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Accounting Problems of Business: Proceedings, Wartime Accounting Conferences, State Societies of Certified Public Accountants

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ACCOUNTING PROBLEMS
OF
BUSINESS

PROCEEDINGS
WARTIME ACCOUNTING CONFERENCES
STATE SOCIETIES OF CERTIFIED PUBLIC ACCOUNTANTS

April, 1944

Accounting Problems of Business

The six addresses printed in this pamphlet were presented at a series of seven wartime accounting conferences held by state societies of certified public accountants or their chapters in April, 1944, with the coöperation of the American Institute of Accountants.

Sponsors, places, and dates of the conferences were as follows: Pittsburgh and Northwestern Chapters, Pennsylvania Institute of Certified Public Accountants, Pittsburgh, April 17th; Society of Louisiana Certified Public Accountants, New Orleans, April 20th; Texas Society of Certified Public Accountants, Houston, April 21st; Oklahoma Society of Certified Public Accountants, Tulsa, April 24th; Missouri Society of Certified Public Accountants, Kansas City, April 25th; Nebraska Society of Certified Public Accountants, Omaha, April 26th; Minnesota Society of Certified Public Accountants and the University of Minnesota, Minneapolis, April 27th and 28th.

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The Post-Victory Challenge

BY VICTOR H. STEMPF

Immediate consideration of the most critical problems certain to confront business and the government in effecting an orderly transition to civilian production, this article contends, would eliminate much confusion and stimulate the war effort. Businessmen, accountants, and legislators are urged to participate now in practical postwar planning. Stability and survival of free enterprise after the war depends upon cooperation between Congress and the business community. The text was originally presented as one of several addresses at a recent series of Wartime Accounting Conferences conducted by seven state societies of certified public accountants or their chapters, in cooperation with the American Institute of Accountants. The author is president of the American Institute and a partner of Touche, Niven & Co., New York.

The Challenge

THE dawn of victory carries a challenge to the citizens of our country to plan the resumption of peacetime pursuits and production with a minimum of confusion and a maximum of courage, cooperation, and competence.

The challenge of the war effort found us willing and able beyond all expectations. The zeal of that effort must continue unabated. The foe must be crushed to enable our armies to return home safely to help in winning the peace.

Plan Now

However, while keeping the tools of war moving to the front, we must safeguard the stability and survival of free enterprise. It is to that end that the war is being fought. Life, liberty, and the pursuit of happiness must be quickened by freedom of opportunity. A maximum war effort is essential, but it is folly not to plan now to hold fast our way of life.

Priority for Business

And in our way of life, business has a prime part. Nearly everything in our social

and economic pattern, aimed at improving the common lot and making life for all more attractive, stems from business. Business provides the employment, plans, methods, and products which yield the payrolls which buy things and pay taxes. Business is the people. Prime priority must be given to the needs of the people, which is another way of saying that high priority must be given to the needs of business.

Too often, business has been spoken and thought of, in terms of an odious class of owners. It is high time to remind ourselves that business comprises widespread stockholders, technicians employed as managers, skilled and unskilled workers, consumers, and creditors; all of whom, as integrated groups, provide vigilant checks and balances.

The Rôle of Business

Jobs in private industry will be the barometer of postwar prosperity. The objective of high levels of employment and productivity contemplates approximately fifty-five million workers and \$125 billion of output.

Before the war, in 1940, there were forty-six million civilian jobs with a record output of \$97 billion, which has been increased by 30 per cent to 45 per cent during the war, but there were from six to nine million competent individuals unemployed. The additions to these forces during the war, after making allowance for enlarged postwar Army and Navy needs, lead to estimates of some seven to ten million new peacetime jobs in industry and commerce combined, if we are to have a satisfactory employment situation.

These postwar jobs must be productive and well paid. Attention must be focused on high output. We must not be misled by the false Utopia of shorter hours such as that proposed in Congressman Klein's bill advocating a thirty-hour week to aid in stabilization. Only by producing more wealth can we improve the common lot.

Philip Murray in a recent speech before the Economic Club said:

"When the war ends, hours will be reduced by some amount, possibly to a national working average of less than forty per week. But we must avoid the concealed unemployment that hides behind short hours and means only a sharing of misery."

The future of private enterprise in the United States depends upon its ability to meet this stupendous task. Inevitably, if private enterprise fails to provide sufficient jobs at satisfactory living standards, government will have to assume the task.

Vital steps in the orderly resumption of civilian enterprise will include the demobilization of the armed forces, the transfer of some twenty million workers from war work to civilian occupations, the settlement of canceled war contracts, the disposal and conversion of war inventories, and the reconversion of war plants to peacetime production.

Carrying through this tremendous program will entail a sharp decline in the production index while the transition occurs.

Fortunately, it is estimated that we shall have at the end of the war an accumulated demand for civilian goods equal to two and one-half years' normal business. This demand, coupled with the reconversion and retooling of plants, and the great unfilled need for housing, afford the base for a "well rounded and self-sustained prosperity." We are reminded repeatedly, also, of the enlarged modern facilities of production created during the war in the fields of plastics, synthetic fibers, nitrates, scores of chemicals, aluminum, magnesium, and other basic materials. All of these will be used in new types of cars, planes, refrigerators, houses, furniture, and other needs for which the domestic and foreign demand will be enormous.

The Matured Economy Specter

How does all this reconcile with the scarecrow of a "matured economy"? The mere thought paralyzed many in the period which immediately preceded the expansion of production induced by the war.

The high lights adduced by Dr. Hansen,

Stuart Chase, and their cohorts before the TNEC and elsewhere in support of this dismal, defeatist theory were the disappearance of our frontiers, decline in growth of population, and highly advanced technology which these advocates say preclude new "bellwether" inventions comparable in importance with the railroad, electric power, or automobile. Absence of these important factors, we were told, had dried up the opportunities for private investment, which would be confined in the future to mere replacement of existing facilities of production.

Certain distinguished industrialists may now blush to recall how they were beguiled into supporting this theory, with testimony to the effect that their companies had attained a degree of financial independence obviating recourse to public financing for any expansion requirements. How many of these large corporations have gotten along without large commercial or government loans, or other financing, to carry the burden of accelerated war production?

These men testified that, in large measure, this financial independence had been attained by the vast cushion of depreciation reserves established by their corporations. Obviously, such reserves should provide resources for replacement of exhausted facilities; but extensions of plant are not contemplated in depreciation theory or practice, by any stretch of the imagination.

At a meeting of the Illinois Manufacturers Association in April, 1940, in commenting on Chase's article in *Harper's Magazine* of February, 1940, I urged that the sponsors of the matured-economy theory ignored the fact that new enterprise has provided the fertile field for employment of new savings throughout the growth of this country, and that these defeatists scorn the concept of unlimited technological frontiers. I said at the time that these assumptions were preposterous emanations of social and economic hysteria, as incredible as the dream of an era of idle abundance which had popular acceptance in the roaring twenties, but at the opposite extreme.

The old misconception of technological

unemployment is showing its ugly face again. We are urged to restrain the introduction of technological advances made during the war to avoid mass unemployment. It has been demonstrated often that only by rapid application of new technology can we bring into full effect better merchandise at better prices. Great effort and patience should be devoted to dispelling this ruinous philosophy.

True enough, technology does, inevitably, cause employment dislocation while the shift is in progress, but it has never failed to enlarge greatly the field of fruitful employment. One need only cite the automotive industry and all of its satellites to demonstrate the point.

Dr. George Terborgh dealt with the specter of a matured economy at the Industrial Conference Board in November, 1943, with devastating dispatch. He pointed out that there is no historical evidence that decline of population growth brings stagnation. He said that the relative increase in population began to fall off shortly after the middle of the last century and had been reduced by more than half before 1929, but that the first three decades of the twentieth century showed a more dynamic and sustained prosperity than the last three decades of the nineteenth century.

Dr. Terborgh reminded his audience that our western frontiers vanished fifty years ago, but that the first third of this century showed about the same ratio of private-capital formation to national income as the last third of the previous century.

Admitting that the railroad, electricity, and the automobile had stimulated investment in large measure, he pointed out that even in their respective ascendancy, these were dwarfed by the single industry of building construction; one of the most ancient of all outlets of capital. In the decade of the twenties all of these bellwether industries contributed less than 20 per cent of the total capital formation of the country.

Dr. Terborgh concluded that:

“If private investment together with normal public investment fails to support

a satisfactory level of production and employment in the postwar economy, it will not be because of a matured economy. Indeed, the situation is so favorable for a boom after the inevitable transition period that many are more worried about how to control it than about a depression.”

Postwar Planning

Now it is self-evident that if business is to have a clear road for the enlargement of postwar production, sales, and employment, it must be ready for its opportunity.

Some of the leading industrial corporations have established planning divisions to prepare for the postwar period. Many trade associations and the larger business associations have formed postwar planning committees, and organizations such as the Committee for Economic Development, the National Planning Association, and other foundations have been formed specifically to deal with the subject.

It is most desirable, highly necessary indeed, that business and professional men should become identified with one of these groups to familiarize themselves with the theories and policies advocated.

The Committee for Economic Development has devoted itself: (1) to research which may aid business in postwar planning; (2) to determine what public policies may create favorable environment for private business; (3) to stimulate planning activities of separate companies, trade associations, and communities; and (4) to serve as a liaison for the exchange of information among such groups in such a way as to disseminate information and integrate ideas as effectively as possible.

In the middle of last February, delegates of sixteen of the strongest nationwide business, labor, and farm groups (including the National Association of Manufacturers, the American Federation of Labor, and the Congress of Industrial Organizations) met in Atlantic City, and adopted a unanimous statement of policy which recognized joint responsibility not only for continued war production but also for coöperation to preserve the American system of democracy. This body agreed on the following postwar objectives:

An economy of plenty instead of scarcity;
 An opportunity for people to have jobs and increasingly better living standards and educational advantages;
 An opportunity for people to save and invest;
 Avoidance of mass unemployment, ruinous farm prices, violent ups and downs in business, monopolistic practices in any field; avoidance also of socialization of business and a government-planned economy.

Discussing the Baruch report on postwar planning, the delegates reached unanimous and emphatic agreement that the national economy must be restored to self-control by voluntary coöperation of its major economic groups as speedily as practicable.

Speed in the reconversion of industry from war to peace and in the relaxation of government controls was declared to be absolutely necessary to avert mass unemployment and economic chaos.

Pressing Problems of the Transition

The most pressing problems confronting both government and business in respect of the transition from war to civilian production relate to termination settlements and disposal of war inventories and facilities. This is neither the time nor place to analyze these problems thoroughly, but it may be said that the key to their solution lies in prompt legislation to implement the Baruch-Hancock report, which has broad general support.

While there are several bills pending, the so-called Industrial Demobilization Act of 1944 (S-1730) sponsored by Senators George and Murray comes closest to serving that end. This bill and the Baruch report stress the importance of the retention of private enterprise and the orderly withdrawal of emergency powers in the postwar period.

The most striking difference between the two is the fact that the Senate bill vests control and surveillance in Congress, where it belongs, while the Baruch report sponsors continued authority in the Office of War Mobilization, which would further entrench the power of executive agencies.

Whereas the Senate bill proposes a separate Director of Demobilization, the Baruch report would retain in the Joint Contract Termination Board the duty of unifying and simplifying procedure, and of controlling regulations, instructions, and interpretations.

The crying need for a disposal policy is clearly recognized in the Baruch-Hancock report, which says:

"Move out and store war materials from plants so as to make room for equipment and materials for civilian production. Centralize the control and disposal of surpluses of all types in such a way as to bring them into ready and effective use and insure orderly markets."

The report recommends a plan which seems to assure a sane and practicable policy, which could become operative by directive through the Office of War Mobilization; but it is certain that procurement officers would prefer specific enabling legislation to relieve them of present personal liability under existing statute. Such legislation is imperatively needed to assure simple and expeditious handling of all termination and disposal problems.

Government policies on certain phases of termination have been made operative by Presidential Executive Orders based upon Baruch-Hancock recommendations, subject to such changes as Congress may determine. Meanwhile there is forming in WPB another reconversion program which it seems will call for an intergovernmental committee to steer the transition, through the Board's industry advisory committees.

Contrary to the belief in some quarters that mere contemplation of postwar considerations has had an unfavorable effect upon war production, it is more logical to assume that the slow-down is due to the confusion and delay in fixing the rules of termination and disposal by specific legislation. Neither industry nor the procurement agencies are content to rely upon directives under the Emergency War Powers. Both would prefer specific Congressional action. Both the war effort and postwar planning would be aided immeasurably by prompt legislative action.

As late as April 4th, the George com-

mittee had given up hope of prompt presentation of its omnibus bill, and had decided to trim it down to specific termination provisions and some sections dealing with disposal of surplus war material. The question of the Comptroller General's hand in terminations is still crucial and by no means settled; it pops up repeatedly. Both the House Military Affairs Committee and the House Naval Affairs Committee are said to be willing to concede some power to the General Accounting Office.

Washington characterizes this dispute by two opposing slogans:

- (1) Unemployment by audit, and
- (2) Sell out government and taxpayer by haste.

The position of the American Institute of Accountants on this matter remains firm. Speed in settlement is paramount. Senator Murray's war-contract subcommittee of the Senate Military Affairs Committee asserts an intention of not permitting audit by the Comptroller General to slow down termination settlements.

Inflation

Among the uncertainties harassing business, the bugaboo of inflation looms large. Industry has been able to absorb higher wages granted since the inception of the stabilization program by reason of operations far in excess of normal capacity, but added pressure will inevitably break present OPA ceilings. Added buying power brought about by further wage increases will stimulate effective market demand which will in turn add more pressure upon prices and price-control mechanism.

Continuance of price control and rationing, at least through the war period, seems essential. In fact, such continuance has been advocated by many responsible groups (including the American Bankers Association) as necessary factors in the anti-inflation program.

Coöperative Planning

Business must not only be ready with its postwar plans, but it must recognize the obligation to think in terms of the in-

terests of all business, including the workers, in carrying out its plans.

It must continue to operate, as enlightened business has always done, with an eye to the public interest. It must so order its house as to forestall and discourage undue government regulation, interference, or control. Its understanding, and solution of economic problems must continue to be superior to that of government; and it must retain its demonstrated superiority in the efficient administration of business projects.

