to be discussed and perhaps demonstrate that the problems of developing a proper uniform cost system for an industry are far from simple.

The attitude of many business men toward the national recovery act and its administration is influenced by the fact that this is emergency legislation. While one may point out that Great Britain has experienced an improvement in business conditions without having anything similar to the recovery act and may feel that today we would be much better off if the act had never been passed, it is nevertheless true that we have gone too far to retrace our steps completely. The emergency phases of the situation will gradually pass, let us hope more quickly than now seems possible, but undoubtedly the idea of restraint on unrestricted competition will continue in some form or another and we shall continue to have greater control over business on the part of the government.

The present administration has again and again stated that many things done are frankly experimental and will be changed if they do not work, so it is obviously the part of wisdom for business men, instead of sitting on the sidelines and watching developments and criticizing lack of results, to take an active part in the movement and to influence it in the right direction. It seems to me that the recovery act gives business men a wonderful opportunity to do what they have hoped to do or endeavored to do over

the last ten or twenty years, namely, exercise some control over competitive conditions in their own industry. It is now possible for each trade to govern itself in a sensible way.

Unless a trade succeeds in governing itself, the administration will be forced to step in and exercise more direct control. There is nothing in the history of government control of railroads in this country or in government control of business in any country, which would lead us to look with any satisfaction on such a plan other than as a make-shift to be succeeded as promptly as possible by business control over itself. Therefore, business men are well advised to move—and to move promptly—toward exercise of that proper control through trade associations. I do not know of any activity at the present moment that can more reasonably call upon the time and energy of the principal executives of each business than assistance in building the code and trade practice agreements for their industries. They are not only in that way helping the industry toward an immediate improvement in its financial condition but are also building a sound foundation for the future.

It is not necessary for business men to wait for the acceptance of a code by the administration before putting into effect the trade-practice agreements for the industry. If sound trade-practice agreements are developed and receive the approval of a large majority in the industry, they can by mutual consent be put into effect immediately, with the knowledge that if they are sound they will eventually be approved by the administration and if not they can be amended at a later date. Too many business men are making the mistake of holding off and deferring the benefit they could have now through trade-association activity. They are waiting for the administration to push action on the code and then further push them to do what they should be eager to do for themselves without any pressure from the administration.

We should urge all clients who are not in a trade association to join one, or to form one if there is none already formed, and to work effectively to strengthen the association and make it active and aggressive in the interest of its members. We must emphasize the fact that the government will look after the interests of labor and of consumers, but business men must look after themselves.

Our clients must have in mind that an unreasonable increase in operating costs and resulting selling prices may drive the whole

industry out of competition. We must remember that the government can not control the consumer. He will buy what he desires. If the price of coal is pushed too high, people will heat their houses by oil or by gas. There are very few products for which substitutes can not be found if the price goes too high. It is, therefore, essential that each industry watch its own problems carefully and refuse to be driven into a situation where all or a majority of its members will have to close down, throwing large numbers out of employment.

It is particularly important that our clients be not unduly influenced by the publicity that is sent out from Washington. Catchy phrases of high-priced publicity men can not change sound economic laws. It is only as the profits exceed the losses that the nation can go ahead, and these profits must be profits made by thousands of individual businesses. We need not worry about excessive profits, as immense sums will be required for taxation, and unreasonable profits in any one industry quickly invite increased competition.

Many features of the N. R. A. movement are fundamentally sound and will prevail after the present ballyhoo is ended. Without a doubt greater government control of business is far from a temporary policy. It will probably continue for many years. Realizing this, it is the duty of business and professional men to lend their influence to steer this movement in the right direction and to see that the maximum permanent benefit is obtained, not only for each individual concern and for each trade association but for the country at large.

The Public Accountant and the Investing Public*

By Frederick B. Andrews

In recommending to the congress the legislation which has since become known as the "federal securities act of 1933," President Roosevelt said:

"What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others."

My purpose is to discuss the function of the public accountant in facilitating this trusteeship—to indicate the extent to which he may, and beyond which he may not, reasonably be held responsible to the investing public. The thesis which I present to you is that the public accounting profession has formulated an adequate concept of that responsibility and has faithfully discharged it in the largest measure possible under present conditions, that its work may be facilitated if auditors are made directly responsible to the investing public, and that the investing public must not expect too much of the public accountant, as I believe in some instances it has.

There has been much loose talk during the past few years, and latterly some loose writing, with regard to the reports of certified public accountants on companies which have collapsed. Accountants have been talking among themselves, as engineers do when a levee breaks, architects when a building collapses or lawyers when the criminal statutes conspicuously fail to check a "crime wave." Such talk is not loose; it understands difficulties, and if it recognizes shortcomings, it does so with the serious purpose of seeking a remedy for them which will not entail other evils of perhaps greater magnitude. Emphatically it does not constitute a plea of mea culpa.

It would be futile for us to wish to be shielded from the searchlight of criticism, whether by accountants or by laymen. No part of our system of public financing can hope to escape inquiry after such a debacle as we have witnessed during the past four years. It is only when critics wilfully or ignorantly assign to certified public accountants burdens of responsibility which are

*A paper read to the National Association of Securities Commissioners at Milwaukee, Wisconsin, September, 1933.

not fairly theirs, and overlook or discount positive accomplishments of great value, that I term their pronouncements "loose talk."

The most notable example appeared recently, embellished by a number of cartoons in which a full half of the author's opprobrium is directed at the certified public accountant. No certified public accountant's report could be so replete with half-truths, with misconceptions and with errors of omission.

