[Journal of Accountancy](https://egrove.olemiss.edu/jofa?utm_source=egrove.olemiss.edu%2Fjofa%2Fvol14%2Fiss4%2F1)

Volume 14 | Issue 4 — Article 1

10-1912

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The Journal of Accountancy

Official Organ of the American
Association of Public Accountants

Vol. 14 OCTOBER, 1912 No. 4

The Abuse of the Audit in Selling Securities*

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The abuse of the audit, especially in relation to the sale of securities, constitutes a serious menace to the community, and the correction of this abuse is a matter worthy of most serious consideration. It is impossible to contemplate complete and universal honesty in business transactions and, to that extent, it is impossible to devise practical means of entirely eliminating this abuse, but I hope to convince you that it is within the province and ability of the American Association of Public Accountants to remedy existing conditions, and to eliminate entirely some of the main procuring causes that lead to the abuse of the audit.

The writer is not an accountant, and does not pretend to have a close knowledge of the fine technicalities of accounting. For this reason you are asked to consider this argument, not in the light of a scientific treatise, but rather as a broad treatment of causes and effects resulting from a somewhat wide experience in observing financial operations based on accountants' reports.

In order that you may thoroughly understand my point of view, it seems necessary that I should impress upon you my conception of the extreme importance of the accountant's function in the business community. I find myself constantly comparing him to the doctor in medical science, or rather to the diagnostician, because, after all, the accountant is not necessarily the

* An address before the American Association of Public Accountants, Chicago, September 17, 1912.

man to cure our business maladies, but he is essentially the man to examine, and test, and probe, and finally to name the disease, which function, after all, is the necessary preliminary to a cure. It would be just as natural to expect the human body to run its natural course without the assistance of a doctor, as to expect the business concern to complete its career without the services of the public accountant. Theoretically, it can; practically, it cannot, and, whether we realize it or not, the fact remains that the science of accounting is the real basis on which our entire commercial and credit structure is built. The relation of the accountant to the banker is peculiarly necessary and intimate, and it is especially from the banker's standpoint, and from his conception of the accountant's function, that you are asked to consider the subject matter of this paper.

The accountant's clients may readily be divided into two classes.

First—The stockholders or owners of a business, who desire independent analyses of their own operations. Here any serious error of the accountant is susceptible of discovery and correction, through the intimate knowledge which its executive officers have of its affairs.

Second—The investing public, and their agent, the banker, and it is this class alone which concerns us in this discussion. Here the purpose of the audit is essentially to form the basis for the issuance of securities in which thousands of investors are concerned—investors of large means, and small resources; the widow, with her husband's life insurance to invest; the trustee, with the prosperity of women and children dependent on his judgment; the tradesman, with his hard earned savings, as well as the millionaire, the prosperous merchant and the man of leisure. Here the efficiency and integrity of the accountant are all important; his word is final. Who is to check him up? Obviously the investor cannot, neither can the banker examine *every* asset comprising his security. He may verify the values of such tangible assets as land and buildings, machinery and equipment, but how is he to verify the subtle and less obvious assets of cash, receivables and inventories, or how is he to satisfy himself that bad debts have been eliminated, and that all liabilities have been shown? To be sure, if the accountant understates the condition of earnings, a violent protest from the company is likely to bring him to a quick realization of his error, but if he overstates the fact, it is not by any means so sure that his attention will be called to the matter. While I am not at all underrating the importance of the public accountant to the stockholder or owner, I am yet trying to emphasize the much more important character of the accountant's function in relation to the investor, and his agent, the banker.

Let us first consider the principal forms which the abuse of the audit takes, then the principal causes of this abuse, and finally, the best means of correcting, and, if possible, preventing the abuse.