Certain government agencies should be of great help to business in planning the return to high levels of civilian employment and output.

It will be unrealistic for business to accept the responsibility for postwar recovery without the full coöperation of government. Essentially, no other factor will do more to restore public confidence than constructive collaboration between government and business.

Business must not surrender to bureaucracy its inalienable right to pursue its own legitimate plans for employment, research, design, production, and marketing. But it will gain nothing by an attitude of distrust and obstruction toward government agencies.

Likewise, government will inflict a dangerous obstacle to sound recovery, if such agencies as remain in operation adopt an attitude of suspicion, or seek arbitrary control of business.

Both government and business must do their full share toward recovery.

Taxation

Coming now to the matter of taxation, it should be borne in mind that sound planning and budgeting are the pillars of orderly business conduct. Unnecessary complexity and uncertainty are anathema in a business world where avoidable impediments should not be permitted to hamper the resumption of private enterprise. Burdensome and confusing federal tax laws are intolerable in an economy harassed by many other crucial problems. The need for tax reform and simplification is universally recognized.

Recent attention of the House Ways and Means Committee has focused upon the simplification of individual income-tax computations and returns, simplification of administrative regulations and policies, and revision of specific statutory provisions. Such tinkering has bred the interminable change in form and incidence of taxation which have confounded confusion since the inception of the act.

A thorough and complete overhauling is needed to establish long-range bases of taxation whereunder rates only shall be changed from time to time to meet the needs of the Treasury.

Emphasis upon the long-range redesign of the federal tax system, as distinguished from partial, piecemeal patchwork, has been fostered for many years by the American Institute of Accountants. Once more, last October, the Institute adopted a resolution calling for the establishment of a non-partisan tax commission to write a simple law that would express a permanent and consistent policy of federal taxation.

Bills that have been introduced by Representatives Carlson, Forand, and Knutson serve this desired objective. Perhaps no one of the three is perfect. The bill to be enacted, ultimately, should distill the best from each of them. The need to delegate the task to an outside body of experts rests upon the highly specialized technical nature and scope of the project. Congressional leaders are chosen to determine broad tax policy; they cannot be expected to devote themselves to intensive tax research.

The existing tax system is the product of haphazard growth in the midst of an expanding and widely diversified economy. No adequate evaluation of both direct and indirect social and economic consequences has been made before enactment of tax laws. It is only natural, therefore, that the tax laws frequently have been poorly integrated.

The rationale of various concepts and forms of taxation, and their impact upon our economy must be reviewed. The correlation of income, estate, and gift taxes, as well as a study of the rôle which the

corporate income tax, if any, should play in the postwar economy to encourage venture capital, are examples of the broad problems to be sifted.

Relief provisions for exceptional situations, plugging loopholes, and many other factors concerning maximum equity and protection of the revenue are in constant competition with objectives of simplicity. These must be carefully weighed to design a practical policy.

Clearly, this is not an overnight job. The most logical solution is the establishment of an independent group of experts to make a completely objective and deliberate study of the tax law, and to recommend to Congress the enactment of a simplified, orderly, and consistent tax structure, properly integrated with post-war fiscal policy.

It is highly important that this study be begun at once as part of our effective post-war-planning program.

The Part of Congress

Congress must take the helm, to bring us through the tempest of the transition from war to peace and to set us on the proper course for the post-victory resumption of the normal American way of life.

Congress has passed many emergency measures imposing artificial and arbitrary controls. These have been commendable and indeed essential to divert and concentrate the national resources and vigor into an all-out war effort.

In seeking a way to implement these measures, Congress has, in addition, delegated its authority on a wholesale basis to bureaus, commissions, and agencies empowered to supplement the enabling acts with rules, regulations, and directives which run into tens of thousands of pages.

This legislation extended trends toward administrative law which were evident in the immediate prewar years. However, there is encouraging evidence that Congress recognizes the fallacy of this abdication, and that it is intent upon resuming its constitutional prerogatives.

Congress recognizes the present temper of the people, and is eager again to take the lead, as is right and proper. As the

elected representatives of the people, Congress should be the first to express the will of the people. When the emergency ceases, when the excuse and reason for these burdensome administrative laws and bureaus no longer exist, Congress should step forward to help the people, by promptly repealing every law enacted solely for the purpose of implementing the war effort, because such repeal will foster the normal means of support of business in its broadest sense.

Congress already senses its opportunity and realizes its obligation to give us better and better government at lower and lower cost. Obviously, this purge cannot be effected in one fell swoop; the limited retention of some of these measures may be advisable to supplement legislation dealing with termination of war contracts, disposal of war materials and facilities, and other demobilization measures, which will be helpful to both government and business in working together for sound postwar recovery.

The program must be balanced to assure an orderly transition of industry, but there must be a constant constriction and ultimate eradication of these emergency measures. It would help immeasurably in raising the public morale, as it relates to the future, if Congress were to adopt a resolution expressing such intent, listing the laws and bureaus which it recognizes must be eliminated as quickly as may be practicable when peace returns.

Business and government have demonstrated during the war that they can work together to the last degree of effort when the nation is in danger. If either fails to see the need for continued cooperation and mutual trust in the postvictory period, then too the nation will be in danger; not from the attack of an armed enemy, but as a consequence of badly planned efforts to solve our economic problems.

Congress should heed the advice of business as to the laws and bureaus needed to hasten postwar recovery, and as to the timing and sequence of the elimination of the burdensome and obstructive agencies.

Business leaders and leaders of our profession who have lived with this regimen-

tation are capable of soundly interpreting the nation's needs in this respect. Certified public accountants have contributed much toward the simplification and workability of the interwoven pattern of many of these measures; it will make an equally valuable contribution to the unraveling process.

Basically, the trends administrative law, whereunder agencies make the rules, administer them, and then presume to act as prosecutor, judge, and jury, affront American concepts of government, and Congress should devote itself to the restoration of our constitutional system of justice under law, and adjudication of our rights before duly constituted courts.

Renegotiation is scheduled for extinction within six months of December 31, 1944. The repricing provisions of Title VIII of the Revenue Act of 1943 should go with it. Priorities will probably have to stay during the transition to assure an orderly flow of critical materials and the resumption of civilian activities to expedite high employment. The same is true of price control and rationing. These too must go as soon as their repeal is justified by a reasonable balance of supply and demand. Wage stabilization and salary limitations should be removed promptly. Congress must restore to business, at the earliest moment, the right to honest salary and profit incentives. While social security will doubtless be retained, and perhaps broadened, it is highly desirable that rates should be so amended as to assure that the effect upon fiscal policy of the nation will be neutralized. Income taxation, obviously, must undergo radical revision.

The profession of accountancy should exert its full influence to encourage Congress to pursue diligently such a program to implement the orderly resumption of civilian enterprise.

Conclusion

The present keen interest in reconversion of our industrial resources to peacetime production must not overshadow the prime necessity for sustained war production; especially in view of the accepted estimate that even the collapse of Ger-

many will enable a production cut of not more than 30 per cent.

The people look to Congress for leadership in bringing the nation successfully into a period of postwar recovery. Congress should help and heed the advice of business in planning for the future. Business has met the challenge of war magnificently. It deserves the full respect and confidence of government.

Concerted thought must find prompt fruition in constructive action by both government and business to solve the problems of the transition and postvictory resumption of civilian enterprise. Government and business must work together in a sincere spirit of coöperation.

Congress should remove, as promptly as may be practicable, from the path of business, all measures passed solely to establish war controls, which are not needed in the postvictory resumption of free enterprise production and employment.

As an imperative aid to business, Congress should extend its present leadership, in simplifying federal taxes for the individual taxpayer, by a thorough overhauling of the entire permanent tax structure.

When "V" day comes, get government out of business as promptly as may be practicable, and turn back to business the orderly resumption of peacetime commerce and industry. Our profession will lend its wholehearted support.

The Accountant and War Contract Termination

BY GEORGE D. BAILEY

Responsibilities of independent public accountants to their clients—whether prime or subcontractors—and to government procurement agencies, in the presentation of termination claims and the settlement of terminated contracts, are described in this article. The author, a vice president of the American Institute of Accountants and chairman of its committee on termination of war contracts, is a partner of Ernst & Ernst, in Detroit. The text was originally presented at a series of wartime accounting conferences recently sponsored by several state societies of certified public accountants or their chapters in cooperation with the American Institute of Accountants.

have come to depend upon small plants for many of the component parts of their product and small plants have come to depend upon large companies for an important part of their business. Until the key plants and the key industries are ready to function, the small plants and other industries cannot function. Thus, all business is going to be affected by the termination procedures which are finally selected.

While the conversion of industry from wartime to peacetime is primarily a physical problem of inventories, machinery, and buildings, and of clearing out the material and machinery that new machinery and materials can be put in, this is all inextricably woven into the problem of the termination claims, for, unless claims can be settled with finality, machinery cannot be moved, inventory cannot be disposed of, leases cannot be canceled, nor can those things be done that are necessary to close up one activity and get into another. The crux of this is in the quick preparation of termination claims and the quick settlement thereof by the government.

Since the problems of termination are not solely those of the large companies in the large war centers, it is equally true that the impact of those problems on accountants will not be merely on the accountants of the large cities or for the large war plants. The impact will be equally strong on the accountants in any section which has participated in the manufacture of war articles being purchased by the government and subject to cancellation as the needs of the war decline.

It is impossible in any single presentation to deal with all phases of termination. I am going to restrict my remarks to those phases which I think are of the greatest importance to the accounting profession. I will deal mostly with the problem of termination claims, and only *some* phases of that problem.

First, let us look at the probable extent of the accountant's participation in the preparation of claims. It is already ap-

WE ARE hearing a great deal these days about the problems of war-contract termination. The subject is a very important one, because the speed with which industry can be put back to peacetime tasks as war contracts are canceled or terminated may well be the controlling factor in the maintenance of the American system of free enterprise. All over the country, manufacturing establishments have changed their activities from peacetime products to war products, and in a very large number of cases this transition required many changes in machinery and buildings and tools. In many others the peacetime equipment and machinery had to be ruthlessly removed to make room for the equipment required by the new contracts. For a large number of plants, the mere problem of reconversion to the needs of a peacetime product will require many weeks. During this period there will inevitably be a substantial amount of unemployment so that the country dare not extend unnecessarily by one single day the time required to make plant reconversions.

This problem is not one for the large plants alone. Industry has developed into a large number of interdependent units, some large and some small. Large plants

parent that the independent public accountant's reports will not be accepted by the government as final and conclusive evidence of the proper amount of the claim, nor would this be advisable. A claim will include a great many items in which judgment is involved, many of them not related to accounting. There may be large factors in each claim which just do not lend themselves to conclusive accounting answers. Further, it has never been the policy of the government to permit its various agencies to delegate to any non-government person the complete responsibility for the determination of an amount to be paid by the government. As to companies having direct contracts with the government (the prime contractors), various government procurement agencies may be expected to check the claims in substantial detail and perhaps to have resident representatives. In these cases the public accountant can undoubtedly be most useful in the field of advising his client as to the proper ways of preparing for terminations and as to the proper manner in which a claim should be prepared, though often, while he will not render a report, he will be called on to assist the client in the preparation of the claim. With respect to subcontractors, however, the activity of the independent public accountant may be expected to be somewhat greater. Many prime contractors will have the responsibility of settling with their subcontractors, and this is bound to mean a certain amount of checking of the subcontractor by the prime contractor. Prime contractors will not often be equipped with organization and personnel to carry out such checking, and the public accountant may have to assist. Also, it may be that, in many cases, the subcontractor will want to file his claim with the prime contractor accompanied by the report of an independent accountant. All in all, the public accountant is likely to have a considerable part in termination procedures, and, if he does his work well, he can contribute to the speed with which the conversion can be made from war manufacturing to peacetime activity. It may look difficult now for accountants to

take on any new responsibilities, but there is no alternative.

The public accountant, however, will be of assistance in the termination field only if his work is well done, and only if he has a thorough knowledge of the requirements of the government. If his participation in termination claims does not have the result of providing for full disclosure of the policies that are followed and of bringing about a reasonably accurate statement of the claim when it is filed, then he will have failed in his participation. This is a very serious point. It is an unfortunate fact that termination claims submitted to date have been reduced by the government on the average around 30 per cent. I think a great deal of this difference is due to the fact that the ground rules were not thoroughly understood, either by the contractor or by the government, and that the government had not been able to educate the contractors in advance of the filing of the claims. Some of it has been due to the fact that in such an area of doubt as often existed, contractors claimed the higher side of that doubtful area. Much has been due to the fact that in many cases there was no knowledge of recognized accounting practices or any attempt to bring the company's practices into line with sound principles. Some of it, too, has been due to failure to read—let alone failure to understand—the instructions that were easily available. Most of the errors are of a kind that would have been prevented by study, by knowledge, by objectivity of viewpoint, and, as to the independent public accountant, by increased emphasis on independence.

This is not the place to explain the requirements of the government with respect to termination claims. This information can come only the hard way—by the individual study of the rules and instructions issued by the government and of the many articles written in explanation of those documents. The most important documents today are the Procurement Regulation No. 15, issued by the War Department, the Termination Accounting Manual from the same department, and the Baruch-Hancock report, published

issues of which contain the Uniform Termination Clause to be included in contracts, and the Statement of Principles for Determination of Costs upon Termination of Government Fixed Price Contracts approved by the Joint Contract Termination Board on December 31, 1943. Procurement Regulation No. 15 have already been amended and undoubtedly will be further revised. The Statement of Costs was issued with the understanding that it would be supplemented by other cost interpretations to be issued from time to time and perhaps by certain general discussions which could serve as criteria for use in the settlement of other questions.

Most independent certified public accountants have received the letter sent out by Victor H. Stempf, president of the American Institute of Accountants, on April 5, 1944, dealing with the participation of public accountants in war-contract termination and stressing the need for the assumption of proper responsibility by the accounting profession. This is one of the most important letters ever sent out by the Institute, and it deserves careful study.

