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Corporate Publicity and the Auditor *

BY GEORGE O. MAY

My presence here tonight is a direct result of the publication by Professor Ripley of his article in the September *Atlantic Monthly* on the subject of publicity of corporation accounts.

Soon after that article appeared I wrote to a leading New York newspaper, drawing attention to certain inaccuracies in it and suggesting that it did not constitute an altogether fair presentation of the situation which exists today. Your committee then invited me to speak at this meeting, and as the regular business programme was filled they suggested that I might take this occasion to make a few remarks on the subject of publicity of accounts from the standpoint of directors and auditors.

I do not propose to discuss Professor Ripley's article in detail. I dissent from him on some of his facts and on some of his arguments, and I entirely disagree with his suggestion as to the rôle which should be played by the federal trade commission. But I do not wish tonight to discuss these disagreements; I would rather express my gratification at the success with which he has attracted the attention of the public to the subject, and consider what we, as accountants, can do to bring about that improvement in the information furnished to stockholders and potential stockholders of corporations for which his article is a plea. No doubt the primary responsibility for furnishing the stockholders adequate information rests on the directors, but the auditor ought to use his best efforts to ensure that the directors publish accounts which conform to the highest established standards and to be able to advise directors what these standards are.

I am not sure that auditors have done their full duty in this respect in the past. To some extent this may have been due to the limitations of their authority and the rather precarious tenure of their appointments. I think the time has come when auditors

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should assume larger responsibilities, and their position be more clearly defined.

The practice of having independent audits has become so general that it is no longer necessary to demonstrate its value. In discussing the subject, therefore, we are now free from any imputation that we are crying up our own wares.

After undertaking to speak tonight I caused an examination to be made to ascertain what percentage of the companies whose stocks were dealt in on a given day on the New York stock exchange had their accounts audited annually, and I was myself surprised to find that in the case of industrial companies the practice had become almost universal; certainly over 90 per cent. of all the industrial companies on the list were audited.

In these circumstances it seems to me that the extension of the independent audit, accompanied by a clearer definition of the authority and responsibility of the auditors, is one of the most valuable remedies to be found for the defects of which Professor Ripley complains; and I think the Institute should consider very seriously, and invite the coöperation of other bodies in considering, what are the proper responsibilities of auditors and what can be done to hold them to such responsibilities and to put them in a position to assume all the responsibilities which they ought to assume.

In England, to which country Professor Ripley pointed, the situation is now fairly clearly defined by statute. I recognize, of course, that owing to the fact that incorporation is a state question it is not readily possible here to define audit standards by legislation, but a reference to the English statutes may at least be helpful as suggesting the objectives at which we ought to aim.

Under the English law the independent audit has for many years been compulsory, and the auditors share with the directors the responsibility for the accounts as published.

Auditors have been held liable for damages, and have even been subjected to criminal prosecution, for participation in the issue of false accounts. As a necessary corollary they have been given adequate powers. The language of the English companies' act is simple:

"Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors."

The following clause provides that the auditors shall make a report to the shareholders on every balance-sheet laid before a shareholders' meeting during their term of office and shall state whether or not they have obtained all the information and explanations they have required and whether the balance-sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs. It is made a misdemeanor to circulate a balance-sheet which has not been audited or which does not bear a copy of the auditor's report or a sufficient reference thereto.

Finally, the position of the auditor is strengthened by a provision that no auditor other than the retiring auditor shall be eligible for election at an annual meeting of shareholders unless due notice has been given in advance of the intention to nominate a new auditor, and this notice must be given to every shareholder and also to the retiring auditor. If, therefore, directors are disposed to seek new auditors because of differences of opinion with the existing auditors, ample opportunity is afforded for the shareholders to become informed of the merits of the case and act accordingly.

A government committee which recently reviewed the English company law in the light of developments during the last twenty years felt able to report:

"We are of the opinion that in general the law as it stands with regard to the powers and duties of auditors is satisfactory."

and also:

"Cases in which auditors fall below the level of their duty are few and far between."

Now, while it is doubtless impracticable to bring about through legislation in this country a development similar to that which has proved so satisfactory in England, I see no reason why this should not be done in a large measure through the coöperation of such bodies as the leading stock exchanges, the investment bankers and the commercial banks which grant credit, and I suggest that the Institute should endeavor to bring about coöperation to this end. Every member of the Institute, I believe, appreciates the value to its membership, to the banks and to the business of the country, of the coöperation with bankers in regard to credit statements which has been developed in recent years. I think the Institute should seek to extend such coöperation to the field

with which Professor Ripley's article deals. The New York stock exchange, for instance, could readily bring about through its listing agreements a situation as respects companies listed on its exchange similar to that which exists in England. In recent years the stock exchange has given various indications that it attaches constantly greater importance to the work of accountants and it has also shown a disposition to examine sympathetically any proposal which may tend to protect those who deal in the securities which it lists. It would, I think, therefore be receptive to a suggestion such as I have put forward.