Although its announced intention is to deal with "this business of the reports and audits of certified public accountants covering companies in which we are asked to invest," and its concluding sentence is "Honest audits are imperative," still, not more than three of its ten sub-captions refer to public accountants, and one of those reads "Don't blame the accountant." And that concluding sentence, "Honest audits are imperative," reminds me of the ship's mate who, smarting under a log-reference to his own insobriety, found opportunity to write on the ship's log: "The captain was sober today"; absolutely true, but absolutely misleading and utterly unfair.

The article deals principally with the methods of the promoters in some of the companies which have so spectacularly collapsed during "the years of the locust." If the general public understanding of these methods is anywhere near accurate, they should not be condoned. But the attempt to pin on the certified public accountant the blame for losses sustained from these crashes, and from business failures generally, is not only unfair in conception but inept in execution.

In one of these cases, the article says, "the reports of certified public accountants fooled everyone." I submit that this is a very loose statement. Let us admit that many people were fooled. It does not follow that this includes every reader of the reports mentioned. We have no way of knowing how many people were kept out of that enterprise because their intelligent reading of these very reports warned them away.

It is also complained that the reports "showed that the company had a surplus of $365,000 when its books failed to show a debt of eight million dollars." What was the character of this debt? And what effect would it have had on the surplus if shown? These are questions which are not answered. Neither does the article indicate how or whether the public accountant could have discovered its existence. These oversights indicate

that the author was not entirely careful in the preparation of his article.

Then there is the story of a plumber who suffered loss because he extended credit in reliance on the simple fact that the balance-sheet showed a surplus. Now, we can not contemplate anyone's heavy loss with equanimity, but to rest an assertion that this victim had been "careful to look at the entire situation before he went into it," and that his loss was attributable to the shortcomings of the certified public accountant, merely on the ground that "his eyes glanced down at the—'surplus account'," betrays an only half-informed realization of the significance of that account. Any experienced credit man wants to know more than the amount of book surplus before granting requested credit.

The simple fact is that swindles have been perpetrated on the public by wildcat financiers. Sometimes they have had the temerity to use in their schemes financial statements audited by certified public accountants. They have been emboldened to do this because some members of the investing public are so gullible as to believe that the mere presence of a certified public accountant's report is a guaranty of the integrity of the enterprise, no matter what may be said in it. It may be that you, by reason of the offices you hold, are particularly interested in this section of the investing public; but the public accountant can do no more than confirm the accuracy of the information given. He can not endow people with the ability to understand what they read.

The article to which I have referred builds up to a suggestion as to what a certified public accountant's report should include, but contains nothing new: in almost every particular its recommendations coincide with the settled opinion of the profession. More than sixteen years ago the American Institute of Accountants, at the request of the federal trade commission, prepared a memorandum of procedure for verifying financial statements which was approved by that commission and by the federal reserve board and subsequently published in pamphlet form with several reprintings and given wide distribution. After ten years the memorandum was revised and it was republished in 1929, again as the result of consideration by the American Institute of Accountants and under the imprint of the federal reserve board. The pamphlet is entitled *Verification of Financial Statements*, and each of you is probably familiar with it. Any report based on an audit conforming to the requirements set forth in that pamphlet

will be all that any investor has the right to ask from a certified public accountant. I shall shortly give a brief summary of these requirements in the hope that you may see what information the profession itself has agreed that the investing public should have.

If we look to the origin of public accounting practice in this country we find foreign capitalists—largely British—sending accountants here to get first-hand information as to what was being done with their money. Perhaps this is why the earliest chartered accountants came from Scotland. But my point is, that the public accountants who verified the accounts of an enterprise were employed by those who furnished the capital for that enterprise. We must come, and we are coming, to that situation in this country, and I submit that the investing public of the United States would be better off today if it had insisted from 1923 to 1930 that American accountants be sent to Sweden, to Germany and to South America for the purpose of seeing what was happening to the vast sums of money lent to those countries and also had insisted that public accountants of their own choosing be permitted to audit the accounts of even domestic enterprises in which they invested. On the domestic side of this assertion, it may be that the investors would have chosen the same accountants who in fact did audit those enterprises, but it would still have been a very different situation.

We must recognize, as President Roosevelt said, that corporate management is a trusteeship. The beneficiaries are the investing public—investors in the stocks and bonds of the enterprises the control of which is committed to the managing trustees. Stockholders and bondholders are entitled to have their questions answered, or to be told that specific questions are of such import that public answers would be detrimental to the enterprise, and why. They should not be required to be content with the information which management sees fit to give them, supported only by the auditor's certificate that the information, however meaningless, is correct. The greatest difficulty confronting many investors is that they are inarticulate—they do not know what questions to ask. As a consequence, despite the fact that they may be furnished with financial statements, they remain in ignorance of the affairs of their company, and, if they are so fortunate as to suffer no loss, that fact is due, perhaps to the management which may love integrity for its own sake, perhaps

to other stockholders sufficiently informed and alert to hold management within the paths of rectitude.