The scope and the nature of the report of an independent public accountant in connection with termination claims is well discussed in a recent bulletin of the committee on auditing procedure of the American Institute of Accountants and it, too, should be carefully studied. This is no time to review it in detail, but there is one phase of it that can well have special discussion. The help which the independent public accountant can give to the contractor and to the governmental agencies depends to a large extent upon whether the agencies get the kind of information they want and get it promptly. The needs of a procurement agency are likely to vary with individual cases. Sometimes the government has already satisfied itself as to the reliability of the internal controls, and wants only a specific check of certain items. In other cases it will want emphasis on the allocation of costs. In some cases it will have made certain checks itself that need not be repeated. I recommend most strongly that an independent public accountant undertaking a termination en-

agement should first confer with the contractor and the government agency interested and find out just what kind of an examination will be helpful.

One of the great services that the independent public accountant can render his client is to impress upon him the necessity for advance planning for preparation of termination claims. This is a broad field in itself. It requires a thorough knowledge of the regulations and study as to where the company's normal procedures will not provide the information which will be required. Specifically, there can be an examination of the company's cost accounting to see whether it provides sufficiently accurate information for termination needs. The company should make plans so that inventories of material can be listed immediately upon termination, and make sure that inventory cards and sheets will be available and in adequate detail. It may be possible, in addition, to arrange in advance with the government on many other points.

Determination of Costs

Let us move now to the problem which is perhaps of greatest interest to us as accountants—the determination of costs. The Statement of Principles of Determination of Costs upon Termination of Government Fixed Price Contracts approved by the Joint Contract Termination Board on December 31, 1943, appears to be acceptable to all departments and to Congress, and can be expected to continue in force.

The basic principle, of course, is the allowance of costs that are applicable to the contract in question. This, however, is not to be interpreted in the same rigid way as has been customary for cost-plus-fixed-fee contracts, but rather as the allowance of general business expenses, which probably means those expenses necessary to running a business that is carrying out war contracts. This contemplates, of course, the allowance of all direct items and specifically necessary indirect items, and provides also for other specific items in reasonable amounts in the light of prewar practice. This is particularly true of insti-

tutional advertising and research and engineering expenses, and undoubtedly will apply also to other items of like character.

Costs are to be computed generally in accordance with the system of accounting regularly employed by the company, provided that such system of accounting is in accordance with sound accounting practice or to the extent that it conforms to recognized commercial accounting practices. It seems to me that the general effect of this is to require that the cost and accounting practices of the individual contractor must be tested against generally recognized practices and that they must be tested against and be in conformity with sound cost accounting principles. This test is particularly important because cost systems generally have been devised for a peacetime product and to provide information for the management but have not been concerned with providing information for outsiders. They customarily have not dealt with all the costs that will be allowable upon termination. In many cases they did not need to be accurate in the allocation of costs between departments or between products. In other cases standard costs were not customarily tested against actual costs, nor were the standards set on a basis of the total anticipated costs. All this means that the cost accounting system of the contractor will have to be examined from the standpoint of whether it does result in a determination of the total cost and whether the allocations of joint costs are made upon a basis which would be approved by a group of trained cost accountants with an objective approach.

It is essential that there be uniform cost interpretations issued on behalf of the settlement services. Fortunately, there is a subcommittee of the Joint Contract Termination Board to deal with this subject. It is under the chairmanship of a certified public accountant, Commander J. Harold Stewart, of the Navy, and is made up of men with a sound knowledge of cost and general accounting. It is a part of the procedures that this committee will issue, from time to time, individual cost inter-

pretations on points that are causing the greatest difficulty.

Allowable and Unallowable Costs

I shall not attempt to discuss in detail allowable or unallowable costs as they have been set forth in the Statement of Principles or as they have been indicated by the Termination Accounting Manual and other available data. But there are a few points I should like to bring out. One of the most troublesome will undoubtedly be the prohibition against including as part of the termination claim expenses that have already been considered in connection with a previous settlement under the Renegotiation Act and have had the effect of changing the amount that would otherwise have been refundable. In those cases it is the position of the government that the costs should not again be allowed as part of a termination claim. This seems to mean that the termination claim can deal with expenses of a prior year, such as overhead or high starting-load costs, only to the extent that for purposes of renegotiation they have been carried forward as assets or deferred charges at the beginning of the current fiscal period. This is going to be a very difficult requirement to handle, but in general theory it cannot be objected to.

Again, the expenses after the date of termination that will be allowed must comply strictly with the provisions of the regulations. For instance, the fact that a company's plant will be left idle and that fixed charges and overhead will not be absorbed during the time it would have taken to finish the contract is not a justification for inclusion of such expenses in the claim. It is obvious, also, that there will be a strict test of allowability on abnormal or unusual elements of cost or expense sought to be included in a claim.

It is not generally understood that claims for obsolescence on special equipment rendered useless by the termination of the contract will not be allowed unless the property involved is turned over to the government. This again is a very complex and difficult problem and may not yet be

finally settled, but some such provision is quite likely to remain.

With respect to profit, it looks very much as if the final practice would be that of the Standard Termination Article, which provides for a reasonable profit but provides also for a ceiling of 2 per cent on unworked materials, 8 per cent on processed materials, but with an over-all limitation of 6 per cent though with full profit on completed articles ready for delivery.

Termination claims are not excluded from renegotiation. With the limitation on profits provided by the Uniform Termination Clause it is not probable that profits will be further reduced in renegotiation, but the certainty of renegotiation where such certainty does exist may save many disputes between the contractor and the government. Accordingly, it is probable that the renegotiation boards and the termination agencies will work very closely together. It is not yet clear how the renegotiation boards will treat termination claims if the profit allowed thereon is less than the profit being allowed in other over-all renegotiation. It would seem that all government business should be treated together and that low-profit contracts should be grouped with high-profit contracts, but it may well be that the renegotiation boards will in effect segregate termination claims.

The General Accounting Office

I started this discussion by referring to the necessity for speed in the settlement of termination claims. This fact has been in the forefront of all administrative and legislative discussions on the subject. It was early realized that if each claim were to be settled entirely on the basis of a formula it would open the door to endless arguments on accounting as well as on many other items. Formula settlements have always been subject to review by the Comptroller General of the United States and his General Accounting Office and the settlement procedures under a formula would take on the nature of litigation on each complicated claim, if, indeed, there was not actual litigation on most of them in the courts.

Thus there developed the negotiated settlement, as an agreement between the contractor and the procurement agency. Unfortunately, the idea grew up that this negotiated amount was arrived at or would be arrived at by agreement between two persons in a smoke-filled room, and that there would be no supporting data for such a settlement other than a single sheet showing the revised contract price, a copy of which would be filed with the General Accounting Office. This was the basis of the controversy as to whether the procurement agencies should be allowed to make settlements that would be final and binding in the absence of fraud, or whether all such settlements should be subject to review by the General Accounting Office before they became final. Business and the procurement agencies knew that such a procedure would make it extremely difficult to come to a preliminary agreement with the contracting agencies, would tremendously delay settlements, and would result in termination by formula rather than by negotiation. In the course of this controversy, it has been interesting to note that those people who have had the best opportunity of study of the procedures of the procurement agencies and who have been most familiar with the problem have come to the conclusion that the Comptroller General should not be given final authority or should not be permitted to participate in the determination. This is borne out best, I think, by the report of the House Committee on Military Affairs where the subcommittee which went through the country talking with manufacturers and seeing the work of the procurement agencies were the members of the committee who felt the Comptroller General should not participate, while those other members who stayed at home appear to have voted in favor of giving authority to him. There is a reason for this. It is only by visiting the field offices of the procurement agencies and seeing just how careful they are in their termination investigations that there can come a realization of the fact that even the negotiated settlement is supported by a large file of reports, of in-

vestigations, of audits, of inventories, of market studies, to mention but a few. As a whole, it has been my impression that the procurement agencies are making too much rather than too little investigation and that the continuation of present practices may slow up settlements when terminations become acute.

The problem of the participation of the Comptroller General in termination procedures is very much alive. The House Military Affairs Committee has rendered a report to the House giving final authority to that office. The matter is by no means settled in the Murray committee. The House Naval Affairs Committee has just decided that the General Accounting Office must check to some extent.

The problem of the participation of the Comptroller General is very much alive at this time, but it will undoubtedly be settled by Congress within a short time. Let us hope it is along the lines recommended by the American Institute of Accountants and provided by the Murray-George bill in the Senate. The Institute has taken the position, and has recommended to Congress and to the Services, that the Comptroller General and his General Accounting Office function in much the same manner as does the independent public accountant in his normal auditing practice. The independent public accountant has no authority in administrative matters, has no authority to disallow payments, makes no preaudit, but does make postaudits of procedures and policies and decisions by sampling and testing to the extent deemed appropriate in relation to the internal controls and the procedures being followed, and renders reports on his findings to the directors and stockholders. So can the Comptroller General act, having free access to the records of termination settlements after they are made for the purpose of examining for

fraud, for checking the adequacy, the procedures, and whether they are being carefully followed, and report thereon to Congress. Then, if the Comptroller General does his work well, Congress can be promptly and adequately advised and can take steps to pass remedial legislation, if any be needed.

We accountants know how effective has been that general procedure in our own experience over many years. The Institute's committee feels that it will be extremely effective in these termination procedures. Of course, it will not prevent all waste, carelessness, inefficiency, or fraud; but, if the Comptroller General does his job, it will bring to light at an early date insufficient procedures, inadequate investigations, careless and wasteful methods, if such there be, so that Congress if it sees fit can tighten the procedures or shift the responsibility for settlements.

Much of the whole question of termination claims is accounting and auditing. The public accounting profession has been called upon to give its opinion on many points during the formulation of policies and legislation. In addition, it has promised to the procurement agencies that it will do its utmost to assist contractors and the government in the prompt settlement of claims. Individual accountants can do this only as they have knowledge of the requirements and only as they are completely objective and realistic in their recommendations to their clients and in the preparation of reports. If it develops as time goes on that the participation of public accountants has the effect of making accurate the claims that are filed or of reducing the percentage of disallowance to a nominal amount, then the public accounting profession will be used more and more frequently and will be of greater and greater help in the prompt settlement of termination claims.

Accounting Problems of the Small Business

By J. A. PHILLIPS

Recognizing the dependence of our entire economy upon the stability and prosperity of small business, this article emphasizes the responsibility of independent public accountants to assist small businessmen in the solution of technical accounting problems, many of which have become more complex as a result of the war. The text was originally presented as one of several addresses at a recent series of Wartime Accounting Conferences conducted by seven state societies of certified public accountants or their chapters, in cooperation with the American Institute of Accountants. The author is a vice-president of the American Institute, a member of its committee on federal taxation, and a partner of J. A. Phillips Company, Houston, Texas.

good of the entire economy." (*Domestic Commerce* issued by the Department of Commerce.)

On March 30, 1944, the committee on special problems of small business of the Committee for Economic Development released a statement dealing with small business after the war. This statement contained the following interesting data:

- A. There are about 2,000,000 businesses which employ fewer than 100 workers each;
- B. About 35,000 which employ between 100 and 1,000 workers each;
- C. About 3,300 which employ more than 1,000 workers each.

The statement then sets forth that about 45 per cent of the total business employment in the United States is accounted for by the businesses which employ fewer workers than 100 each.

Importance of Small Business

A small business standing alone may appear to be of minor importance in any community, but when one associates its payroll and volume of business done with that of other small enterprises, it will readily be seen that "small business" is most essential to the preservation of free private enterprise which fundamentally represents the American way of life. Small business collectively represents a large and essential part of our national economy.

The committee on the special problems of small business of the CED sets forth that there are five self-evident facts in respect of small business. These five facts may be summarized as follows:

1. High production and employment must be attained by intelligent planning.
2. Small business is one of the greatest laboratories for new ideas and new products.
3. Small business promotes flexibility and competition in our economy.
4. Small business provides a splendid train-

WHAT do we mean when we say "small business"? Maurice H. Stans posed this question in an article appearing in the September, 1943, issue of THE JOURNAL OF ACCOUNTANCY, and then said, "The line between what constitutes 'big business' and what might be classed as 'small business' is as indefinite as the demarcation between rich and poor. While at the extremes the contrast is obvious, the distinction becomes nebulous in the middle ranges." Walter Mitchell, of Dun & Bradstreet, when testifying before the Senate Special Committee to Study the Problems of American Small Business, February 23, 1943, said: "I have heard a group of well-informed businessmen agree that a small manufacturer is one who employs fewer than 100 people. By this definition small manufacturing comprises 90 per cent of United States factories, employs one-fourth of the labor, and takes in 30 per cent of the revenue." In a recent article, Jesse Jones, Secretary of Commerce, pointed out that small business numbers about 2,750,000 concerns normally employing more than 8,000,000 workers, and then added that "small business must be stable and prosperous for the

ing school for our citizens in the matter of self-reliance and resourcefulness.

5. The maintenance of opportunity for every individual to establish and build his own independent business is essential to the preservation of a free society in America.

If small business is to contribute high production and high employment to the postwar period, it must be dealt with fairly—now, and then. And when I say “now, and then,” I do not mean intermittently. If the great majority of the presently existing 2,000,000 smaller enterprises and a large number of new ones are to conform to the plan, then it is essential that many of the present restrictions and impediments be removed. Mr. Jones has posed this question. “What is happening to that basically American characteristic—private initiative—the quality that impels men to broaden their vision and take risks?” I think Mr. Jones (as well as most of us) knows what has happened. The problem is, What can be done about it? If risks are to be taken, if incentive capital is to be employed, high tax burdens and punitive tax legislation must be decreased or removed.

Impediments

At this point, I would like to direct attention to one deterrent to small business. I have reference to Internal Revenue Code, section 102, dealing with accumulation of corporate surpluses. This section of the Code provides for a penalty tax of 27½ per cent minimum on accumulated earnings left in the business, if such earnings are not needed in the business. It may be that such language does not sound bad but it nonetheless represents a threat that engenders fear. The regulations interpreting this Code section provide that the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence proves to the contrary. This permits the government to establish its right to the penalty tax by showing the fact that

the accumulation of earnings is unnecessary for the needs of the business.

