EDITORIAL

Contingent Liability for Repurchase Contracts

Several readers of The Journal of Accountancy have drawn attention to what they believe to be heresy in an article which appeared in the February issue of this magazine. The offending paragraphs occur in a discussion of instalment financing contributed by C. A. H. Narlian. After considering the effect of the repurchase agreement which is becoming a common clause in financing companies' practice, particularly those which have to do with the purchase of motor cars, Mr. Narlian said:

"The principal factor in an agreement of this kind may be said to place upon the dealer the obligation to accept delivery of repossessions made by the finance company resulting from the purchaser's failure to meet his instalments and thereupon to reimburse the finance company for the unpaid balance. Under this plan, the finance company is called upon to repossess the car and to deliver it to the dealer, and in the event of a material collision damage, the agreement usually obligates the finance company to make due allowance therefor to the dealer.

"Legal opinions rendered by the highest authorities agree that under the repurchase-agreement plan, it is unnecessary for the dealer's balance-sheet to show any contingent liability, and this principle appears to be fully accepted by the banks."

Our readers who have criticized the statements made by Mr. Narlian seem to have overlooked the fact that he does not speak at all of accounting opinions. The address from which these paragraphs were taken was delivered at a meeting of the New York State Society of Certified Public Accountants. Mr. Narlian no doubt fully understood that his audience was competent to decide the accounting question involved; consequently, he referred solely to matters of law and banking practice. Indeed, the omission of reference to accounting opinion is quite noticeable. There is, however, this much to be said in support of the critics: the author might have added that legal opinions have nothing whatever to do with the case. It is wholly a question of what is or what is not proper accounting procedure; and there does not
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seem to be any valid reason to believe that accountants as a whole would subscribe to the theory that a repurchase clause is not a contingent liability of such importance as to merit inclusion in a balance-sheet. We believe that the great preponderance of opinion would incline to the theory that a contingent liability of anything more than insignificant magnitude must be shown, whatever the degree of contingency may be.

Accounting Opinion Is Firm

To support this assertion of the attitude of accountants, it is interesting to quote from certain opinions which are soon to be published in a bulletin now in course of preparation by the bureau of information of the American Institute of Accountants. This bureau, as most of our readers know, is a clearing house of question and answer upon accounting principles. The questions asked are placed before several competent authorities for reply and the answers are then sent to the accountant or the firm that inquires. In the correspondence which is now before us, we find a question relative to the treatment of the contingent liability in the case of accounts receivable sold subject to a repurchase plan. This is on all fours with the question arising in the case of a repurchase clause in finance-company contracts. The inquiry was sent to a number of prominent accounting firms and in order to support our contention that the contingency should be shown, we quote the following extracts from replies received:

1. "One fact in connection with the business under consideration which appears to be essential to a true understanding of its financial position is that its bankers hold large amounts of accounts receivable which it may be required to repurchase for cash in case debtors default. Another fact of importance to one seeking to know the financial status of the business is that experience in the past has been that losses in connection with such 'repurchases' have been negligible.

"The client apparently urges that the second fact be offset against the first and that both be eliminated from the accountant's report. From the information given it does not appear that such an offset can properly be made.

"On the other hand, we feel that it is important that both of the facts mentioned be definitely presented, because both of them would be of practical informative value to anyone who may study the statement.

"Going a little beyond the scope of the question, it seems to us that the client should logically be entirely satisfied to have the statement presented with both of these facts included, because it would seem that any unfavorable impression which might be made by admitting the amount of contingent liabilities would be more than overcome by the fact that losses in connection with such liabilities had been negligible in the past, and by the effect of the desire to present the 'whole picture' which desire would be evidenced by including these facts in the certificate or in the statement."

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2. "It seems that your interrogator might well have directed his client's attention to the provisions in this connection contained in the pamphlet, Approved Methods for the Preparation of Balance-sheet Statements, published in the Federal Reserve Bulletin for April, 1917. They are as follows:

"Contingent liabilities."—'It is not enough that a balance sheet shows what must be paid; it should set forth with as much particularity as possible what may have to be paid. It is the duty of an auditor who makes a balance sheet audit to discover and report upon liabilities of every description, not only liquidated debts but possible debts. The following are the usual forms under which contingent liabilities will be found:

Indorsements
Guaranties
Unfilled contracts

"Notes receivable."—'When notes receivable are discounted by banks the company has a liability therefor which should appear on the balance sheet. Lists of discounted notes not matured at the date of the audit should be obtained from the banks as verification and their totals entered under 20a, if the cash therefor is shown as an asset.'