Rarely in this country does the public accountant have such a relation to the stockholders as to give him other than a moral duty to them, and it is to his everlasting credit that he recognizes this moral duty so clearly that he is not infrequently required to suffer direct financial loss in the performance of it. Of this the public seldom hears, but since the newspapers mentioned it quite casually it may not be amiss for me to remind you that in a case in Illinois this very thing happened—and it was only after practising public accountants had refused to certify the accounts that the company called on an employee who held a C. P. A. certificate to do the necessary certifying. Such a pretense to independence should not be possible. The federal trade commission, by its regulations issued under the new federal securities act, has refused to recognize the certificate of a certified or public accountant who is employed by or is financially interested in the enterprise whose accounts he certifies; and the American Institute of Accountants has recently gone on record as holding it improper for a member to certify the accounts of a company in which he has a substantial financial interest. It is a short step from this point to the proposition that the public accountant must not owe his selection, and hence his opportunity to earn his fee, to the very management whose accounts are under audit. It is no reflection on the integrity of the public accountant to say that he should not be placed in this embarrassing position. There is no answer to the proposition that the public accountant who is to audit a company's accounts should be chosen by its stockholders; the statement that they are not competent to make this choice begs the question, because even if they do thoughtlessly give their proxies to management the situation is still no worse than at present and merely indicates that they really are not competent to invest their funds in corporate shares. Anyone who is not able and willing to give his investments adequate study and supervision should confine them to government bonds or other issues of similar safety and low return. Yet unless and until we are willing to forbid unlicensed persons to buy stocks and bonds we must regard them as competent to perform the functions of stockholders and bondholders, and we should take such steps as we can to ensure that they be furnished with all proper information to help them in doing so. A year ago I was able to find only one jurisdiction

in this country—Massachusetts—which gave the stockholders a voice in selecting the company auditors; since then Pennsylvania has passed a corporation law which requires the auditor to be selected by stockholders in the absence of specific by-laws to the contrary.

According to the newspapers, the United States Steel Corporation has voluntarily arranged that its auditors shall be elected by the stockholders. I do not believe that this will result in any change, either in the personnel of the auditors or in the manner in which they discharge their duty to the investors. But it does this: it anticipates future emergencies by establishing the auditors as independent advisors of the stockholders, co-equal for that purpose with the management itself. Regardless of how it may affect the present auditors and the present management, it is a most desirable safeguard for the future.

There has been considerable discussion with reference to published accounts, hung on the question "Whose accounts are they?" That is to say, may the auditor revise the statements to conform to his views of how they should be presented in order to make them effective, or must he content himself with the form adopted by the company, and, if he finds the figures correct, so certify? Personally, I have leaned to the former view, but I can easily understand the latter. Management prepares the financial statements from the records, then calls in the public accountant and says to him, "Audit these records, compare the statements with them, and say whether or not the statements are correct." It is a perfectly honorable engagement which the auditor is asked to accept, and a man must mind his belly. If the statement of income contains only two figures, "operating income" and "net income after all charges," and the auditor finds those two figures correct, there is no reason under our system of management-selected auditors why he should not so certify. It may or may not occur to the investor in the company to seek further information; if he does, he may get it, and if he does not he is immediately set down as satisfied with that which has been presented. But if the auditor had been elected by the stockholders, his instructions would undoubtedly have been to some such general effect as this: "Audit the accounts of the company and tell us what has been done with our money." These instructions would not be satisfied by certifying to the correctness of such an income statement. If management would give ade-

quate recognition to the trust character of its position, it would not itself be content with such a statement.

The members of your association are chosen, by election or appointment, to represent these inarticulate stockholders. It may be that the stockholders would like you to do all their work for them, and to make a yes-or-no decision as to whether a given security is or is not a good investment, with a guaranty backing your affirmative judgment. This, of course, you can not do. But you can do much for them by insisting that all necessary information be available to those investors who are able and willing to use it, withholding your permission for the sale of securities whose issuers have not furnished such information to be made available to investors. Some investors may not be able to utilize it, but some can, and the mere fact that it must be prepared and filed in your offices, where it will be available to the public, will have a salutary effect on management.

Just what this information should be will of course vary so greatly in different cases as to make almost every enterprise unique. But the old cry that the information will be used by competitors to the company's detriment should not be given too great weight. An enterprise which looks to the public for capital ought not to be using that capital in such fashion that it would be jeopardized by publicity. The final report of the auditors who last year investigated the affairs of Kreuger & Toll, after Ivan Kreuger's death, contains this very pertinent comment: "The history of this group of companies emphasizes anew the truth that enterprises in which complete secrecy on the part of the chief executive officer as to the way in which important parts of the capital are employed is, or is alleged to be, essential to success are fundamentally unsuited for public investment, since such secrecy undermines all ordinary safeguards and affords to the dishonest executive unequalled opportunity for the perpetration and concealment of frauds."

If the stockholders were to select the auditors, these latter might well advise the stockholders that information of interest to them was being withheld from published statements because its publication was deemed by the management to be detrimental to the best interests of the company. Then if there were a sufficient number of stockholders interested in determining the company's policies they could order the divulgence of this information, and the auditor would be secure in his position. If

such stockholders were a minority in a large company, the newspapers might safely be relied upon to give publicity to the controversy, as they did recently in one case with the result that finally a majority of the stockholders was aroused to action. If, on the other hand, the stockholders should agree to accept such information as was tendered them and not to ask for more, they would still be in the position of having made the final decision as to how much information they wanted.

I have no doubt that you are all acquainted with the registration-statement form prescribed by the federal trade commission under the new federal securities act, but I should like to point out some of its major provisions, all of which are in accord with the bulletin prepared by the American Institute of Accountants and published by the federal reserve board, to which I have previously referred.