I submit that the determination of the question in any particular case of what constitutes an unreasonable accumulation of profits is an extremely difficult problem. Businessmen have their own practical difficulties in determining the needs of their business. They ask themselves, Just how much cushion do I need, particularly in times of stress such as we have experienced for several years? The word “reasonable” is a relative term, depending for its proper application on factors of judgment and experiences. What would be reasonable in one situation, or for one business, might be clearly unreasonable in another. Even so, Treasury Decision 4914 provides, among other things, that returns filed by the following classes of corporations will be given close attention to determine whether section 102 is applicable:

- “1. Corporations which have not distributed at least 70 per cent of their earnings as taxable dividends.
- “2. Corporations, a majority of whose stock is held by a family group or other small group of individuals.”

The provisions quoted obviously have their greatest impact upon small business corporations. Does anyone think that a small corporation’s stock would be in the hands of a large group of individuals? Why should the Treasury Department view with suspicion the small corporation which plows back into its business more than 30 per cent of its earnings? Many small businesses were founded by owners who fondly hoped that the little fellows would grow up. Most of our big businesses of today started out small and then experienced growing pains. If small business is to continue as a laboratory for new ideas, individual enterprises must be given an opportunity to live and to grow. If new small businesses are to fit into the postwar plan and thereby risk the small capital that can be provided, then the risks must be within reason. Again quoting from the special committee of CED:

“Many measures, such as the reduction

of business-tax burdens, and the elimination of restrictive controls which now hamper business incentives will increase the willingness of individuals to assume business risks.

"Such measures should be encouraged. The heart of a free-enterprise system is the taking of business risks. Through risk-taking, new ideas, new businesses, and new men are developed. Risk-taking is the dynamic factor in our economy which makes for growth and expansion."

Influence of Taxation

The imposition of the income tax is primarily responsible for more complete record keeping by small business. While very few small-business men have the time to keep informed in respect of the principles of income taxation, and the problems incident thereto, most of them have learned the importance of accounting data. It is in connection with federal taxation that the accountant has his greatest opportunity to be helpful to small business. The small business, speaking generally, simply does not have the personnel to handle properly such matters. In many cases fairly good accounting departments are manned by personnel that is thoroughly lacking in understanding of deductible expenditures and nondeductible expenditures. Many bookkeepers do not understand the nice distinctions between certain types of taxable and nontaxable income, and to a great number the benefit, and the application, of carry-forward and carry-back is beyond comprehension. I have in mind one small business that has in charge of its accounting, a capable and an energetic person, who nonetheless failed to deduct in the current year's return the net operating loss of the two preceding years. The concern is capitalized at \$100,000, and it uses the invested-capital method for the purpose of calculating the excess-profits-tax credit. When the company accountant set about to prepare the 1943 returns, he was shocked by the amount of tax determined. He then sought outside advice, and learned the meaning of carry-forward. The company had paid substantial taxes in 1941 and 1942, though it was not liable for any tax.

It may be that the present high tax rates will prove a "blessing in disguise" for many small businesses. The high rates of tax, together with the low net cost of expert advice, impels the businessman to seek advice that normally he would not. When called upon, it is the duty of the public accountant to bring to the attention of the businessman all proper accounting procedures to accomplish accurate determination of taxable income. Many times we are called upon to give advice in respect of the form of carrying on business, and the resultant impact of taxes. In such instances, our services should be performed in close coöperation with the client's attorney.

In the case of established businesses, what could be done in respect of "form" has been limited. Bearing on this question, however, I would like to direct attention to section 120 of the Revenue Act of 1943, dealing with the election as to gain in certain corporate liquidations. This new provision, section 112(b)7, IRC, affords relief in a situation where there exists a closely held corporation, the business of which could be just as well operated as a partnership or an individual proprietorship and which would pay less taxes under such operation. In the past, corporations have frequently deferred liquidation because of the gain which would be taxed to shareholders whose stock had a low base as compared with the value of the property they would receive in liquidation. The section affords relief where the gain in liquidation is represented by appreciation in value of the corporation's property, by prescribing rules under which, at the election of the shareholders, a part or all of the gain may be received free from tax at the time of the liquidation. However, if such relief is availed of, an offsetting adjustment is required which may have the effect of taxing the gain if and when the property received in liquidation is subsequently sold. One feature of the rules prescribed in the new section is "complete liquidation must occur within some one calendar month of 1944." I have pointed out this particular change, effected by the 1943 Act, solely for the purpose of em-

phasizing that we must be continuously on the alert in serving small business, which does not have the personnel to keep informed in respect of many changes in the whole scheme of taxation.

Accounting Problems

In my opinion, the public accountant has both a great opportunity and a great responsibility in respect of the problems of small business. Small businessmen need all the help available in the matter of modern business and accounting techniques and the developments in business operation. The broad experience of the public accountant, acquired in his professional service to his clientele, enables him to bring to small businessmen the knowledge gained through such experience.

In his relationship with small business the accountant may be likened to the old-time family doctor. In such relationship he obtains a most intimate knowledge of the business of the client and its management problems. An accountant so situated must be more than a specialist. He must be experienced in all matters dealt with by the profession, and particularly he must be on the alert in the matter of assisting the client to comply with all governmental requirements, and see to it that no benefits which the various rules provide are lost through lapse of time or otherwise.

The small business requires the accountant to do more than audit the books and submit a report thereon. Tax returns and governmental reports, too numerous to list here, must be properly prepared and filed on time. The small corporation's returns and reports, where required, differ not from those of its well staffed big brother. Many small-business clients look to the accountant for much needed help in forming management policy.

The last few years have brought greatly increased burdens to all American business. The small business, today, suffers from all-inclusive governmental regulation and control, wartime restrictions, heavy taxes, and many other burdens that create for it involved and difficult accounting problems. Failure to comply with the rules, for whatever reason, and inaccuracies as

well, may subject the small business to confiscatory penalties. Small business needs both accountant and lawyer to guide its footsteps through the wilderness of payroll deductions, excise taxes, stabilization difficulties, price controls, production and inventory limitations, and the wide range of government reports. These comparatively new requirements, that defy the unskilled, present real problems for small business, unaccustomed as it has been to regimentation and regulation. Keeping informed and then discharging the obligations and responsibilities under existing requirements, leaves executive and administrative personnel little time to carry on business. Many variations in accounting requirements for the various reports have increased record-keeping difficulties to a point where the personnel cost is out of all proportion to the business done. One starts a small business on the principle that transactions are of paramount importance and that keeping the records thereof should be as inexpensive as possible. Otherwise the new venture would find it difficult to meet competition and survive against established and "big business."

The public accountant can be of most substantial help to small business in the matter of constant search for facts and the drawing of proper conclusions therefrom, to the end that small business may have sound management. We can help it plan, check its plans, and segregate the important from the unimportant. Good management is good thinking bottomed on facts developed through well planned studies, translated into effective action. Big business is able to employ capable men for each job, and thereby have sound and well rounded management, but small business must have outside advisers and consultants if it is to compete. If small business is to survive and maintain its place in our national economy, it must be provided business advice. The public accountant will have an important part in such planning.

Case Study

To emphasize the many headaches that small business now suffers, I will take the

case of one small business in Houston. In peacetime this small business deals with private enterprises. In 1943, 90 per cent of its volume was government business. In 1940 its volume was \$250,000, all non-government. In 1943 its volume was \$1,350,000, 90 per cent government. In normal times the key personnel consists of manager, engineer, shop superintendent, and the accountant. One additional key employee has been added to handle personnel matters before the War Labor Board and the salary stabilization unit, material priorities, and similar problems. Needed assistance for the key personnel has been inefficient and difficult to obtain. The management of this small business, with limited assistance, has to maintain contact with numerous government agencies to deal with:

- The procurement of machinery, tools, equipment, and transportation facilities;
- The procurement of materials and supplies;
- The procurement of labor sufficiently to carry on the business;
- Draft deferments;
- Wage and salary stabilization;
- Gasoline rationing;
- Victory tax, withholding taxes, old-age benefit and unemployment taxes;
- Federal income-tax returns and individual declarations;
- Renegotiation of contracts;
- Preparing bids and the related cost data required by the contracting offices;
- Numerous other matters; and now
- Contract termination.

All bids have been competitive. None are cost plus fixed fee. Some of the problems are: When material is obtained, will labor be available? When labor is available, will materials be forthcoming? What will be the losses from wasted time, spoiled materials, and inefficient labor? What will be the cost in dollars and time of training employees, and can they be retained? Temporary shutdowns, due to changes in government specifications, breakdowns, slow delivery of materials—how much will they cost?

Late in 1943, this concern obtained another government contract, for a particular product with accessories, at a lump-sum

price of approximately \$250,000. Early in 1944, almost immediately prior to producing under the contract, which provided for delivery over a period of 120 days, the contract was canceled, except that accessories only were to be furnished under a new contract to be presently executed; with deliveries to begin immediately; and the price to be fixed on a negotiated basis, if, as, and when a reasonable price could be agreed upon. Negotiation of price continues and in all probability it will not be fixed until after all deliveries have been completed. One difficulty in fixing the price stems from the fact that the concern's cost records, for the pregovernment business period, do not lend themselves to the accumulation of the elaborate statistical data required by the contracting office.

The public accountant can be most helpful to a small business experiencing the difficulties that have been discussed, but it must be remembered that the profession has its own acute manpower problem.

Contract Termination

Contract termination affords the accountancy profession another opportunity to perform valuable service to small business. One small-business man recently discussed with me his company's experience in the matter of contract termination. The high lights of his experience may be briefly summarized as follows:

The contract was canceled by telephone call from Washington, and the contractor was asked to estimate the cost of termination, as quickly as possible. Within a few hours it submitted an estimate and within three days the claim was completed. Shortly thereafter the contracting office sent its representatives to the contractor's place of business to verify the claim. The examiners required more than three weeks to check the claim and their findings varied from the contractor's figures less than seven-tenths of one per cent. The contractor had the very small parts stored in boxes neatly arranged in a downtown warehouse, each box containing one thousand of the small parts. The examiners insisted upon opening each box and counting its contents (worse than counting pennies when auditing a bank). The contract was

canceled in early August, 1943, but the claim was unsettled in late March, 1944.

Payrolls and Payroll Taxes

One of the new accounting problems for small business has to do with payroll taxes and other payroll deductions. Mr. Stans, in concluding his discussion of this problem (*THE JOURNAL OF ACCOUNTANCY*, September, 1943), pointed out the following:

"Each of these types of deductions involves a separate accounting for the funds and separate reporting at varying intervals—federal insurance contributions and income taxes quarterly, payroll-allotment funds monthly, and union dues usually weekly. Each of these reports requires a complete listing of all employee names and amounts for the period. In addition, state unemployment insurance returns must be filed quarterly with similar information; and a federal unemployment-insurance return must be filed annually in summary form, showing the amount of such tax after credit for state taxes paid. As a part of all these taxes, the employer usually finds it expedient to keep accumulative history records for each employee, and may be required by contract to keep seniority records for the employees' union, or by state law to file dismissal notices or other reports covering changes in employment. Under the income-tax withholding, he must secure an exemption certificate from each employee in order to establish the basis of application of the tax. In addition to reconciling the total of withheld taxes with the amounts paid to each employee, and so reporting to the government, the employer must furnish each employee with a receipt for such taxes annually (and upon termination of employment).

"Each of these conditions brings with it innumerable problems of interpretation. The federal wage-and-hour law and the executive orders and regulations under the

wage-stabilization law have also caused added difficulties going far beyond those of mere record-keeping. The distinction between employee and independent contractor, between casual help and taxable employee, and between the employee entitled to overtime and the exempt executive or administrative employee, are obscurities usually beyond the ken of the small employer. A classic example of interpretive confusion is that of the originally conflicting, and still complicated, rulings with regard to the computation of overtime pay, in varying situations, under the wage-stabilization orders. Finally, the "freezing" of wages and salaries has necessitated the establishment of job classifications and rate schedules, has required the promulgation of policies for merit or length-of-service increases, and in general, under the threat of severe penalties and in the face of labor shortages, has contributed to make the payroll problem almost a delirium."

Conclusion

In conclusion, I would like to point out that the problems of small business require the attention of the accounting profession. We can be helpful. Small business is important to the growth of our profession and small business has had a lot to do with the growth of "big business." Under our political philosophy every American youth has a chance to become president of our country. Under our economic philosophy and our system of free private enterprise, every small business has a chance to grow big. We must see to it that we do our bit, by enlarging the range of our service to smaller firms. The benefit of our experience in the service of one should flow to many others. In the language of our Secretary of Commerce, "the preservation of small business is essential to democracy in our country."

Recent Developments in Accounting and Auditing

BY SAMUEL J. BROAD

Noting a recent trend toward increased objectivity in the approach to accounting and auditing problems, this article suggests that the individual practitioner should assume the burden of proof in justifying any departure from generally recognized accounting principles. Impact of the war and of increasing government regulation upon accounting and auditing practice is emphasized. The text was originally presented as one of several addresses at a recent series of Wartime Accounting Conferences conducted by seven state societies of certified public accountants or their chapters, in cooperation with the American Institute of Accountants. The author is treasurer of the American Institute; chairman of its committee on auditing procedure; and a partner of Peat, Marwick, Mitchell & Co., New York.

THE subject, "Recent Developments in Accounting and Auditing," which has been assigned to me is a very extensive one. Dealing with it is almost like discussing what happens in the spring of the year. We can say in general that the days get longer, the sun gets warmer, flowers begin to bloom, and the birds come back. An astronomer would discourse at length upon why the days get longer or the sun gets warmer. A botanist would explain in detail why, and by what process, the flowers get ready to bloom. Similarly, an adequate discussion of some of the recent developments in accounting and auditing would be worthy of the entire time assigned to us, so that we will necessarily have to look at them with the long range view of a telescope and not through a microscope.

Objective Approach

The trend in the last few years has definitely been in the direction of increased objectivity in our approach to accounting and auditing problems. In 1934 we started for the first time to express opinions in our reports as to whether the financial state-

ments were prepared in conformity with *accepted* principles of accounting. There was discussion at that time of the word "acceptable" as well as the word "accepted," and the choice rested on "accepted," which required reference to principles which had already received acceptance. A few years later, in 1939, the phrase was expanded to "generally accepted principles of accounting," crystallizing in words the sense in which "accepted" had generally been used.