The Principal Forms of Abuse

First of all, there is what we may justly term the "DEADLY AVERAGE," which is a method of certifying average annual earnings over a period of years. This particular form of abuse is flagrant and common, and its results are far reaching and vicious. The accountant's certificate may show, with absolute truth, that the average annual net earnings of a business represent a certain sum, which may appear to the investor to be ample for the protection of interest and principal of his investment, and yet, an exact analysis of the component units of the average may reveal a condition highly alarming to the safety of the security involved. Earnings decreasing materially every year may still show a satisfactory average, without disclosing the fact that they *are* decreasing, and that they are decreasing owing to some fundamental cause that will soon spell "No earnings at all," as, for example, obsolete facilities, prohibitive cost of production, bad management, wrong location, ruinous competition, dry rot in organization, abuse of family control, etc., etc. I have in mind one of the oldest manufacturing companies in Illinois, established sixty years ago, with assets and average earnings which indicated ample security for the proposed investment. An analysis of the earnings, however, showed steadily decreasing profits, and, in probing for the cause, the concern was found to be hopelessly permeated with "dry rot." Its competitors had been steadily outstripping it in manufacturing and selling facilities, and in general energy and enterprise, for years, and its doom was sealed. Immediately following the banker's refusal to purchase an issue of bonds, the company went into bankruptcy. Yet the assets and average earnings of this concern, backed by the name of a responsible banking house, would have made a marketable and apparently an attractive issue of securities, although to have distributed such an issue to innocent investors would have been nothing short of a crime.

It is needless to say that the only case in which it is admissible to quote the earnings of a business solely in the form of an average is when that average fairly represents not more than the actual earning capacity of the business at the time its securities are issued.

The banker who employs an average statement of earnings in order to cover up a serious defect in his securities is clearly dishonest, but I venture to suggest that he would be very chary of employing this particular form of deception were it not for the fact that he is able to cover it with the respectability and authority of the public accountant's name. The accountant delivers the audit to the banker, and the banker publishes in his prospectus and advertises in the public press that "The books have been audited by Messrs. Addit & Chargit, the well known firm of public accountants, whose report shows that the average annual net earnings for the last five years have been at the rate of blank dollars and cents, an amount equal to four times the annual interest requirements of this entire issue of securities." The statement is technically true. The investing public accepts it, because it is clearly associated with the name of an accounting firm in whose integrity and efficiency the public has complete faith. Without the use of the accountant's name, the operation of this particular form of fraud would be materially curtailed. I admit that the accountant's position is a difficult one, but it must be clear that by his silence and indifference he is participating in a deception and is, for the moment, the silent, but still culpable, partner of the dishonest banker.

Another form of abuse, almost equally common, is concealed in the phrase, "Net earnings before charging interest." This form of language is so universally met with in the financial circular that the investor has learned to accept it as the usual and proper way of expressing the relation between the annual earnings of the business and the annual requirements for interest on his investment.

When the securities which the investor is buying are issued for the purpose of refunding the bank loans, or commercial paper, of the issuing company, the expression is apt and proper, because the funds formerly used to pay interest on floating indebtedness are now available to pay interest on funded debt, but there are many cases in which the proceeds of new securities do not completely retire the floating debt, and there are cases where the proceeds of new securities are put entirely into new plant or equipment, and do not at all replace the floating debt. In such cases it must be apparent that the funds formerly required for interest on floating debt are still required for the same purpose, and must, as a matter of practical fact, be deducted from the operating income before showing the balance available for the protection of the investor's interest.

Here again the unscrupulous banker can very well say, "The books of the company have been audited by Messrs. Addit & Chargit, the well known firm of public accountants, and, according to their report, the net earnings, before charging interest, for the year ending December 31, 1911, were blank dollars and cents." The investor is entitled to understand from this language that the net earnings reported represent the sum available for the protection of his investment. If such is not the case, a gross fraud has been perpetrated on the public, and again, the accountant, through the power of his name, is unconsciously participating in a fraud.

Less common, but equally misleading, is the covering up of depreciation charge in the statement of net earnings, generally by ignoring it altogether, but also by quoting the earnings as before charging interest and depreciation, and passing the matter off in this inconspicuous way. A proper charge for depreciation may be vitally necessary for a correct presentation of the earnings, but the glamour of the accountant's name is all sufficient, and the investor accepts the statement without analysis, and in careless good faith.