First, fixed-asset accounts must be so set up in the balance-sheet as to show cost, book appreciation and provision for depreciation, all separately;

Second, intangibles must be separated from other assets and the basis of valuation disclosed;

Third, investments in subsidiary or affiliated companies must be separated from other investments, and the basis of valuation of each disclosed;

Fourth, the amounts of both receivables and bad debt reserves must be shown, not merely the net receivables after deducting the reserves;

Fifth, the basis for valuation of inventories must be declared and should preferably be the lower of cost or market;

Sixth, the market as well as book values of marketable securities must be shown, and indebtedness of officers or stockholders and of affiliated companies must also be segregated from other current assets;

Seventh, liabilities must be classified in such detail as to show priorities both of lien and maturity;

Eighth, the proceeds of issue must be shown for all classes of capital stock, and the source and amount of each element of surplus must be set forth clearly;

Ninth, gross sales and details of cost of goods sold are requested to be stated, although not required if the company will be injured thereby;

Tenth, charges for bad-debt-loss provisions, fixed-asset maintenance, taxes and depreciation must be shown separately; the new regulations also require in another place detailed information regarding compensation paid to officers, and it might be well to include the total amount so paid as a separate charge in the income statement;

Eleventh, extraordinary and non-recurring revenues and expenses must be separated from others and clearly described; and

Twelfth, there must be a statement showing all changes in surplus during the period covered by the income statement.

There is, of course, much more in the work of the public accountant than the arranging of items in the balance-sheet and statement of income and surplus in such fashion as to bring out the facts which investors are entitled to know. The bulletin of the federal reserve board, *Verification of Financial Statements*, contains a detailed manual of sound auditing procedure, the following of which would place the auditor in position to know the character of his materials before he begins to assemble the financial statements or to test such statements previously prepared by the company under audit. It would be very pertinent for securities commissioners to make inquiry of a public accountant whose certificate is presented to them in support of financial statements filed with applications for permission to sell securities as to whether or not before issuing such certificate he had made an audit conforming in all particulars to the procedure laid down in that bulletin. In many cases the management of companies under audit has been unable or unwilling to see the reason for some of the steps of audit procedure which are laid down in that bulletin and has required the auditor to forego such steps. If an inquiry made by a securities commissioner should develop this as a fact, the commissioner might well judge as to the sufficiency of the audit with the specified steps omitted. When you consider the fact that the public accountant is engaged in the first instance by management you will recognize that he is under compulsion to accept such restrictions with the single alternative of refusing the engagement. In the latter case it is not improbable that the work will be done by others with a lower ethical ideal and with less regard for the rights of investors to full and complete information. Thus it is better to accept the engagement in spite of

those restrictions and to do the utmost for investors which is possible under the terms of employment.

The public accountant who has been selected by the stockholders of a corporation, independent of its management, to audit its accounts, which constitute a record of that management's stewardship, will obviously enjoy an improved position and a greater independence, with benefit resulting not only to the stockholders but to bondholders and other investors as well. In years gone by trust indentures underlying bond issues frequently contained a provision to the effect that the accounts of the issuing company should be audited by a certified public accountant selected by or at least acceptable to the trustee, with the result that the public accountant knew that his engagement depended on his doing work and rendering a report which would be satisfactory to the trustee as a representative of the bondholders. With the increase in the amount of public financing done by issuance of preferred and common stock and with the growth of the practice on the part of corporations to have their accounts audited by public accountants selected by the management, this practice of having the auditors in a sense selected by the trustee for the bondholders has fallen into disuse. It might well be revived.

I have tried to show the importance of having the public accountant selected by and responsible to those who have furnished the capital of the enterprise to be audited, that is to say the investing public, and to indicate the type of information which he should be required to give for the benefit of the investing public. It is important that the investing public should have this information, which can be supplied to it only through properly prepared financial statements, but a word of caution is necessary lest this information be regarded by some as all sufficient. That word of caution was most eloquently spoken by the American Institute's committee on coöperation with stock exchanges in a report which was made public last winter. The committee said:

"But even when all has been done that can be done, the limitations on the significance of even the best of accounts must be recognized, and the shorter the period covered by them the more pronounced usually are these limitations. Accounts are essentially continuous historical records; and, as is true of history in general, correct interpretations and sound forecasts for the future can not be reached upon a hurried survey of temporary conditions, but only by longer retrospect and a careful distinction

between permanent tendencies and transitory influences. If the investor is unable or unwilling to make or secure an adequate survey, it will be best for him not to rely on the results of a superficial one."

The extent of the public accountant's financial responsibility to the investing public has entered what appears likely to be a long-drawn-out process of determination. It has been held that the public accountant is liable for damages if guilty of such palpable negligence as to amount to fraud on the investing public even though there be no fraudulent intent. Provisions for such financial responsibility on the part of the public accountant are included in the new federal securities act. Many public accountants feel that these provisions are of such drastic character as to defeat their own purpose by imposing a risk too great for a careful and solvent public accountant to assume. Under this new law it is conceivable that a public accountant with sufficient temerity to certify financial statements will find that he has risked his entire personal fortune, not only on his skill and ability as an auditor, but on his ability to demonstrate to a jury of laymen that his highly technical work was done honestly and with reasonable care and ability. The unfairness of putting the public accountant in this position will be seen most clearly when you consider that even if he succeeds in his defense he still will have incurred heavy expenses for which no provision can possibly be made in fixing the amount of his audit fee. He is put in a position where he must even sustain attacks brought in bad faith, with no penalty imposed upon his accuser when he utterly fails to make out a case. This risk on the public accountant's part would certainly seem to be disproportionate, and it is to be hoped that a way may be found to permit him to perform his very valuable function without being thus overburdened.