Similarly, during the past two or three years it has become general practice, at least in published statements, for accountants to represent that their examination has been made "in accordance with generally accepted auditing standards." This change came about initially at the instance of the Securities and Exchange Commission, which wished accountants specifically to accept responsibility for audits measuring up to objective standards.

I would like to call attention to the different criteria underlying the two terms "generally accepted" principles and "sound" principles. It is, of course, to be expected that the two will coincide. At times there may exist a difference of opinion as to whether a particular practice is sound or not. Whether a principle is generally accepted, however, is primarily a question of fact rather than of opinion, and the conformance of financial statements to generally accepted principles must be determined in the light of objective criteria, not according to what the accountant or his client happens to think is sound or acceptable.

While objective standards, and not the opinion of the individual, are thus the deciding factor, there nevertheless still remains ample scope for the exercise of professional judgment; in determining, for example, what principle or standard applies in particular circumstances where a choice is possible; or in deciding the manner or extent to which it is to be applied.

In the sphere of auditing, for example, we may arrive at the conclusion that a particular transaction is not an arm's-length one and that a conflict of interest exists. Auditing standards probably require the transaction to be supported by evidence stronger than would otherwise be necessary. But it is still a matter of judgment how strong the evidence should be and at what point the auditor should feel satisfied.

The same applies in the sphere of accounting. In *Accounting Research Bulletin No. 19*,¹ for instance, the committee on accounting procedure of the American Institute of Accountants discusses accounting for profits under cost-plus-fixed-fee contracts and relates the question to two different accounting principles (1) that profits are not ordinarily recognized until the right to full payment has become unconditional, and (2) that under certain types of contracts revenues may be accrued on the basis of partial performance. The conclusion is reached that though "CPFF contracts fall within the basic principles of both the foregoing procedures, and have characteristics of both" there is adequate justification for accrual of the fee as the contract is performed. The question primarily was which principle applied in the circumstances which surround CPFF contracts.

Again, in discussing provision for renegotiation of war contracts in *Research Bulletin No. 21*, the committee refers to "the long-recognized accounting principle that provision should be made in the financial statements for all liabilities that can be reasonably estimated." The problem there was not in determining what principle applied when the liability could be reasonably estimated but in the nature and extent of the disclosure when it could not. The conclusion is reached that where no reserve can be estimated because the basis of the prior year's settlement does not provide an adequate measure for the current year, a statement should be made explaining those circumstances.

It thus seems clear that even if the

Utopian day should arrive and we have general agreement upon all principles of accounting and all auditing standards, there will still remain ample scope for professional judgment.

Independence

This emphasis on objective standards is both a bulwark and a challenge to the accountant in maintaining his independence. We have heard a great deal about independence in recent years. There is now no dissent within the profession and little if any, I believe, outside it, to the proposition that the public accountant should be independent in his relations with his clients. There may be some difference of opinion as to how independence is to be displayed and proved, that is, as to the outward symbols or manifestations of independence; but there can be no serious difference of opinion on the basic issue.

I think it is also accepted by those involved, both in the profession and outside it, that the accountant should not surrender his professional independence in his dealings with government and regulatory bodies. He is expected to express his opinion, an honest opinion based on an examination made in accordance with generally accepted auditing standards and determined in the light of generally accepted accounting principle; but his own opinion and not the opinion of someone else, however authoritative that person may be.

Perhaps we should add a third article to the code of independence and say that the professional accountant should not permit himself to be unduly swayed even by his own personal views when he has reason to believe that they differ from those of the majority. Thus he may think, as some perhaps still do, that it is the essence of futility for accountants to attend and observe the taking of inventories and that disclosure of his non-conformance in this respect is therefore unnecessary. He may believe that depreciation charged against income should be based on cost notwithstanding the fact that the asset may be carried on the balance-sheet at appraisal value which is higher than cost.

¹ Issued by the American Institute of Accountants committee on accounting procedure, December, 1942.

And he may not agree that it is proper to carry forward the premium on redemption or other expenses of a bond issue which has been refunded. These are matters on which honest differences of opinion are possible. Nevertheless, in respect of questions such as these on which the profession has taken a position, an accountant could not represent that he had complied with generally accepted auditing standards if he had not undertaken the required inventory procedures; nor could he expect his personal views to prevail against accounting principles which are generally accepted. The burden of proof would be upon him to defend any departure from them. He might believe that his views were sound but it would be difficult for him to show that they were generally accepted.

Progress and improvement in the application of accounting principle comes about as a result of individuals promoting or urging a change of practice on the ground that the modified practice is sound even though it may not be generally accepted. A minority is not infrequently right and any individual has the right to disagree with the majority and to express his disagreement and try to convince others. But, until he has accomplished that, the majority view should control. We should be willing to be governed by the democratic principle of majority rule and to recognize what is generally accepted at the time as being sound practice. To substitute subjective and personal opinion for the objective standard of what is generally accepted to my mind would constitute a distinctly retrogressive step. If what is generally accepted is unsound the strength of opposing arguments will quickly make itself felt. As *The New York Times* put it in a recent editorial, "Good goods, in ideas or in manufactured articles, win our support, as time demonstrates their worth."

Government Regulation

Accounting has proved to be an effective tool for regulation though its full power has not been recognized until recently. The accounting profession must be on guard lest the tool be used improperly and by unskilled hands. We are entitled to

expect from regulatory bodies the same objective approach which we establish for ourselves and to which they on their part properly hold us. To illustrate, however wise or desirable the exclusive use of straight-line depreciation might be for regulation purposes, we as accountants would be greatly concerned if it should be made a requirement on the ground that "sound" accounting required it, with the implication that other accepted methods of providing for depreciation are unsound. Before agreeing, we would have to insist that the statement be proved.

Another question which has come up with increasing frequency in recent years, and one which we are forced to face, is the accounting treatment of goodwill and other intangibles, and particularly their amortization. Regardless of whether it is generally accepted, does "sound" accounting require that goodwill be amortized against income? The arguments in favor of it, stated concisely, are that goodwill may disappear and that therefore conservatism requires its amortization; that profits arising from goodwill purchased do not accrue until after the purchase price has been recovered; that the original goodwill has probably disappeared and should be written off even though it has been replaced by other goodwill; and that conservation of capital requires a charge against earnings for amortization of goodwill. Generally speaking, the arguments are not based upon the premise that goodwill is not a valuable asset or that it does not constitute property.

The various expenditures which result in the building up or maintenance of goodwill must be continuous in any organization which expects to enjoy continued prosperity. These expenditures take various forms, such as advertising, costs of public and customer and employee relations, promotion of new products, favorable location, and all the varied elements which help to make a business successful. From an accounting standpoint it would seem that if past or present goodwill carried on the books is amortized, consistency would require that expenditures which result in maintaining that goodwill intact

or creating future goodwill should be capitalized. Otherwise, there would be a doubling up of the charges, by writing off at the same time the cost of the old goodwill and the cost of new goodwill. This could only result in an understatement of income.

Accountants have generally been hesitant in approving the capitalization of current intangible costs of the nature referred to, even though their benefits may lie in the future, for the very reason that they do represent costs of maintenance and development of earning power of goodwill. To do so, moreover, would be merely to substitute for the present procedure of carrying forward the old goodwill amount unchanged, another procedure, theoretically sound but difficult in practice, which would probably produce substantially the same result.

If the goodwill or other non-wasting intangibles continue to exist, and it is desired for reasons of conservatism or for reasons of policy to write them off, accountants generally would raise no objection, provided the charge is not made against profits with a resulting understatement of the income but is rather a utilization of profits. Thus most accountants, I believe, think that in the ordinary case the writing off or amortization of such intangibles, though not required by sound accounting principle, may properly be accomplished, if desired as a matter of policy, by an appropriation of (as distinct from a charge against) income or of earned or capital surplus.

It must be admitted that occasionally the value of goodwill does decline or disappear; if the shrinkage can be considered more or less permanent there may be some question as to the propriety of continuing to carry the goodwill on the balance-sheet at an amount in excess of its value. However, bad cases make bad law; and an accounting rule or principle should not be controlled by the exceptional case but by the ordinary case; it should, moreover, be in harmony with the accounting convention that financial statements generally are prepared on the assumption that the concern is going to continue in business.

The point I would like to make is this. The achievement of economic and financial changes or reforms may be sought for one reason or another, and we may, or may not, agree that they are desirable. Naturally with our financial training, we are very much interested; we have the same interest as any other informed citizen. Our interest quickens, however, and we become deeply and directly concerned, when an attempt is made to bring such changes about on the plea that sound accounting requires them. That affects us in our capacity as accountants and is a question on which we are entitled to be heard, and to speak with authority.

Regulatory bodies having accounting authority have and exercise a very substantial influence in the determination and acceptance of accounting principles. But until the rightness of their accounting views has been tested and proved in the crucible of frank discussion they, as we ourselves, should be willing to accept the democratic principle of majority rule inherent in the phrase "generally accepted." They too, should not be unduly swayed, in making accounting decisions, by personal or subjective views not shared by the majority. Accounting decisions should be based on objective criteria; and should not be influenced by preconceived objectives, however praiseworthy.

Basic Accounting Questions

During recent years the accounting profession has been moving gradually towards a limitation of the areas of disagreement on specific questions, but agreement on a number of other questions has proved more difficult in spite of extensive consideration and discussion. Difficulties sometimes seem to arise because different individuals approach questions from the standpoint of different basic accounting and economic concepts. There are varying views as to the status of corporate capital and surplus, as to the time and manner of incidence of some elements of income and loss, as to the nature of income taxes, and even as to the purpose of financial statements.

Corporate financial statements are usu-

ally prepared as an accounting by the management for its stewardship of the stockholders' property, and as a periodical report on progress. An important question which arises right there is whether they should be prepared solely as an historical report relating to the past or whether, under our present economic system, they should be prepared in such a manner as to afford a more effective guide to the future, and thereby partake to some extent of the nature of a prospectus. It seems clear that no set of financial statements can serve all purposes equally well and the question is what weight should be given in their preparation to their various uses.

As an example of the different treatment which different purposes might require, let us consider the treatment of income taxes, a subject which recently has been actively before the Institute's committee on accounting procedure. Taxes on income are now so important an element that their treatment and presentation often have a vital effect on the reader's judgment of the results reported. The first question which arises has to do with the nature of income taxes. Are they an operating charge related to the operating income of the business or are they a share of the profits required to be paid to the dominant partner, the government? Does the unilateral nature of the act by which they are levied take them outside the scope of management and, if so, is profit before income taxes the item of outstanding importance in judging management accomplishments?

Again, on the theory of matching costs against income, should the taxes be applied against the income which is taxed rather than the book income, and regardless of whether the income taxed appears in the income account, or the earned-surplus account, or whether it is reflected on the books in reserves created in prior years? Or are the variations between book income and taxable income so great and so fundamental that any attempt at matching them is bound to be ineffectual and should not be attempted?

Further, if the financial statements should deal with the past in such a manner as to afford some guide to the future, to

what extent should the non-recurring nature of tax charges and credits be recognized or disclosed? Is the relationship of the past to the future of sufficient importance that a carry-forward of unused excess-profits-tax credit, which occurs in one year only, should be reflected; and, if so, how prominently? When a carry-back tax credit arises, is the event from which it stems the lower profit of the current year or the higher profit of the earlier year, and does it involve an adjustment of past years' taxes or of the current year's, and in what manner should the one or the other be disclosed?

Or, on the other hand, should we consider taxes as historical facts only? Should the fortuitous circumstances attending their incidence be ignored and merely the fact of the amount of taxes payable be recognized? If so, should their relation to accounting profits also be ignored and should they therefore be shown up among the operating expenses and charges of the business? Or should they be deducted from profits before taxes at the foot of the statement, not because the two figures are related in any way, but solely because the amount of taxes is beyond the control of the management and represents the dominant partner's share of the profits?

Many clear-cut differences and shades of opinion exist as to the manner and the position in which income taxes should be reflected in the income statement, and the extent of the disclosure regarding them. These differences seem to arise, however, from different attitudes towards certain of these more basic questions.

Similarly, differences of opinion as to the nature and character of corporate surplus are undoubtedly responsible for opposing viewpoints as to the proper accounting treatment of such items as premiums paid on capital stock reacquired. To reconcile these differences we need to agree first whether a corporation's capital is that of the business as an entity separate from its stockholders; and whether the paid-in surplus is the surplus of the corporation as an entity or remains permanently apportionable to the different classes of stockholders who contributed it.

The examples I have given seem to suggest that agreement on some of the specific questions regarding which differences of opinion exist must be preceded by agreement as to the underlying philosophy of financial statements, what are their functions, and on what foundations are they to be built. This fact seems to be realized by the leaders of our profession and as the questions emerge and crystallize themselves I feel confident that solutions will be reached which can receive general acceptance.

Auditing

Far fields are supposed to look greener, and perhaps that is why I have been wandering so widely in the fields of accounting principle rather than staying in my own particular field of auditing procedure.

In years gone by the public had an exaggerated idea of the effectiveness of auditing procedures, and undoubtedly practicing accountants were partly responsible. There seemed to be a feeling that by some sort of magic a few additions and calculations and classifications could be made and certain auditing checks be applied, and everything was assured. This view has in great measure been corrected, largely through the undertaking by the profession of a realistic educational program, but we still occasionally come across evidence of the same misconception. For instance, some surprise was expressed in connection with a labor-racketeering trial a year or two ago that, out of hundreds of thousands of disbursements made by a particular industry, auditors had not discovered a number of moderate-sized items improperly paid which in the aggregate amounted to a considerable sum. It is just as well to admit frankly that under the recognized processes of testing and sampling of transactions and reliance upon adequate measures of internal control the chances of an auditor running across comparatively small and scattered items of doubtful propriety are comparatively slight. The testing and sampling procedure is based upon general acceptance of the proposition that auditing procedures should not be extended to a point where their relative cost would ex-

ceed any gain likely to result from them. If we are to assume that everyone is dishonest the cost of a much more extensive audit might be justified. On the contrary assumption, its cost would not be justified; but the corollary is that occasional lapses of integrity or probity, especially if they are relatively small and carefully concealed, may quite possibly remain undiscovered. It is preferable that we admit this frankly, because our best public relations as a profession lie in the honesty with which we offer our wares and in the extent to which our services measure up to our promises. We will do ourselves more harm than good if we hold ourselves out as infallible.