"Accounts receivable."—'Inquiry must be made as to whether any of the accounts receivable have been hypothecated or assigned and the sum total of accounts so listed entered under 20b.

'The above references to '20a' and '20b' refer to sub-classifications shown under the main classification of secured liabilities which appears on the liability side of the form of balance-sheet contained in the Federal Reserve Bulletin. Those sub-classifications are as follows:

'20a—Notes receivable discounted or sold with indorsement or guaranty (contra),'

'20b—Customers' accounts discounted or assigned (contra),'

'20c—Obligations secured by liens on inventories,'

'20d—Obligations secured by securities deposited as collateral.'

'Whether obligations for the repurchase of instalment notes and accounts receivable are shown as direct liabilities in the manner required by the above quotations from the Federal Reserve Bulletin, or are shown as contingent liabilities in foot-notes to the balance-sheet, is a matter to be governed largely by the client's preference; the important matter being, of course, that the balance sheet discloses the existence of the obligations.

"The fact that losses experienced by the company in repurchasing instalment accounts during the past few years have been negligible is quite irrelevant to the question of the necessity of disclosing the existence of the obligation to repurchase the unpaid accounts.'"

3. "We have on more than one occasion insisted upon mentioning in balance-sheets the fact that the concern had disposed of instalment paper subject to a repurchase agreement. We believe that in most cases these so-called repurchase agreements call for the finance company's repossessing the merchandise and selling the merchandise to the business concern for the amount outstanding on the paper. Accordingly, it is maintained by some finance companies—and perhaps some accountants and bankers—that the position of the business concern with respect to its obligation to repurchase the merchandise is precisely the same as it is with respect to any other commitments for the purchase of merchandise, which, admittedly, do not have to be recognized in the balance-sheet. Notwithstanding this argument, we believe that any person who is considering the financial condition of the concern is entitled to know that the concern has disposed of its receivables and may have to take some of them back. There is some doubt as to whether this commitment can properly be characterized as a contingent liability, but the fact remains, we think, that it is an important factor in the consideration of financial condition.

"If the repurchase agreement does not call for the repossession of the merchandise by the finance company and the purchase of the repossessed
merchandise by the business concern from the finance company, but merely calls for a reversal of the transaction whereby the paper was purchased by the finance company; it seems to us that the situation is not essentially different from an assignment with recourse; and, that being the case, there seems to be a definite contingent liability.

"We are very much interested in the statement in the letter that the attitude of the client is supported by several banks. We took the trouble to canvass a number of large banks on this subject, and found that without exception they insisted that information regarding such transactions should be shown in the balance-sheet."

4. "It is our opinion that a balance-sheet should show all liabilities, both actual and contingent. The exact liability which the concern who sold the accounts receivable may be called upon to meet, is difficult of determination. Therefore, we feel that reference thereto, in the form of explanatory memoranda on the face of the balance-sheet, should be sufficient. The important thing is that their existence be disclosed and that such data as will give an idea of the nature, status and amount be clearly set forth. In other words, show the total amount of outstanding accounts sold and the nature of the repurchase agreement. If there has been any experience as to the amount which the concern has been called upon to repurchase in the past, these data might be shown for the information of bankers and others who make use of the balance-sheet."

Other replies were in agreement with the principles enunciated in the foregoing quotations. There was no reply in which the slightest approval was given to the theory that contingent liabilities of this sort, even when most unlikely to become actual liabilities, should not be disclosed. It may be assumed, therefore, that the weight of accounting opinion is entirely in support of the principle that a contingency of any magnitude must be clearly set forth.

Bankers and Lawyers May Not Agree

It will be noted that one of the letters from which we have quoted draws attention to the provision in the pamphlet Approved Methods for the Preparation of Balance-sheet Statements, issued by the federal reserve board, dealing with this problem. There may be some bankers who would look with complaisance upon failure to disclose contingent items if the contingencies were extremely remote, but we do not believe that there are many bankers who would fall in this category. It seems to us that it could be only in extraordinary circumstances that a banker would be willing to accept a statement which did not reveal the true condition with all its possibilities of peril. As has been said, however, the statement made by Mr. Narlian did not make any claim that the views which he expressed were those of the accounting profession. The legal opinion on an accounting matter is not always of great value, for the lawyer is of necessity an advocate and if any purpose could be served by reticence on the
part of a client, the lawyer would naturally seek to find some justification for withholding information which would prejudice unfavorably the opinion of his client’s financial stability. This does not infer anything derogatory to the legal profession. The whole question of the respective duties of lawyers and of accountants is thoroughly understood by both the professions. The lawyer is always a special pleader. The accountant should be never. As a matter of fact, it is not true that the contingency in the case of repurchase contracts is always remote. There may be unexpected developments which will throw upon the finance company the positive obligation to repurchase, and if this may happen in small amount it may happen equally well in large amount. The balance-sheet, it is axiomatic to say, is a statement of fact and also of possibilities.