The investing public has a right to look to the public accountant for skill, judgment and integrity of a high order, and the public accountant similarly has a right to expect of the investing public a recognition of the unavoidable limitations on his work and a fair and thorough study of what he submits as a result of it. Thus and only thus can the two groups be mutually helpful.

Legal Notes

HAROLD DUDLEY GREELEY, *Editor*

DAMAGE SUIT AGAINST ACCOUNTANTS

In THE JOURNAL OF ACCOUNTANCY for July, 1933, the opinion of a lower court in a case raising an interesting point was summarized and discussed. Since then, an appeal has been argued and the appellate court has sustained the decision of the court below but without writing an opinion. It is understood that no further appeal on this point will be taken.

The facts as alleged by the plaintiff have not yet been proved but in substance the allegations are as follows:

A certain corporation asked plaintiff for a time loan of $300,000, which was refused, but plaintiff made a demand loan of this amount and agreed to change it to a time loan if a certified balance-sheet were furnished which would justify the making of a time loan. Defendants, as auditors, certified to such a balance-sheet, which was presented to the plaintiff and plaintiff thereupon changed the loan from demand to time. Thereafter, the plaintiff suffered a loss of $197,-561.27, which was the excess of the amount of the loan over the amount received by the plaintiff as dividends in the bankruptcy of the corporation to which the loan was made. Plaintiff sued defendants to recover this amount and defendants, in a preliminary proceeding, sought to have the action dismissed on the theory that the plaintiff had suffered no damage by changing the terms of the loan.

The court below refused to dismiss the action but held that the damages alleged were not conjectural or speculative and that the plaintiff should be allowed to prove the amount of its loss in a trial of the alleged facts. It was from this decision that the defendants appealed.

On the appeal, the defendants argued that plaintiff did not rely on the defendants' balance-sheet in making the loan and that the extension of the maturity of an existing loan, even if on the faith of false representations, did not furnish a basis from which damage may be inferred. Plaintiff argued that the alleged facts brought this case within the doctrine of *Ultramares Corporation* v. *Touche*, 255 N. Y. 170, and that if plaintiff in reliance upon defendants' certification of the balance-sheet had merely refrained from calling the demand loan, whereby a loss had been incurred, such refraining would be a sufficient reliance upon the misrepresentations in defendants' balance-sheet to make defendants liable in damages. Plaintiff argued that in reliance upon the balance-sheet it had made an affirmative change of position in that it had bound itself not to call the loan until the maturity of the time loan, and that fraudulent statements resulting in such an affirmative change in position, in reliance thereon, were actionable. The appellate court agreed with the plaintiff's argument and we may now expect the case to be tried on its merits.

RESPONSIBILITY IN LIMITED AUDITS

The Canadian case of *International Laboratories, Inc.* v. *Dewar, et al.*, (1933) 2 *Western Weekly Reports* 529, was one of major interest to accountants and was commented upon at length in THE JOURNAL OF ACCOUNTANCY for September,

1933. By the decision of the Manitoba court of appeal, the plaintiff, a manufacturer, was not allowed to recover from the defendants, its auditors, the amount of defalcations which the audits by defendants had not disclosed. The principal point at issue was whether or not the auditors were liable for negligence in view of the fact that the plaintiff, by contract with them, had so strictly limited the scope of their audits that it was practically impossible for the auditors to uncover the defalcations, and in view of the further fact that plaintiff's officers and employees themselves had been negligent with respect to some of the thefts. The court of appeal held that the auditors were not negligent in performing their work because the measure of their responsibility depended upon the terms of their employment in this particular case. It was expected that the plaintiff would appeal to the privy council but we are now informed that plaintiff's time to appeal has been judicially determined to have expired and that no appeal can be taken.

This is a valuable decision, coming as it does from one of the highest courts in Canada. Accountants in the United States should be thoroughly advised concerning it and other related cases when they are called upon by clients to limit the scope of proposed audits. Costly litigation and much resulting bitterness can often be avoided by a sufficiently complete and clear written statement prepared in advance to show a definite understanding of the rights and duties of both parties to the transaction.

NEGLIGENCE OF AMATEUR AUDITORS

Under the caption "Negligence of amateur auditors" a New York decision concerning an auditing committee of bank directors (*People* v. *Horvatt*, 261 N. Y. S. 303) was discussed in THE JOURNAL OF ACCOUNTANCY for April, 1933. Recently the Ontario court of appeal had much the same kind of situation before it in *County of Renfrew* v. *Lockhart, et al.*, (1933) 32 *Ontario Weekly Notes* 627. In the latter litigation the county sued two non-professional auditors to recover approximately $118,000, the amount of defalcations by the county treasurer during the years when defendants were making their audits. The county was not allowed to recover any amount, one of appellate judges stating that the county got "the kind of audit it paid for."

The two defendants were appointed auditors of the county under the provisions of the municipal act, and they acted as such auditors from the beginning of 1925 until some time in 1931. During that period the county treasurer misappropriated $117,901.42, and upon discovery of it the county sued the auditors, alleging negligence in that defendants had failed to use proper care and diligence. Neither defendant was a chartered accountant or a professional auditor, although at the same time they were auditing the books of the town of Pembroke. One of the appellate judges stated that they were men of responsibility but of very little business capacity or experience. The treasurer, on the other hand, was characterized as an expert in falsification, although the only one of his methods described in the opinions of the judges should not have escaped detection by an ordinarily competent professional auditor.