The effect of the war has been to create many new problems for us in our capacity as auditors. Our problems are more numerous and the uncertainties with which we have to deal are magnified. If anything, we have had to place increased emphasis on the functions of internal control as a deterrent for errors even though at the same time we have had to recognize that systems of internal control have developed temporary weaknesses. We have had to meet the increased claims upon us oftentimes with a shrinkage and weakening of personnel. As a result, delays have often been unavoidable and I think it is only right that we acknowledge the sympathetic attitude with which these conditions have been recognized by the Securities and Exchange Commission, by stock exchanges, by banks and other credit groups, and, generally speaking, by our clients. Their attitude has been reasonable and helpful and I think it has been induced in part by the fact that we early announced our intention not to relax our auditing standards but rather to decline engagements if necessary, and to do those we undertook in a workmanlike way. The personnel of our organizations, and especially our key men, have responded gallantly to the heavy demands made upon them and are doing their utmost to keep the national and business economy functioning smoothly. For this we owe them a debt of gratitude which we frequently are not permitted to repay in a more practical way.

As the committee on auditing procedure pursues its studies it is becoming more and more evident that the determination of what is sound auditing procedure in particular circumstances revolves around the application of judgment in respect of a series of relationships: (1) the materiality of the item in relation to the whole; (2) the relative risk of material error, whether of omission or commission, or of judgment; and (3) the relationship of cost to the benefit or protection provided.

As an example, let me refer to one or two of the recent statements of the committee. Statement on Auditing Procedure No. 14 issued in December, 1942, dealt with confirmation of public-utility accounts receivable and centered around the means by which control was exercised over the mass accounts receivable. The conclusion was reached, in the case discussed, that under the system of internal control prescribed a sufficient separation of duties existed to assure substantial accuracy and to prevent significant irregularities; and that, accordingly, the mass accounts-receivable balances could be considered reliable for financial-statement purposes. Test confirmation of the mass receivables was not considered necessary for the purpose of checking the credibility of the company's representations as to their authenticity, though a small—quite small—sample or test circularization was recommended as an additional check upon the functioning of the internal control. This is a clear example of the effect upon the audit program of the relative risk of material error.

Let me refer also to Statement No. 20, issued in December, 1943, dealing with "Termination of Fixed Price Supply Contracts" and the auditor's "Examination on Contractors' Statements of Proposed Settlements." There the position was taken that available accounting and auditing talent would require to be used with maximum effectiveness, as otherwise the available supply at the end of the war would not be adequate properly to review or audit termination proposals. It was pointed out that if independent public accountants' examinations were to be so ex-

tensive that they were unduly costly and caused delays, this would more than offset any benefits resulting from them; and that, accordingly, in view of limited available manpower, the national interest could best be served by making intelligent reviews and by applying test checks less extensive than those commonly performed in industrial practice, even though this entailed assuming a lesser degree of responsibility. Particular stress was laid upon inquiries into matters of accounting principle such as the distribution of overhead and other expenses, rather than upon checking the details of the underlying figures. The emphasis was placed there because the relative risk of material error, whether of omission or commission or of judgment, was greater at that point and because a greater degree of protection could be provided at a relatively lower cost in time and money.

Another matter which has been before the committee on auditing procedure relates to auditing procedures in connection with wartime regulations and, as the committee has not yet reached a decision on this point, what I have to say must necessarily represent my personal views. The auditor is primarily concerned with the financial statements and the opinion which he is called upon to express, whether they present fairly the position of the company in accordance with generally accepted principles of accounting applied on a consistent basis. Where the non-compliance by a corporation with wartime regulations may affect its financial statements, the auditor thus has a responsibility the extent of which will naturally vary as the risk of material error in the statements increases. Non-compliance with certain regulations, such as priority regulations, may result in a penalty affecting future business in greater or lesser degree, but having little if any effect upon the financial statements of a past date. Penalties which result from other regulations may affect the statements materially, however. Failure to observe salary-stabilization regulations, for example, may result in substantial tax penalties for a past period. Furthermore, the situation may be

such that the interests of senior officials possessing authority in salary matters are adverse to the interests of the company, so that in addition to the amounts involved being larger, the risk of penalties may be relatively greater in the case of their salaries than in the case of those of the rank and file of employees. These factors of materiality and relative risk seem to control the extent of the examination, and our responsibility as auditors in connection with government wartime regulations appears to be determined in the ordinary case by the materiality of the effect non-compliance is likely to have on the financial statements, and to be governed by the same general principles of auditing as apply in other cases.

Thus, in both the sphere of auditing and

the sphere of accounting, the answers to questions which arise, new questions and old questions, would seem to be found in the application of certain broad general or philosophical principles which apply throughout our work. If we can succeed in defining these clearly and in applying them in the two major fields of accounting principles and auditing standards, I think that the underlying questions will fall into place, and can be settled by the case method with comparative ease. We shall have a unified and coördinated body of theory both in accounting and in auditing. That is "a consummation devoutly to be wished." It will call for sound thinking and earnest application, and a generous supply of patience. May we have the tenacity to persist until it is accomplished.

What Is Wrong with the Federal Tax System?

BY GEORGE P. ELLIS

The basic reason for our hopelessly jumbled tax structure, this article explains, is the absence of any long-range tax policy. As a practical approach to tax simplification, the author proposes appointment of a non-partisan commission for the specific purpose of reexamining tax laws and making recommendations to Congress for the establishment of a permanent, well integrated tax system. The text was originally presented as one of several addresses at a recent series of Wartime Accounting Conferences conducted by seven state societies of certified public accountants or their chapters, in cooperation with the American Institute of Accountants. The author is general chairman of the Institute's committee on federal taxation, and a partner of a nationally known public accounting firm with headquarters in Chicago.

FROM the leading experts to the average taxpayer, there is quite general agreement that something is wrong with our tax laws. The multiplicity of taxes together with varying bases of income makes the computation of the tax difficult for all concerned. Social-reform provisions, the attempt to plug every possible loophole, and the unnecessarily technical interpretation by the Treasury Department makes the preparation of the tax returns a very hazardous and uncertain procedure. All of these difficult situations also make the administration of the laws a heavy burden to both the government and the taxpayer.

Several months ago, the House Ways and Means Committee labeled the task of tax simplification the No. 1 job of the Committee. The press has repeatedly stated that the job of overhauling is long overdue, and general and overwhelming public indignation reached a peak last March 15th.

In addition, the importance which a sound revised tax system will play in the postwar period has been emphasized in

official Treasury statements and government reports.

The difficulties in the tax law may be the result of the piecemeal approach which has been taken to a problem which is much broader and more fundamental in scope. For that reason, we are concerned in this discussion with the basic causes for the present situation and with what may be done to improve the entire tax structure.

A major factor in the present dilemma is the fact that our tax system has developed without any clear basis of tax policy as a framework within which to build.

Roswell Magill, former Undersecretary of the Treasury, in his book, *The Impact of Federal Taxes*, says:

"In his daily life he (the ordinary citizen) meets or hears of many sorts of taxes—those on corporations, sales, estates and gifts, admissions, telephone messages, railroad tickets, and so on. He even reads statements that vastly more money could be raised if this new tax were used, or that old one really put to work. Is there any rhyme or reason in the system? Are there any guiding principles by which the Treasury, Congress, or the humble taxpayer can judge whether the government is performing this major function wisely and fairly?"

"The shattering of so many shibboleths in the past quarter century has left him a little doubtful whether there is any better guide to tax policy than expediency. The Treasury has hardly given him any better lead. Recent tax bills in general have sought to tap each of the possible sources of funds, with some conspicuous exceptions. Although the Secretary has talked about the undesirability of business taxes so high as to injure the economy permanently, there has not been much discussion of the fundamental bases on which the proposed tax structure was being organized."

Statutory changes have been numerous—more than twenty major ones—but these have been piled one on top of another within the existing structure until, like Topsy, the tax system has just "grewed."

The natural result is that the system lacks a few well developed rules or principles which could remain in more or less permanent form and upon which the taxpayer could rely.

Mr. Magill further states:

"There has been no reëxamination of the fundamental aspects of our tax laws nor any attempt to develop an orderly and consistent structure.

"The Treasury has not advocated recently any fundamental changes in the structure of our tax system, other than, perhaps, its recommendation of a spending tax. If the system is basically sound, this is wise policy. . . . On the other hand, in so far as the current tax structure is defective, severe increases in rates accentuate the defects. No one needed to adjust his business policies greatly on account of the 1 per cent normal tax and 1 to 6 per cent surtaxes originally imposed by the 1913 Act. A corporation tax of 40 per cent, plus a confiscatory excess-profits tax, is another matter. Such a tax can drive taxpayers out of business or into policies or adjustments that will plague the state for some time to come.

"The last ten years have seen the addition and repeal of many pages in the statute books, but the fundamental policies have remained curiously static. The great changes have not been in the general philosophy of the revenue acts, but primarily in the addition of new taxes. The core of the structure has remained the same. Additions have been stuck on here and there, which do not fit very well, for the architects had differing ideas. The roof has been pretty completely patched, so that it would not leak so much, and fresh paint has been put on occasionally; but certainly the old house built in the twenties is still recognizable and its foundations are unchanged."

Oftentimes new provisions have been added which have not been properly integrated with the other parts of the tax system.

The primary emphasis has quite normally been on revenue-raising measures, but too frequently enactment of specific measures has been motivated by the policy of short-term expediency, often without regard to the long-range tax effect or economic consequences.

The result is a lack of correlation between the various taxes, such as the corporate income tax and the individual income tax, and lack of integration between the estate tax and the gift tax, and lack of coördination between federal, state, and local taxation. Measures are enacted largely on the basis of expediency, such as the employment of the unscientific "guessing game," the capital-stock tax, at a time when revenues were low, and similarly the undistributed-profits tax.

Regarding corporate taxes, Randolph Paul, former General Counsel of the United States Treasury Department, in his address, "Problems Involved in an Approach to the Simplification of Tax Laws," on January 14, 1944, in Providence, Rhode Island, said:

"With the ratification of the 16th amendment, and the passage of the 1913 income-tax law, the 1 per cent excise tax on corporations became in name what it had been in fact—a 1 per cent income tax. However, since this rate was the same as the normal tax on individual incomes, and since dividends were not subjected to the normal tax on individual incomes, the new corporation income tax was not so much a tax on corporate enterprise as a collection-at-source tax on individuals. Had it remained so, the problem which is now confronting us might never have arisen. . . .

"Little consideration appears to have been given at the time to the rationale of the corporation income tax or to the possible effects of giving this tax a permanent place in the federal tax system. The belief that corporations as such possessed tax-paying ability had by this time undoubtedly taken root in the minds of many, but we embarked upon the taxation of corporate enterprise not so much because we had believed the corporation tax to be a good tax, as because we had found it to be a productive one.

"In 1936 an attempt was made to de-emphasize the taxation of corporations as such; this attempt recognized the problem of undistributed corporate profits as tax-avoiding device. Under the plan proposed by the President in that year the undistributed-profits tax, designed to replace all other corporation taxes, would have been an adjunct of the individual income tax.

Corporate income would have been taxed only once, either as individual income or as an undistributed profit. As you know, the House followed the recommendation of the President, but the Senate was reluctant to relinquish the corporation tax, and the 1936 Act contained both a tax on corporate income and one on undistributed profits. Few were satisfied with this compromise, and the undistributed-profits tax, after a short period of invalidism, died.

"Thus we entered the Second World War with corporation income tax still firmly established in the federal tax system. With the increasing demands for revenue in 1941 and 1942, it was inevitable that we should turn to this tax, as well as to the individual income tax.

"Combined normal tax and surtax rates were raised to 31 per cent in 1941 and to 40 per cent in 1942. In addition, Congress imposed an excess-profits tax in 1940, with rates now at the all-time peak of 90 per cent, and presently, perhaps, to 95 per cent. . . .

"Although a frontal attack on the corporate tax may have little chance of success, there remains a method of blunting its edge. In 1942 the public-utility industry succeeded in reducing the effective burden of the tax not by working on the rate, but rather by attaining an adjustment in the base. The deduction of preferred dividends from surtax net income of the utility companies is more than a straw in the wind. Where preferred dividends have led, common dividends may follow. I leave it to you whether businessmen will be inclined to push further along this path, bearing in mind, as they should, that it leads directly back to the undistributed-profits tax of 1936."

The lack of correlation between state and federal taxation has resulted in overlapping of federal taxes, such as the estate tax, with the resulting duplicate administrative costs. However, I believe that this is such a large problem that it deserves separate and exclusive study itself. However, it is a related problem in determining long-range tax policy. To quote again from Professor Magill's book, *The Impact of Federal Taxes*:

"At this time, let us consider the general use to be made of them (estate and gift

taxes) in the federal tax structure of the next ten years. First, should such taxes be used at all by the federal government? Legally the states have a prior claim, for the power to transmit property is theoretically conferred and controlled by them and not by the federal government. Whether the federal government should relinquish the taxes, however, must turn on pragmatic, not legalistic, conclusions. All would agree that if the United States is to employ these taxes, there should be much greater coördination with the states, at least administratively. It ought not to be beyond the wit of man to devise and put into effect a single return form, duplicated for the two jurisdictions; a single administrative investigation; and even corresponding taxing provisions. At present, the United States certainly needs the money; these taxes are an appropriate measure of capacity to pay. Hence, it is reasonable for the federal government to continue their use, always with an awareness of the state's employment of the same taxes, and with all possible efforts to simplify and unify administration. Thus the present credit against the federal estate tax for state death taxes should be continued, since it serves to unify the two imposts and to lessen the burden imposed by them. It ought to be simplified, however, by gearing it to the present effective rates of the federal tax, not to the 1926 rates."

Hand in hand with the lack of a long-range tax policy has been the prevalent endeavor to incorporate specific provisions to fit each part of our complex social and economic structure. This has been reflected in: (1) an effort to differentiate for tax-treatment purposes all the adverse situations under which income is produced and derived, and (2) in elaborate equity provisions which attempt to provide relief and remove hardship in every special case. Provisions have been inserted which also endeavor to plug loopholes against tax avoiders and tax evaders.