Ownership of Working Papers

Readers of this magazine will remember that last year the supreme judicial court of Massachusetts in the case Ipswich Mills v. William Dillon, et al., decided that the ownership of an accountant’s working papers is vested in the accountant. The case was appealed by counsel for the American Institute of Accountants, and the victory won in the highest court of Massachusetts was of the utmost importance to all accountants and, incidentally, to all clients of accountants. There is, however, a further question which occasionally arises upon which there has not been a legal decision. It concerns the ownership of working papers which were the property of an accountant who died after the conclusion of a case in which he was retained. Such a question was brought to attention a few weeks ago, and the Hon. J. Harry Covington, counsel for the American Institute of Accountants, was asked to express his opinion on the question. He has written the following reply:

“I beg to acknowledge receipt of your letter relating to the matter of working papers which were the property of an accountant now deceased. The question raised by the firm of accountants which has taken over the estate of the deceased accountant is a novel one. Obviously there are no precedents. But I think a careful consideration of the principles underlying the ownership of working papers by an accountant point clearly to a sound solution of the problem. “In an analysis of the legal situation there must be kept in mind the language of the supreme court of Massachusetts in the Dillon case. In discussing the question of title the court indicated an interest of the client in the papers by the use of three expressions as follows:

(a) ‘It may be that these papers contained information confidential in its nature and of importance to the plaintiff.’

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(b) 'The interest of the plaintiff in the information collected and copied by the defendants and the confidential nature of this information do not give title to the plaintiff of the defendants' working papers.'

(c) 'Even if it is assumed that the defendants could be enjoined from the publication of the contents of these papers.'

In other words, while the legal title to working papers was decided to be in the accountant, the court clearly indicated a doubt that he had any right either to dispose of them or to make them public.

"Title to property is not necessarily free from limitations, and such must be the case with an accountant's working papers. If the deceased accountant had retired from business while alive he could not have undertaken to sell the working papers relating to the business of any client to any person who succeeded him in practice. And, of course, it is obvious that the estate of the deceased accountant has no greater right in the working papers of clients than the deceased had while alive. Certainly, therefore, his successors cannot obtain any title to working papers from the representative of his estate.

"And as there is no liability by the estate for the negligent work of a deceased accountant there is no use whatever to which the representative of the estate can put working papers. But assuming that the executor may have the technical right to retain the working papers during the time he is administering the estate they would be in a 'dead hand' so to speak, and when he closes the estate he cannot distribute them to any heir or representative of the deceased. The confidential nature of the property would be thus destroyed.

"Having in mind what was said by the Massachusetts court, I consequently have no doubt that in an appropriate legal proceeding (the title of the accountant to the working papers having become a right without value or purpose) any court would find no difficulty in expanding the right of a client to protect the confidential nature of the material in the working papers into an unrestricted right of possession. Manifestly the accounting profession should not be on the defendant side of such a possible legal controversy.

"There is also, it seems to me, a controlling ethical question involved. The whole theory of the right of the accountant to retain his working papers against the demand of the client is based upon the proposition that they represent peculiarly his own work as preliminary to a completed result which the client has employed him to bring about. And as the integrity of his work may at any time be called into question, he ought always to be in possession of the material which demonstrates its accuracy and soundness. After the death of the accountant, as I have already stated, there can arise no question of liability for negligent performance of service. As the title is peculiarly in the accountant alone with no right of transfer inherent in such title the accountancy profession must, it seems to me, recognize that the interest of the client has been expanded into an immediate right of possession.

"The rule I have just suggested works no hardship to partnerships for of course the law of partnership gives to surviving partners the interest in partnership property, and the surviving partners in an accountancy firm are, of course, continuously liable for the soundness and accuracy of the work done as a firm matter by a deceased partner. Their right, therefore, to retain the working papers of a client is unaffected by the death of any one of the partners.'

No doubt, as counsel affirms, the ethical question involved is one that would have great weight with any competent court in a decision of ownership in such a case as that cited. The estate of the accountant would not be affected by adopting the theory expressed in this opinion and the rights of the client would be pro-
tected. It is very much a question of equity, when all is said and done, and it is upon this broad basis that Judge Covington has founded his conclusions.