As I have said, the accounts of a very large proportion of the industrial companies whose stocks are listed (and I limit for the present the suggestion to industrial companies and exclude railways, public utilities and other companies which are under some form of public supervision) are now audited; the public would welcome a clearer definition of the significance of such audits and of the responsibilities of auditors. Such clearer definition, though it might increase the accountant's obligation, would also in the long run be of advantage to the members of the profession and give them enhanced importance in the business world, just as it has done in England.

By similar coöperation, standards might be established for balance-sheets and income accounts which would be welcomed by many corporation executives and accountants who desire to be guided by the best practice, if they can be assured what that practice is.

As regards balance-sheets, the essential points are fairly well established and observed by the leading companies. A clear statement of the way in which the capital assets are valued is one requirement of an adequate disclosure which is not now generally observed, and there might be some discussion as to the form of statement of surplus. The object should be so to state the surplus as to indicate what part of it is legally available for dividend distributions and what part is not so available; but in the present state of the law, particularly in the case of companies with stock of no par value, this is not always easy, and it is impossible to lay down hard and fast rules.

The practice in regard to the income account is not so well established, and there is probably room for more difference of opinion as to what would constitute a proper disclosure. The difficulties arise largely from two facts which are not at all times

adequately appreciated. The first is, that the significance of an income account is two-fold: it shows what amounts have been earned and are available for distribution in dividends if the directors see fit to make the distribution. The income account of the past is also in a measure a guide to the expectations of income in the future. In many cases this second use is the more important because it is the reasonable expectation of yield in the future which determines the value of any property today. This economic truism, which incidentally makes much of the discussion of the values of capital assets from the standpoint of reproduction cost irrelevant and meaningless, should never be lost sight of or obscured.

The second difficulty is that the attribution of income to particular periods of time is at best in a large measure arbitrary and based on conventions. While we accountants recognize this fact more fully the longer we practise, it is by no means properly appreciated by the general public, and far too much significance is commonly attached to the figure of income for a particular year or other period.

Bearing in mind these two points, it seems to me that fairness in the presentation of an income account is even more important than fulness. Much of the information that is contained in more elaborate reports is no doubt interesting to stockholders and appeals to their sense of proprietorship, but is of little practical value to them. The vitally important requirements are that, if the profits of the year include extraordinary or extraneous profits which render the figures useless as a guide to earning capacity, these should be clearly disclosed; and, second, that where the accounts are based on any conventions other than those commonly accepted, that fact should also be clearly disclosed. I have in mind such departures from accepted convention as the valuing of inventories on a basis other than cost or market, or the failure to provide for depreciation or depletion. Probably discussion would arise as to whether the amount of depreciation provided should be shown separately; probably on the whole it should, although the precise amount set aside for depreciation or the amount expended for maintenance is of less real significance to a stockholder than the statement of a competent and disinterested person who is familiar with the details of the business that the amount provided or expended is in his judgment adequate for the purpose.

Undoubtedly there would be differences of opinion on the question whether gross sales should be disclosed. Viewing the matter solely from the standpoint of the stockholder it seems to me this is a question of expediency. Where the percentage of gross profit is high, the profit is apt to be regarded as unreasonable, although in judging its reasonableness many factors besides the percentage it bears to sales ought really to be taken into account. A packing company which can earn a fair return on its investment with a relatively small percentage of profit on a large turnover can very well afford to publish its sales and to point to the small percentage of profits with an expression of surprise at its own moderation. On the other hand, an agricultural-implement company with a large investment and a relatively small turnover might be merely inviting ill-informed criticism by a similar disclosure.

Undoubtedly many of the objections to fuller disclosure are based on unsubstantial grounds and would be cleared up by frank discussion. Many corporations, as Professor Ripley points out, disclose in their listing applications information which they do not give in their reports to their stockholders.

I have been able to touch only briefly tonight on some of the important phases of the question of publicity of corporation accounts; my main purpose is to urge that coöperation between interested bodies should do much to improve the existing situation and that the American Institute of Accountants might well take the initiative in an effort to bring about such coöperation. I think the Institute has reason to be proud of its accomplishments in the single decade of its existence, but I believe that there is here a field in which the Institute could do still greater service and in doing so could help its members to render a higher service to the community.