In the lower court, the judge pointed out that the plaintiff had the burden of proving that defendants had been negligent and that plaintiff had sustained damages by reason of such negligence. He held that defendants by accepting the positions as auditors had assumed the obligation to perform their duties in a

reasonable, skilful and careful manner, but that it was proper to consider their experience as auditors in determining the degree of skill that should have been exercised by them and that the same degree could not have been expected of them as of chartered accountants or professional auditors. The judge found as facts that the treasurer's methods were rather skilful and so framed as to disarm suspicion and that defendants had not been negligent. He then quoted from *Canadian Woodmen of the World* v. *Hooper*, (1932) 41 *Ontario Weekly Notes* 328, to the effect that auditors were not responsible for losses flowing from an embezzler's misconduct but were responsible for losses resulting from their failure to report an irregularity at the time they discovered it. The lower court held that plaintiff had not proved that the treasurer would have been discharged had defendants reported defalcations in the earlier years of the period, and dismissed plaintiff's action. Plaintiff then appealed.

In the court of appeal there were five judges. Each of them gave an opinion, three in favor of dismissing the appeal and two in favor of allowing it. Plaintiff therefore lost by the narrowest possible margin. The facts were stated somewhat more fully in the opinions of the judges of the appellate court. It appeared that the treasurer had made it a practice at the end of each year to deposit current receipts in the bank but not to enter them in the cashbook, thereby covering up approximately the total of unauthorized and unrecorded withdrawals from the bank. It is obvious that merely checking the cashbook with the bank deposits would have disclosed this irregularity but defendants failed to do it and were completely satisfied when the bank's balance was "in general correspondence or agreement" with the cashbook balance. One of the auditors was a merchant and insurance agent and he testified that he knew of no way by which auditors could have ascertained whether or not all cash received had been recorded in the cashbook. One of the judges, in his opinion, excused defendants for not making this simple check by stating that they were not "versed in the fine points of accountancy" and then referred to *In re Kingston Cotton Mill Co.*, (1896) 2 Ch. 279 in support of the doctrine that an auditor need not approach his task with a view to demonstrating known or suspected dishonesty but may assume a certain amount of honesty, and that while he must be alert he is not bound to believe that there is concealed fraud for him to discover. Another of the three concurring judges stated that he would be opposed to overruling the trial judge who had found that defendants were not legally negligent, but that even if negligence had been found plaintiff could recover only nominal damages because its loss did not result from that negligence. The auditors did not steal the money.

The opinions of the two dissenting judges were short. Those judges concluded that defendants had failed to perform their duty as auditors, especially in their failure to check deposits with cashbook entries, and that plaintiff had been damaged by not having the defalcations brought to its attention.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 16, 1933, 1:30 P.M. to 6:30 P.M.

Answer problems 1, 2 and 3 and either problem 4 or problem 5.

No. 1 (30 points):

On the basis of the following information prepare:

1. A balance-sheet of all funds after closing the books at December 31, 1932.
2. A statement of the current surplus of the general fund for the year, showing the revenue, the expenditures and other items increasing or decreasing surplus during the year and the balance of surplus at the end of the year.
3. A statement of income and expense of the water department for the year.

The city of Dowell classifies its accounts under four different funds. The balances in the accounts of those funds on January 1, 1932, and on December 31st of the same year before closing were as follows:

General fund	January 1st	December 31st
Cash	$ 10,162	$ 21,215
1931 taxes receivable	15,676	12,429
Accounts receivable	2,325	3,545
Stores	9,641	9,533
Permanent property	3,154,695	3,154,695
1932 taxes receivable		60,838
Estimated revenue from taxes		225,000
Estimated revenue from miscellaneous sources		62,000
Appropriation expenditures for current purposes		234,398
Appropriation expenditures for capital additions		8,716
Appropriation expenditures for payment of bonds		25,000
Appropriation encumbrances (1932)		5,842
	$3,192,499	$3,823,211
Accounts payable	$ 2,826	$ 5,626
Reserve for 1931 taxes	10,200	10,200
Reserve for orders and contracts	3,286	5,842
Reserve for stores	10,000	10,000
Current surplus	11,492	11,603
Bonds payable	250,000	225,000
Capital surplus	2,904,695	2,929,695
1932 tax anticipation notes payable		25,000
Reserve for 1932 taxes		24,766
Revenue from taxes		222,894
Revenue from miscellaneous sources		64,325
Appropriations		276,000
Estimated budget surplus		11,000
Sale of old equipment		1,260
	$3,192,499	$3,823,211

Water fund	January 1st	December 31st
Cash	$ 6,126	$ 717
Accounts receivable	7,645	5,573
Stores	13,826	12,635
Investments of replacement fund	21,700	24,500
Permanent property	212,604	214,204
Labor and material expense		109,638
Interest on bonds		3,000
Depreciation charge		10,600
Accounts of prior years written off		1,097
Expended for additions to plant		12,460
	$ 261,901	$ 394,424
Accounts payable	$ 4,324	$ 4,318
Customers' deposits	1,500	1,600
Replacement fund reserve	21,700	24,500
Operating surplus	21,773	21,773
Bonds payable	60,000	40,000
Capital surplus	152,604	154,204
Services billed		146,867
Deposits lapsed		60
Interest on investments		1,102
	$ 261,901	$ 394,424

Assessment fund	January 1st	December 31
Improvement No. 50		
Cash	$ 4,653	$ 1,844
Assessments receivable	46,829	33,414
Delinquent assessments receivable	4,826	2,010
Public benefit receivable	5,632	4,516
Interest on bonds		3,000
	$ 61,940	$ 44,784
Bonds payable	$ 60,000	$ 40,000
Surplus	1,940	1,940
Interest on assessments		2,844
	$ 61,940	$ 44,784