Among the provisions to meet adverse situations under which income is produced and to provide equity and relief are such provisions as the last-in first-out method of inventory with all its technical provisions and uncertainty as to its proper application.

The special relief provisions recently placed in the Code affecting instalment-bases taxpayers; the relief provisions on long-term contracts requiring more than twelve months to perform, and then there are the depletion provisions to which a number of additions have been made in recent revisions of the law. There has been added recently a rather interesting provision of a relief character, primarily for the relief of real estate—the provision which permits capitalization of taxes and other carrying charges on unimproved or unproductive real estate. This is an optional provision.

Among the loophole-plugging provisions are: losses from sales or exchanges of property between members of families and between corporations and controlling stockholders; also the provision that interest and expenses accrued at the end of the year will not be allowed if not paid within 2½ months after the close of the year, and the recent provision that interest on indebtedness to carry single-payment life insurance is not deductible.

The revisions and additions in the 1943 Revenue Act indicate the difficulties of present processes of revision. For instance, there are five provisions that can be termed equity provisions and special benefits, such as (1) provisions allowing corporations which go through reorganization or bankruptcy proceedings to keep their old capital base for tax purposes, (2) the addition of several minerals to the list already allowed a 15 per cent wartime depletion allowance, (3) a section which taxes as capital gains, instead of at higher ordinary-income rate, timber which is cut by the owner and sold as lumber, (4) the exclusion from the excess-profits taxes of part of the output of new coal and iron mines and timber tracks, (5) relief granted natural gas companies.

There were also added to the loophole-plugging devices two additional amendments: (1) the section to prevent corporations from acquiring the assets of defunct corporations for tax-avoidance purposes, and (2) the so-called Marshall Field amendment which limits the deductibility of losses in the case of a trade

or business carried on by the taxpayer for five consecutive years in each of which such years the expenses exceeded the gross income derived from such trade or business.

The Senate Finance Committee realized the difficulties which might arise over the section providing for the acquisition of assets of defunct corporations. They stated in their report "the success of such a provision will depend upon a sane and intelligent administration. It should not be used to upset or overturn bona-fide acquisitions with no intent or desire to avoid or evade federal income or profits taxes."

When we get into the question of the intent in such transactions as these, it will be necessary to introduce the crystal ball as standard equipment for revenue agents.

Individuals today have three separate taxes—a normal income tax, a surtax, and a Victory tax. These taxes are based on different exemptions and credits, on different amounts of income, and at different rates. Whatever may be the justification for the individual items of exemptions or deductions, the material simplification of the tax structure could be achieved by consolidating the various types of taxes into a single tax graduated in an equitable manner. This would probably mean very little change to the individual taxpayer in his total tax cost or in the total revenue received by the government.

The revisions recently reported by the Ways and Means Committee indicate that some changes will be made in the law along these lines. The present simplification program includes changes only in the individual taxes. The problem for corporations has not yet been undertaken.

Corporations face a normal tax, surtax, excess-profits tax, capital-stock tax, and declared-value excess-profits tax.

The complexity of the excess-profits tax and the annual guessing game of the annual stock tax are well known. Inasmuch as the excess-profits tax should be repealed immediately after the war, it is not likely that much time will be spent in revisions of this phase of the tax law. It is

hoped that the capital-stock tax provisions will be repealed. A substantial simplification of the remaining corporate taxes could be achieved by integrating them into a single tax which, in addition to simplification of the tax computation, would also eliminate much of the ridiculous confusion that exists in the different statutes of limitation, penalties, and settlements of tax adjustments.

The effort to determine with absolute certainty net income for tax purposes, has resulted in a statutory concept of such income which frequently varies widely from generally accepted accounting concepts of net income as used in ordinary business. The result has been continual arguments over the allowability of deductions and the year of realization of income. This has been true although sections 41, 42, and 43 of the Internal Revenue Code provide that net income be reported on the basis of sound accounting practice. Accounting is already recognized as a major tool in the determination of income by enterprise and for government regulatory purposes.

It is difficult to understand why it has been disregarded in the tax field. As accountants, we are particularly aware of the wide differences which may have grown up between income as generally accepted by the business community, as opposed to the concepts of taxable income as indicated by the Internal Revenue Code and the administration thereof. Some of these differences may be illustrated by a few examples. For instance, rent received in advance, which under proper accrual accounting would be deferred over the period affected. Under income-tax regulations, rents received in advance are considered income in the period received, even though the taxpayer is on the accrual basis. The accrual of real-estate taxes under the accounting treatment accrue from the time the ownership of property is acquired. The Bureau and the courts have consistently held that the tax becomes a lien as of a certain date depending upon the state tax laws, and only the owner of record on that particular date may have the benefit of the deduction, and he must deduct it all

in any period in which this lien date occurs. For instance, if the lien date were May 1st, in a fiscal return dated June 30th, the entire amount would have to be accrued even though from an accounting standpoint it would be considered that the amount should be spread over the entire calendar year.

In the sale of real estate, it is usual to prorate the taxes between the seller and the buyer. The buyer discovers, however, that he may not deduct the tax as an expense because he did not own the property on the date the lien attached.

Other items received in advance, such as royalties, bonus, prepaid subscription premiums on loans, etc.—the tax law treats such income for accrual-basis taxpayers in the same manner as cash-basis taxpayers. In capital-stock tax accruals for tax purposes, it is considered the liability accrues instantly as of July 1st, and the entire amount is deductible without any deferment. For accounting purposes, the treatment would be either to set up the entire liability and defer the charge, or provide monthly accruals to build up the total liability by the year-end.

In bond premiums and discounts, accounting recognizes the appropriateness of amortizing both premiums and discounts in order to arrive at the effective rates or yields. Limited recognition of this is found in the tax law, although amortization of the discount by the issuer is permissible.

No one doubts that our society is a complex one, but there is no need to have tax laws which needlessly add to the existing complexity. A practicable approach is necessary. This applies equally to the present attempt to provide tax equity in every case by lengthy technical exceptions and distinctions. It is inevitable that this aim should lead to a complicated structure which, though a commendable goal, also has distinct limitations.

It is, first of all, impossible to cover every special situation individually, and, second, it is quite possible to extend such provisions to a point where practical operation is impaired and more inequality created than relieved.

In actual practice, these relief provisions

are frequently so general or so lacking in standards that their usefulness is questionable.

In other cases, some relief is afforded to a select few while the general law is less than fair in the average case.

Roswell Magill has suggested that the problem might be solved by drawing the law in more general terms and conferring wide powers upon Treasury officials to make rules to fit special cases as well as general cases. We already have too much government by men rather than by law. We should not have any more such government.

The technical provisions and the hair-splitting determination by the Treasury Department do not form a basis for confidence that, if given such wide powers, the Treasury Department would administer the laws more fairly than they do at the present time, and there is much to be desired in the present attitude of the Treasury Department.

For instance, many taxpayers pay taxes illegally because the amounts in any single instance are too small for the single taxpayer to fight. The unfair attitude of the Treasury Department in refusing to recognize test cases shuts out relief to these small taxpayers.

Another point is the tendency of revenue agents to raise two or more points in the tax return and compel the taxpayer to go to the Tax Court unless he compromises by conceding at least one of the points so that he may assess an additional tax. Many times the amount involved is about equal to, or less than, what it would cost to appeal the case, and therefore the taxpayer again pays taxes illegally because of this unwarranted practice by the Department.

Another problem is the retaliatory attitude of the Treasury Department, such as the attacking of executives' salaries because certain high officials in Washington were resentful because the \$25,000 limitation on salaries was eliminated by Congress. There is also the increased activity of revenue agents in section 102 cases since the repeal of the undistributed-profits-tax law.

This misuse of the taxing authority is responsible for much of the difficulty encountered by taxpayers.

Another answer may be that, if the problem is approached realistically, some equity should be sacrificed in the interest of simplicity.

The present revenue law, which provides that the taxpayer's status for income-tax purposes will be determined as of July 1st instead of on a monthly prorata basis is a recognition of this principle. The elimination of the earned-income credit is another example.

Again, it may be that much of the difficulty stems from the lack of a long-range tax policy and a well integrated tax law, and that equity measures are simply being grafted on bad stock.

Provisions for plugging loopholes against tax avoidance and tax evasion may be indications that the tax laws were originally poorly drawn and not well planned. They are also probably a reflection of the administration of our tax laws which set up a tug of war between the taxpayer and the government to see who can get away with the most. This may be due to the fact that there is a feeling that all doubts will be resolved against the taxpayer, and that government interpretations of the laws will be highly legalistic and technical. A recent analysis, published in the January, 1944, *JOURNAL OF ACCOUNTANCY*, of 600 replies from certified public accountants all over the country to a circular letter distributed by Colonel Robert H. Montgomery, indicated that an administrative policy of short-range expediency of obtaining maximum revenue year by year without regard to the long-range tax consequences prevails. In the experience of these accountants, additional assessments rarely are based on improper or fraudulent returns, but are assessed on items of valuation and accrual such as depreciation, or are nuisance assessments on items of minor revenue value.

The former type of adjustment merely results in shifting income from one year to another, and, during the increasing rates we are experiencing, has resulted in a net tax loss to the government. We are

all familiar with the tax benefits clients are receiving as a result of reduced depreciation rates in the 30's and the consequent prolongation of the lives of the assets into the present high rates. This approach by the government, of course, does not recognize the equalizing factors in taxation and the fact that assuming a consistent depreciation policy, the taxpayer could set his own depreciation rate, as suggested by Colonel Montgomery, and the net tax receipts would average out over a period of years so long as the total amount allowed over the life of the property could not exceed the cost.

The entire situation is simply an indication of a very poorly developed tax system.

In addition to these basic complicating features, there is another major factor which adds to both the complexity and the uncertainty in our tax structure. It is the fact that tax laws today have been utilized directly and indirectly for nonfiscal purposes.

We speak of using the tax law to control inflation, to avoid depression, etc. Financing by debt rather than by equity stock is currently getting attention, since bond interest is deductible by corporations from their gross income, while dividends are not, which results in double taxation of dividends (once to the corporation and again to the stockholder when the dividend is received). George O. May, in a recent article in the *Harvard Business Review*, made this point very clear by explaining that, apart from the excess-profits tax, a corporation which today has outstanding 6 per cent preferred stock of one million dollars must earn one hundred thousand dollars before taxes in order to have sixty thousand dollars left with which to pay dividends; whereas, if an issue of 5 per cent bonds were substituted for the same preferred stock, the amount to be earned before taxes would be cut to fifty thousand dollars, or exactly in half.

It is not my purpose to evaluate the soundness or desirability of these measures individually. Some have merit, others not, and it is, of course, true that all tax levies by their mere imposition have indirect effects. But it is important to realize that

as the emphasis shifts more and more away from a tax law "for revenue purposes," it creates complications and has long-range effects which are not easily determined in advance. Also, it creates uncertainty as to future demands and levies and makes business hesitant to embark on new enterprises. Therefore, several questions arise. Could social betterment and economic reform be accomplished more effectively and more adequately in specific measures clearly designed for such purposes? Should the tax law give special privileges which are in effect subsidies, or should the subsidy be clearly stated?

It would probably be a sin of omission to leave out the language complexity which we must endure. The length and technicality of the statutes, regulations, and interpretations are the product of the factors already discussed. But to what extent the extreme language complexity is a necessary evil is debatable. It is quite hard to justify the highly legalistic, ambiguous wording, the parenthetical phrasing, and the innumerable references and cross references.

For example, what excuse is there for this section recently cited in a *Reader's Digest* article by Miss Sylvia Porter, which tries to say that an employer may deduct from his income tax reasonable payments made under a pension plan? The law reads as follows: "If contributions are paid by an employer, to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or approved on account of any employer under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent . . ."

Miss Porter suggested that the writers of income-tax prose be exiled, and that it be mandatory for the new authors of tax-instruction sheets to use (1) short words, (2) short sentences, (3) no semicolons, and (4) no parentheses.

All the defects show the lack of a long-range, well integrated tax policy and tax

structure. They show that we need a thorough overhauling of the entire tax system and the enactment of a new tax law based on permanent and consistent principles of taxation.

We need to begin this task now as part of an effective postwar-planning program. This is not an easy job which can be done overnight. It is a huge task. A complete, careful study and analysis of the tax structure and its technical aspects must be made. The rationale of the various forms of taxes and their relation to other parts must be reviewed. The existing studies, reports, and recommendations made by private organizations and government staffs must be sifted.

Now, who should do this job? We have existing processes of revision through the Treasury's legal, economic, and statistical staffs, the members of the Congressional committees and their experts and draftsmen, as well as the individual organizations and private individuals who make recommendations for improving the tax system. However, unfortunately, these efforts are inadequate for the larger task which confronts us. The emphasis of the government staffs of necessity is largely on revenue-raising measures today, or on providing relief or loophole-plugging measures. They are not sufficiently free to undertake the broad problem of complete overhauling.

The representatives of the private organizations, as well as the individuals who appear before the Congressional hearings with their recommendations, are generally concerned with specific technical amendments, or with special privilege pleas. They are made before a group who is burdened with many other legislative tasks and whose members are admittedly not expected to be tax technicians.

The only logical solution is a non-partisan commission appointed for the specific purpose of reexamining and reevaluating our tax laws. The goal of the commission would be to make recommendations to Congress for the determination of sound, basic tax principles, and for the enactment of a long-range, integrated tax system based on these basic principles, which

could remain in more or less permanent form and which would be written in simple, understandable language so that the tax could be computed and collected with relative ease. Consideration to economic consequences and effects, particularly to stimulating and encouraging citizens to produce to maximum capacity would be a major factor.

The fundamental consideration for study by an advisory council may be summarized as follows:

- (1) What are the criteria of a well designed tax system? That is, adequacy, stability of yield, simple and economical administration, fairness in distribution—proportionate to benefits received and ability to pay.
- (2) How does the federal tax system measure up to these criteria?
- (3) What is the rationale of the various concepts of taxation?
- (4) What is their impact on our economy?
- (5) What principal changes are indicated?
- (6) What will be the fiscal requirements after the war?
- (7) What forms of taxes should be employed?
- (8) What is the reasonable ratio derived from direct and indirect taxes?