**Accountants Not Accepted as Registrars**

The field of the accountant is constantly growing in breadth, and sometimes it seems a little difficult to determine what is the logical and proper boundary beyond which the accountant should not go. The more conservative members of the profession are somewhat perturbed at times by the apparent inclination of clients and others to demand of the accountant a variety of functions for which there is no precedent. There are, of course, other developments to which every accountant would lend his sanction. For example, the appointment of accountants as receivers and trustees in bankruptcy has everything to recommend it and there is no valid argument against it. In California there has recently been an effort to obtain authority for the appointment of certified public accountants as registrars. The matter was brought to the attention of the commissioner of corporations, from whose office we have received the following letter:

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New York, N. Y.

Sometime ago Mr.———, a certified public accountant of Los Angeles, requested the commissioner of corporations in writing to authorize the appointment of certified public accountants as registrars. Mr.———'s request was made in behalf of members of his profession who had received certificates as accountants.

The commissioner has made a careful study in this matter, the results of which are contained in a letter to Mr.——— under date of December 15th, a copy of which letter is herewith attached.

Briefly, the commissioner's decision is that only trust companies, banks or similar institutions should be approved as registrars in this state.

We believe the commissioner's decision, together with the reasoning upon which it is based, is of so much importance to the accountancy profession, to trust companies and banks, that we are submitting the attached letter to several publications which devote their columns to matters of interest to the profession and institutions affected by the ruling.

If the commissioner's letter or any portion of it is published we would appreciate it very much if we could have a copy of the issue in which the publication appears.

We are also attaching a resume of our investigation in this matter and which is referred to in the commissioner's letter to Mr.———.

The enclosure to which the commissioner refers expresses the opinion that registrars, in order effectively to protect the holders of securities, should be those qualified to do a trust business under the laws of California or of the United States. The primary and
specific purpose of a registrar, independent from the corporation or its transfer agent is, according to the commissioner, to certify and to guard against an over-issue of stock either by the corporation or its transfer agent. The certification of a registrar is accepted practically as a guaranty that the security issued to him is not spurious. The commissioner then goes on to say,

"It is obvious, therefore, that the duties and activities of the registrar in this respect are more than a mere clerical, ministerial and mechanical function. It is quite apparent, therefore, under these circumstances that should the registrar abuse or violate the confidence and trust so reposed in him by the certificate-holder . . . a definite liability accrues. To pursue this reasoning further, it would follow that the certificate holder or the beneficiary would have recourse and redress in law against the registrar. Manifestly, the relation between the parties reflects all the characteristic elements of a voluntary and express trust. The theory that a registrar stands in a fiduciary relationship to both stockholder and corporation is seemingly and substantially supported by the authorities found in the law reports.

"From these premises we believe the conclusion is perhaps permissible that the activities and duties of a registrar, fundamentally and primarily, fall within the broad and general classification of trusts. It equally follows then, assuming that the premise is not altogether fallacious, that those acting as registrars should qualify as such in pursuance to the law of the state made and provided in such cases.

"In the second place, we have made a careful survey of all the leading exchanges and even those exchanges of smaller magnitude in the entire country. We communicated with twenty-six exchanges variously located from the Atlantic to the Pacific and from the most northerly part of the country to the Gulf states and our file discloses that we received twenty-two answers, three failed to reply and one turned out to be something of a trading corporation and not an exchange. Seventeen of the exchanges—and they include the most important and most outstanding in the country—absolutely require a trust company or a bank to act as registrar. Only five, which cannot even be considered minor exchanges, make no distinction in this respect. . . .

"Third, you no doubt will be able to understand and appreciate the results that might ensue if this department decides to adopt the policy which in effect will single out with approval certified public accountants as registrars, particularly with regard to other professions. We feel that under these circumstances it would be an unjust discrimination against those others who are engaged in other professional endeavors, for instance the legal profession, etc. They, too, like the profession of public accountants, hold licenses from the state. The inference persists that if everyone who holds a license from the state to practise a trade or profession qualifies as a registrar, the field becomes beyond reach, its extremities become vague and its control unwieldy and affords little or no value of the protection that is contemplated by a registrar. . . .

"Lastly, the department must confine itself to those who apply for and those who operate under a permit from the department and that is the extent of our jurisdiction. Should this department assert itself without warrant in the direction of injecting itself in the management of a corporation by way of supervising and regulating the dealing of the corporation and its beneficiaries other than stockholders and shareholders, the precedent would be dangerous and it would detract in no small measure from the effectiveness of the enforcement of the law that is our charge.