	January 1st	December 31st
Improvement No. 51		
Cash		$ 851
Assessments receivable		21,600
Public benefit receivable		2,400
		$ 24,851
Bonds payable		$ 24,000
Surplus		390
Interest on assessments		461
		$ 24,851

Trust funds	January 1st	December 31st
Cash	$ 3,216	$ 31
Investments	94,425	99,425
Premium on investments		800
Accrued interest purchased		260
Cemetery maintenance		849
Cemetery expense		2,976
Policemen's pensions paid		3,200
Firemen's pensions paid		2,400
	$ 97,641	$ 109,941

	January 1st	December 31st
Cemetery endowment fund reserve	$ 60,000	$ 60,000
Policemen's pension fund reserve	18,691	18,691
Firemen's pension fund reserve	16,824	16,824
Cemetery maintenance fund reserve	2,126	2,126
Profit on sale of investments		600
Undistributed income		4,800
Policemen's pension fund contributions		4,160
Firemen's pension fund contributions		2,740
	$ 97,641	$ 109,941

It is the practice of the city to close out the unencumbered balance of appropriations of the general fund at the end of each year. Depreciation on the general property of the city is not entered and accrued interest on investments or on outstanding bonds is disregarded. Income and profit on trust fund investments are distributed 62 per cent. to cemetery funds, 20 per cent. to policemen's pension fund, 18 per cent. to firemen's pension fund.

The cemetery maintenance fund consists of the income from the cemetery endowment fund and is used for cemetery expense. Excess of receipts over disbursements of pension funds are closed to the reserve accounts of the respective funds at the end of each year.

Attention is directed to the following facts and conditions at the close of the year 1932:

(1) 1931 taxes in excess of the reserve against them are to be written off.

(2) Because of the increased uncertainty of 1932 tax collections the reserve on them is to be increased by fifty per cent.

(3) Invoices on all orders and contracts outstanding at beginning of year have been paid with a saving of $111, which has been credited to current surplus.

(4) The old property sold during the year was carried in the accounts at a value of $6,000.

(5) Permanent property valued at $1,820, becoming useless, was discarded during the year.

(6) Replacements of water-department equipment costing $6,200 were made from the replacement fund during the year at a cost of $7,800.

Solution:

CITY OF DOWELL

Balance-sheet, December 31, 1932

Assets			*Liabilities and surplus*		
General fund:			**General fund:**		
Current assets:			Current liabilities and surplus:		
Cash		$ 21,215	Accounts payable	$ 5,626	
Accounts receivable		3,545	Reserve for orders and contracts	5,842	
Taxes receivable:			1932 tax anticipation notes payable	25,000	
1931 taxes	$12,429		Reserve for stores	10,000	
Less: reserve for uncollectible taxes	12,429		Current surplus	11,514	$ 57,982
1932 taxes	$60,838		Public benefits payable		6,916
Less: reserve for uncollectible taxes	37,149	23,689	Plant liabilities and surplus:		
Stores		9,533 $ 57,982	Bonds payable	$ 225,000	
Public benefits—improvements		6,916	Capital surplus	2,930,591	3,155,591
Permanent property		3,155,591			
Total		$3,220,489	Total		$3,220,489
Water fund:			**Water fund:**		
Current assets:			Current liabilities and surplus:		
Cash		$ 717	Accounts payable	$ 4,318	
Accounts receivable		5,573	Customers' deposits	1,600	
Stores		12,635 $ 18,925	Operating surplus	13,007	$ 18,925
Permanent property and replacement fund:			Plant liabilities and surplus:		
Permanent property		$226,664	Bonds payable	$ 40,000	
Investments of replacement fund		24,500 251,164	Replacement fund reserve	24,500	
Total		$ 270,089	Capital surplus	186,664	251,164
			Total		$ 270,089

Assessment funds:

	Improvement No. 50	Improvement No. 51			Improvement No. 50	Improvement No. 51	
Cash	$ 1,844	$ 851	$ 2,695	Bonds payable	$40,000	$ 24,000	$ 64,000
Assessments receivable	33,414	21,600	55,014	Surplus	1,784	851	2,635
Delinquent assessments receivable	2,010		2,010				
Public benefit receivable	4,516	2,400	6,916				
Total	$41,784	$24,851	$ 66,635	Total	$41,784	$ 24,851	$ 66,635

Trust funds:			**Trust funds:**	
Cash	$ 31		Cemetery endowment fund reserve	$ 60,000
Investments	99,425		Policemen's pension fund reserve	20,519
			Firemen's pension fund reserve	17,945
			Cemetery maintenance fund	992
Total	$ 99,456		Total	$ 99,456

CITY OF DOWELL

Statement of the current surplus of the general fund for the period January 1, 1932, to December 31, 1932

Current surplus, January 1, 1932			$ 11,492
Add: revenue during the year:			
From taxes	$247,660		
Less: provision for loss on the 1932 taxes receivable	37,149	$210,511	
From miscellaneous sources		64,325	
From sale of old equipment		1,260	
Savings on orders and contracts		111	
			276,207
Total			$287,699
Less: expenditures during the year:			
For current purposes		$234,398	
For capital additions		8,716	
For payment of bonds		25,000	
For reserve for orders and contracts (1932)		5,842	273,956
Balance			$ 13,743
Less: uncollectible taxes, 1931			2,229
Current surplus, December 31, 1932			$ 11,514

CITY OF DOWELL

Statement of income and expense—water department for the period January 1, 1932, to December 31, 1932