Suggestions regarding policy:

- (1) We have urged that with a well integrated, long-range, consistent tax policy, a framework be established in which rates could be raised and lowered as the fiscal requirements of the government dictated, but the basis of taxes might be expected to remain the same so that business could reasonably plan for the future without fear of new policies not contemplated.
- (2) The new tax law must, as the Baruch war and postwar report states, be designed "so that the loans made available can be repaid and to encourage new enterprises," and, as the Brookings Institution study has said, "to stimulate postwar expansion and employment."

We should not lose sight, however, of the fact that if it were possible to assemble a group of experts who would develop from the standpoint of the experts a perfect law, this law must be enacted into legislation.

The legislator influenced by his constituents representing special interests, will continue to complicate the tax laws with provisions that meet these varied and numerous demands. Political and legislative problems involved in tax legislation are perhaps more difficult of solution than are the technical problems.

Following the adoption of the resolution advocating the establishment of a non-partisan tax commission at the annual meeting of the Institute on October 19, 1943, Institute officers, committee members, and staff have made every effort to bring about the introduction of legislation. Four of the five bills which have been subsequently introduced in conformity with the purposes of our resolution may be said to be the direct or indirect result of

these efforts. These bills which are now pending include Representative Carlson's (R-Kan.) HJ Res. 211, and Representative Forand's (D-RI) HR 4086, providing for a non-partisan commission composed of lawyers, accountants, economists, and others, to make a thorough study of the tax system and submit recommendations to Congress; Representative Knutson's (R-Minn.) HJ Res. 233, and Representative Talle's (R-Iowa) HJ Res. 236, which would establish an advisory council to the Joint Congressional Committee on Internal Revenue Taxation for the same purpose; and Senator Davis' (R-Penn). Senate Con. Res. 36 providing for the appointment of ten certified public accountants as a committee to submit recommendations to Congress for simplification of tax laws.

Building a Profession

BY JOHN L. CAREY

Recent developments in the accounting profession and responsibilities which the profession should be prepared to assume, on behalf of industry and the public, are discussed in this article by the secretary of the American Institute of Accountants. The text was originally presented as one of several addresses at a recent series of Wartime Accounting Conferences conducted by seven state societies of certified public accountants or their chapters, in coöperation with the American Institute.

WHAT has made accountancy a profession instead of a business, as it might have been? What makes it a profession is the acceptance by those who practice it of a responsibility far greater than that of merely rendering competent technical service—the responsibility of exercising independent judgment. This carries with it a sense of responsibility to others than the person who pays the bill, a subordination of desire for profit to the obligation of service to society as a whole.

This is not only a moral or an ethical question, but a very practical question. The enlightened self-interest of professional certified public accountants demands their acceptance of what Dr. William E. Wickenden described as a necessary characteristic of any profession—“conscious recognition of social duty.”

The professional status carries with it valuable privileges. It confers on the holder prestige which broadens his opportunities for service. In a sense the public says: “Since you are a profession we seek your advice and we trust you. You know more about your subject than we do, and we must rely on your knowledge and your judgment, even though the results are intangible, and we are unable to judge the value of your product.” In return the public expects that the profession will maintain among its members standards of competence and integrity which will assure able and honest service to the public.

The Federal Court of Appeals, in the *American Medical Association* case, put it this way: “Professions exist because the people believe they will be better served by licensing especially prepared experts to administer to their needs. . . . The people give the privilege of professional monopoly and the people may take it away.”

Now a curious thing about professional accounting, unlike law and medicine, is that every one of its purely technical functions could be performed by someone else. There are competent auditors and accountants in the employ of industry and the government. There are competent lawyers in the field of taxation. The broad and diversified experience of the practicing certified public accountant gives him an advantage, but the principal thing he can offer which nobody else can offer is his independent, impartial judgment, anchored to a conscious recognition of social duty—in short, the peculiar responsibility assumed by the professional certified public accountant.

Tax Practice

Consider an example. It is because the determination of income is an accounting problem that certified public accountants are generally requested to prepare tax returns. Lawyers can understand statutes and regulations. It is properly their business to fight cases in the courts. The more income taxes become based on statutory rules and explicit regulations, and the less they are based on generally accepted accounting rules, the more the legal profession may be called upon to render tax services.

If taxes become simpler and less legalistic, if they are determined on the basis of generally accepted accounting rules, the certified public accountant, by jealously preserving his independent position, may have an opportunity to render a great service to the community. His expression of opinion on the client's statement of in-

come for tax purposes may eventually be accepted by the government, just as it is for purposes of reports to stockholders or to the Securities and Exchange Commission, thus minimizing the necessity for investigation by government tax agents.

In the past ten years there have been numerous conferences at which committees of the American Bar Association and the American Institute of Accountants have discussed the proper field of the lawyer and the certified public accountant in tax practice. Attempts at definitions have been fruitless. Law and accounting are so inextricably interwoven in income-tax problems that no sharp line can be drawn between them. The Institute has pointed out that the preparation of the return is the business of the accountant; that, at the other extreme, the trial of a tax case in court is the business of the lawyer—that, in between, the two must cooperate, as circumstances dictate, in the best interests of the client and the public.

The latest report of the American Bar Association's committee on unauthorized practice of the law acknowledges the accountant's status in the field of taxation. It says:

"It is regrettable that from the inception of the income-tax laws the lawyers generally have not taken as much interest in this field of law practice as they might have, and consequently the public has grown accustomed to employ accountants and other laymen. Furthermore, the federal government throughout the period has favored laymen giving aid to others in filling out income-tax returns, and many laymen are enrolled and permitted by the Treasury Department to practice before it. . . .

Your committee has issued an informative opinion on this subject, and recommended to the Association's committee on public relations that it study the problem to see whether some plan could not be adopted whereby the public might be advised that the services of lawyers can and should be enlisted in this field of work, and also that by postgraduate course of instruction, lawyers generally should be given the opportunity to gain more knowledge of the law of taxation and thus be more generally qualified to render public service in this field."

There is now in process of organization a National Conference Group of Lawyers and Accountants, authorized by the house of delegates of the American Bar Association and the executive committee of the American Institute of Accountants. This group will consist of five members of each organization. It will consider all matters of mutual interest to the two professions, not only questions related to tax practice, but, for example, such subjects as the natural business year, and accounting in government regulation. The first meeting of the conference group will be on May 6, 1944. This new approach promises an opportunity for a close coöperative relationship between the two professions, through which they can work together on a basis of equality on many projects of importance to the public.

Auditing

The major activity of most certified public accountants is auditing, usually followed by the expression of an opinion on the fairness of the financial statements. Others could render this service, too. Internal auditors of large companies do much verification work similar to that of the public accountant. Banks have experimented with audit departments, though not very successfully. Government examiners check the accounts of banks, insurance companies, railroads, and utilities, and, in some cases, municipalities. Federal examiners in some cases audit the accounts of savings-and-loan associations. If our economy goes further in the direction of government regulation and control over business, government audits might extend on a wider scale to regulated business.

There has been a disappointing reluctance on the part of some government agencies to accept financial statements audited by independent certified public accountants. In fact, the price adjustment boards have been criticized in Congress for so doing. Very recently Senator McKellar attacked the Tennessee Valley Authority for having an independent audit by certified public accountants. The value of the independent audit was

belittled, and it was alleged to be a duplication of the audit required to be made by the General Accounting Office. As a result the Senate Appropriations Committee eliminated a provision for independent audit of the TVA. The American Institute of Accountants filed a statement on this matter, pointing out the value of the independent, objective approach of the certified public accountant, which was submitted by Senator Hill on the floor of the Senate and was inserted in the Congressional Record. The appropriation was later restored.

"Do you think," asked Senator Aiken recently, in questioning a witness about independent auditors, "that any company is wholly independent of their best customers?" The Institute answered him by stating that the professional accountant's best "customer" is the public.

The professional certified public accountant's responsibility is wider, heavier, and more difficult to discharge than that of any other profession—yet he must bear it if he is to survive, because it is his principal reason for existence.

SEC on Independence

As you know, the Securities and Exchange Commission has recently given a lot of attention to the question of the independence of accountants certifying statements filed with the Commission. It added to its rule last May the following paragraph:

"In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and the registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Institute representatives discussed this matter at length with the Commission and its staff before this amendment was finally issued. Naturally, the question arose as to what "relationships between the accountant and the registrant" might have a bearing on the Commission's view of the ac-

countant's independence. Some light was thrown on this question by another release of the Commission issued January 25, 1944, summarizing all prior releases, and twenty decisions hitherto unpublished, bearing on independence. In most of the cases the accountants held substantial financial interests in the corporations whose statements they certified, or held office, or were members of the board of directors, or some similar position. In a few cases, however, the Commission had considered the certifying accountant not independent simply because he had had a hand in the affairs of the company before undertaking his audit, or had regularly given advice on the accounting policies of the client.

The question is an important one and deserves debate and discussion in the meetings of state societies. The profession should have a clear view of what it considers independence to be, and what its members can and can not do in harmony with that concept. Perhaps it should express that concept in the form of a rule of professional conduct and be prepared to enforce compliance as an assurance to the public that its interests will be protected.

Accounting as an Instrument of Regulation

As the government has extended its control and supervision over economic activity, it has become recognized more clearly that accounting is an important instrument of regulation.

The Institute recently protested a Commission order as not justified on the grounds of sound accounting. The case went to the Supreme Court and the Institute filed a brief as friend of the court. The Supreme Court upheld the Commission, but in its decision acknowledged the Institute's contention in the following words:

"Although, as suggested in a brief filed by the American Institute of Accountants, the Commission's prescribed method of eliminating the write-up may not accord with the best accounting practice, it is sustained by expert evidence. It is not for us to determine what is the better practice

so long as the Commission has not plainly adopted an obviously arbitrary plan."

Individual members of the accounting profession have testified recently in several important cases before regulatory commissions in which questions of accounting were major points at issue.

It seems desirable that in cases of this sort the profession should express itself either through its societies or through the testimony of individual members as to what constitutes generally accepted accounting principles. Otherwise accounting chaos may result. Regulatory agencies of government usually have a specific purpose to accomplish. Their view of proper accounting may be influenced accordingly. Their purposes being different, their views on accounting may be expected to be different. Witness the accounting rules of the SEC, and those of the Treasury Department. Yet, the authority of these bodies lends a prestige to their findings which may give them weight as general precedents. It seems that the accounting profession, composed of certified public accountants, who are both expert and independent, is in the best position to act as umpire in controversies of this nature.

What Should Be Done

The building of the accounting profession in the United States has not been completed. A solid foundation is there, but no one can tell yet what the size or appearance of the finished structure will be. Here are some things which must be considered.

Personnel

It is imperative that if the profession's opportunities are to be realized the highest possible type of personnel be developed. There will be great competition for brains and character in the postwar world, and the accounting profession must get its share. With this problem in mind, the Institute has launched a \$50,000, five-year research project on selection of accounting personnel, which is designed to develop the best ways of encouraging well qualified men to enter the accounting profession, and discourage those not fitted for the work from undertaking it. In addition to

the selection of personnel, more attention should be given by practicing accountants to education and training.

Research

Research, discussion, and writing for publication are indispensable in the development of any profession. A conscious effort is being made to encourage scholarship in accounting. Prizes and awards have been established by the Institute, and by some state societies, for the best books and articles on accounting, and the most valuable services to the profession. State societies might consider the desirability of holding more meetings devoted to discussion of technical subjects of current importance and submitting the papers delivered at such meetings for publication in *THE JOURNAL OF ACCOUNTANCY*, *The Accounting Review*, or the state society magazines. The Institute's research department is planning to issue studies of the discussion type, not necessarily reaching conclusions, in order to stimulate discussion and debate.

Coördination

There is much work to be done in developing uniform CPA legislation, in maintaining high standards, in informing the public, in fact, in all areas of professional interest. To facilitate all this work an Institute committee on coördination of activities of state and national organizations recommends the establishment of a department in the headquarters of the Institute which would act as a clearing house of information and suggestions for all the state societies. Through full-time daily operation of such a department, it is believed all the officers and committees of all the state societies could be kept currently informed of events which were of particular interest to them, and could obtain advice based on the experience of others in the solution of problems with which they were confronted. Likewise, officers and committees of the Institute would be fully informed of the work of all the state societies. A program worked out in considerable detail will be discussed at the meeting of the council in May.

Relations between the state societies and the Institute have become much closer in the eight years since the merger of the two national organizations. A complete coördination of the activities of all the professional societies of certified public accountants would achieve the goal of complete professional unity, and would greatly expedite the work of building the profession.

"The Age of Accounting"

While the professional practice of accounting today presents many difficult and absorbing problems, it is even more stimulating to speculate on the relation of accounting as a function of the economy in relation to the community as a whole. Some of the most thoughtful members of the profession assure us that we are entering the age of accounting; that accounting has ceased to be merely a mechanical instrument for the assistance of business management, and has become a social force of considerable intensity.

They point out that accounting is the only language in which the results of business transactions can be reported—in which the matching of costs against revenues, the relationships of assets and equities, can be expressed.

In a broad sense, the production of goods and services and their distribution among the individuals who make up the nation is the major objective of all economic

activity. Those who furnish the capital, those who perform the labor, those who manage the business, and those who constitute the market, as well as the government which administers the nation's affairs, all demand a share in the fruits of production, in the form of interest or dividends, wages, salaries and bonuses, fair prices, or taxes.

If accounting is the only method by which the fruits of production can be fairly measured—in which, in other words, the relationships between costs, prices, and profits can be expressed—every citizen, whether he knows it or not, has a direct personal interest in accounting. Is it not reasonable to assume that the certified public accountant, if he maintains public confidence in his independence, in his "conscious recognition of social duty," may become the arbiter and interpreter among these varied interests? The day may come when financial reports, bearing the opinion of a certified public accountant that they fairly show what they purport to show, will be accepted by the government for tax purposes, by unions for purposes of fixing wage rates, by consumers as a basis for prices, by stockholders as a basis for dividends, by management as a basis for salaries and bonuses?

That will indeed be the "Age of Accounting," and the building of the accounting profession will have been completed.