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"It is therefore obvious to us, in the light we see it, that the method of having trust companies, banks or those others organized to do a business in this state in conformity with the laws that apply to trust companies, is more practical and is best calculated and designed to give the public the protection that it is entitled to in the regulation of dealing in securities."

So far as we know there has been no attempt in other parts of the country to broaden the scope of accountancy to include the functions of a registrar and it does not seem probable that the opinion rendered by the commissioner of corporations of California will excite any violent opposition in the minds of accountants generally.

Should an Auditor Act as Director? A correspondent asks whether it is proper or not for a professional accountant who is the auditor of a corporation to act simultaneously as a director of the corporation and also whether it is considered proper or improper for an auditor to hold stock in a company while he is professionally engaged as auditor. These are significant questions and it is probable that the opinion of the conservative members of the profession would call for a unanimous "no" to the first and a somewhat qualified "no" to the second. The great principle at issue is, of course, the necessity for absolutely impartial consideration of the company's financial conditions and for frank exposition of the facts whatever may be the effect of such exposure. It is conceivable that an accountant could be found who would be oblivious to his personal interest while exercising his professional function of inquisitor and judge. There are hundreds of accountants who would not let their conclusions be influenced knowingly by the fact of personal interest. But from every point of view it seems eminently desirable that the accountant should be so utterly divorced from financial or other participation in the success or failure of an undertaking under audit that no one could ever point an accusing finger, however unjustly, and allege the possibility of bias. The entirely honest accountants, of whom the overwhelming majority consists, would be unfairly affected by personal interest, because remembering that the imputation of iniquity might arise because of the apparent reason for partiality they would go to the other extreme and become unduly destructive in criticism. It is needless to discuss the accountant, if he exists, who would present a clean bill of health to a sick corporation of which he happened to be a part owner. At the worst he is rare and altogether beyond the pale of

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decency. The chief and enduring value of accountancy is not its technical ability to analyze and suggest—it is rather the total impartiality of its practitioners. It seems quite certain, therefore, that in all cases, except some in which unusual conditions exist, the accountant should be neither stockholder, bondholder nor an officer or a director of a corporation to which he accepts appointment as auditor. But the exceptions are worth consideration and there are times when an auditor may be almost compelled to act as director. For example, it happens now and then that a company passing through reorganization or some other form of metamorphosis needs the directing mind of the man who has been its auditor and knows the facts better than anyone else knows them. In such cases there is not the least cause to question the propriety of the accountant if he joins the board of directors and acts as auditor at the same time, but—and here is the vital desideratum—it must always be distinctly understood by security holders and potential investors that the dual relationship prevails. The arrangement must be openly made and openly carried out. Then no one can truthfully say that the auditor is guilty even of unwise conduct. He is acting merely at the will of the owners who know all about it.

Should the Auditor be a Stockholder?

The possible correctness of acting as director and auditor at the same time does not affect in any way the impropriety of accepting engagement as auditor in a corporation in which one has a substantial interest. It would perhaps be a counsel of perfection to suggest that it would be wrong for an accountant to hold a few shares of stock in a corporation after he had been appointed to make an audit and to report, but there are many accountants who make it an invariable rule to sever any personal interest which they may have when called in to act as auditors. It would be extremely difficult also to determine at what point an interest might be considered substantial. Could an auditor properly hold one hundred shares or two hundred? If not two hundred, might he retain one hundred and one—and so on without ever reaching a decision. When a question of this general sort was before the committee on professional ethics of the American Institute of Accountants some time ago, the chairman expressed himself in emphatic manner. He said:

"The principal value of an accountant's certificate is that it is supposed to be given by a competent, disinterested and impartial party. When an
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Auditor certifies to the accounts of a company whose policies have been determined to a greater or lesser extent by himself, the certificate would not have much more value than if he were certifying to his own accounts. The benefit of an independent judgment is missing in such a certificate, no matter how honestly and carefully the auditor may have done his work. The same comment would apply in respect to an auditor certifying to the accounts of a company in which he had a substantial investment, as his judgment as an investor could not help but affect his judgment as an auditor, and the benefit of an independent judgment would be lacking.

"I am of the opinion that a disclosure of the dual relation of the auditor to the company should have been made to the bank at the time that his report was submitted, as this would be one of the elements to which the bank officials would have given consideration.

"I would not go so far as to say that it would be improper for an auditor, or his firm, to certify to the accounts of a large corporation in which he happened to own a few shares of stock, but wherever the investment is sufficient to question his disinterestedness, he should not certify to the accounts without a full disclosure of his relation.

"I have been informed of at least one firm of accountants whose partners do not invest in the stock of any company to whose accounts they certify."