Income:			
Services billed		$146,867	
Deposits lapsed		60	$146,927
Expenses:			
Labor and material expense		$109,638	
Depreciation		10,600	
Accounts of prior years written off		1,097	121,335
Balance			$ 25,592
Non-operating income and expense:			
Interest on bonds payable		$ 3,000	
Interest on investments		1,102	1,898
Net income—January 1, 1932, to December 31, 1932			$ 23,694

CITY OF DOWELL

Statement of operating surplus—water department for the period, January 1, 1932, to December 31, 1932

Balance, January 1, 1932			$21,773
Add: net income for the year 1932			23,694
Total			$45,467
Deduct:			
Expenditures for additions to plant		$12,460	
Current funds used for the payment of bonds		20,000	32,460
Balance, December 31, 1932			$13,007

CITY OF DOWELL

Statement of replacement fund reserve for the period, January 1, 1932, to December 31, 1932

Balance, January 1, 1932	$21,700
Depreciation for the year 1932	10,600
Total	$32,300
Cost of replacements made during the year 1932	7,800
Balance, December 31, 1932	$24,500

CITY OF DOWELL

Statement of trust fund reserves for the period, January 1, 1932, to December 31, 1932

		Reserves		
		Cemetery maintenance fund	Policemen's pension fund	Firemen's pension fund
Balances, January 1, 1932		$2,126	$18,691	$16,824
Add:				
Contributions			4,160	2,740
Investment income:				
Income	$4,800			
Profit on sale of investments	600			
Total	$5,400			
Less: premium on investments	$ 800			
Accrued interest purchased	260			
Total	$1,060			
Net income	$4,340	2,691	868	781
(Ratio of distribution, 62, 20, 18; amounts taken to nearest dollar)				
Totals		$4,817	$23,719	$20,345
Less: pensions paid			3,200	2,400
Maintenance and expense		3,825		
Balances, December 31, 1932		$ 992	$20,519	$17,945

The accrued interest purchased has been charged against current income, as there is better reason for charging it against 1932 than against any other years; the statement in the problem that "accrued interest on investments or on outstanding bonds is disregarded" must refer to the omission of accruals at December 31st, and not to this item.

The premium on investments has also been charged to expense, as this seems to be the company's practice: although the investments account balance ($94,425) would appear to be cost rather than par, the more positive fact that the premium on investments account had no balance at January 1st, governs. Premium and discount on investments should properly be amortized over the life of the investments.

On the following page appear the working papers and adjustments for the general fund, not part of the solution, but merely submitted for purposes of explanation.

Explanation of adjustments

(1) To increase reserve for 1931 taxes to amount of taxes uncollected.
(2) To increase reserve for 1932 taxes 50%.
(3) To set out from surplus the $111 saving on 1931 invoice payments.
(4) To write off cost of property sold during the year, by charges to capital surplus.
(5) To write off cost of property discarded during the year.
(6) To set up 1932 additions to property.
(7) To reverse budget figures incorporated in accounts for purposes of record.
(8) To set up liability to improvement funds for public benefits:

No. 50	$4,516
No. 51	2,400
Total	$6,916

This item does not appear on the January 1st trial balance of the general fund, although a similar liability existed, and should have been shown, at that date. It can not be determined whether the indicated payment from the general fund to improvement No. 50 in 1932 was charged to expense, or capitalized as an addition; for this reason the item "public benefit" is shown separately on the asset side of the balance-sheet and not added to the property account.

CITY OF DOWELL

General fund—Working papers, December 31, 1932

	Trial balance December 31, 1932		Adjustments				Current surplus		Balance-sheet	
Cash	$ 21,215								$ 21,215	
1931 taxes receivable	12,429								12,429	
Accounts receivable	3,545								3,545	
Stores	9,533								9,533	
Permanent property	3,154,695		(6) $ 8,716	(4) $ 6,000					3,155,591	
				(5) 1,820						
1932 taxes receivable	60,838								60,838	
Estimated revenue from taxes	225,000			(7) 225,000						
Estimated revenue from miscellaneous sources	62,000			(7) 62,000						
Appropriation expenditures for current purposes	234,398						$234,398			
Appropriation expenditures for capital additions	8,716						8,716			
Appropriation expenditures for payment of bonds	25,000						25,000			
Appropriation encumbrances (1932)	5,842						5,842			
Accounts payable		$ 5,626								$ 5,626
Reserve for 1931 taxes		10,200		(1) 2,229						12,429
Reserve for orders and contracts		5,842								5,842
Reserve for stores		10,000								10,000
Current surplus		11,603	(3) 111					$ 11,492		
Bonds payable		225,000								225,000
Capital surplus		2,929,695	(4) 6,000		(6) 8,716					2,930,591
			(5) 1,820							
1932 tax anticipation notes payable		25,000								25,000
Reserve for 1932 taxes		24,766		(2) 12,383						37,149
Revenue from taxes		222,894	(2) 12,383					210,511		
Revenue from miscellaneous sources		64,325						64,325		
Appropriations		276,000	(7) 276,000							
Estimated budget surplus		11,000	(7) 11,000							
Sale of old equipment		1,260						1,260		
	$3,823,211	$3,823,211								
Additional provision for loss on 1931 taxes			(1) 2,229				2,229			
Saving on payment of 1931 orders				(3) 111				111		
Public benefits—improvements			(8) 6,916						6,916	
Public benefits payable				(8) 6,916						6,916
Current surplus, December 31, 1932							11,514			11,514
			$325,175		$325,175		$287,699	$287,699	$3,270,067	$3,270,067

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