Another phrase that frequently covers a multitude of sins is to be found in the expression, "Quick Cash Assets, or Working

Capital." This is often the dumping ground for all sorts of questionable assets—unmarketable securities, prepaid insurance, loans to subsidiary companies, bills receivable from officers and stockholders, who are by no means sure pay; even horses and wagons, by some strange and subtle reasoning, are sometimes included in this item of working capital.

Then finished inventory comes in for some strange treatment. It is figured at selling price, instead of at cost, on the specious argument that it is under contract of sale, and with supreme indifference to the fact that contracts *may* be broken for many causes and *may* end in expensive litigation and claims for damage. Raw materials are hoisted to the level of an ascending market, but are not permitted to follow a descending market below the point of cost; articles in process of manufacture are inflated with their share of next year's selling expense, although this expense may never be recovered in their final disposal. In businesses concerned with articles of a seasonal character, subject to the continually changing demands of fashion, or public fad, even the cost price of inventory may be entirely too high to justify its use in the balance sheet.

This valuation of inventory is altogether the most important and difficult part of the accountant's work. It is subject to considerable diversity of opinion among accountants themselves. It requires not only the correct assembling of items and figures, but an honest and painstaking investigation of the facts behind the figures. When it is borne in mind how vital to a correct presentation of earnings, quick assets, and surplus, is this matter of correct inventory, it will be seen how readily it becomes a subject of abuse by the indifferent, inefficient, or dishonest accountant. In the matter of quick assets, and especially in the matter of inventory, the abuse of the audit can come only with the connivance, consciously or unconsciously, of the accountant. The banker, if he bases his statement on the authority of the accountant at all, has no means of deceiving the investor as to this particular part of the balance sheet, because the technical truth and the absolute truth are one and the same thing, and no amount of linguistic chicanery can alter it.

Occasionally the investing public is startled by the unexpected collapse of a business that has just been the subject of a favorable audit, publicly announced. In twenty-four hours the value of the shares has disappeared. What, then, has changed the flourishing company over night to a bankrupt concern? An investigation of the company's working capital will, in every instance, reveal the discrepancy—inflated inventory, bad accounts, concealed liabilities. The mischief was not accomplished over night—it has been in progress for months or years, but through the dishonesty or inefficiency of the accountant the true condition has not been brought to light. This is an abuse of the audit of the very worst character, and by the public accountant himself.

There are many other, though less serious, forms of abuse that must have come under your notice as they have under my own, but I think these examples are sufficient to show the serious need for reform, and the necessity for concerted action by your Association.

Let us now inquire into the causes that lead to these abuses.

The Causes Leading to the Abuse of the Audit.

There are three main procuring causes:

First—The lack of scientific methods of accounting, and the lack of uniform principles and expressions of accounting.

Second—Dishonesty or incompetency of the accountant, and especially his indifference towards the abuse of his certificate by other parties.

Third—The inefficiency of the banker and his dishonesty in wilfully misinterpreting the audit.

I believe that accounting is, or should be, a science—not a system of ethics but an exact science, amenable to definite laws, constructed on definite axioms, and capable, in proper practice, of producing definite and exact results. The expert chemist can tell us exactly the component ingredients of any substance, and to the minutest subdivisions of a grain the exact amount of each ingredient. His analysis is not a matter of opinion at all. It is an exact scientific conclusion. If you submit the same substance to another chemist, the result will be exactly the same. I maintain that accounting should be almost, if not entirely, as exact a science as chemistry. I also maintain that it is within your power to make it an exact science. You can do this by adopting and putting in practice a system of fundamental principles so clearly and exactly defined that they will admit of no material latitude in their interpretation, so exactly defined that the optimism, or the pessimism, or the individual prejudice of the accountant, will not be brought into the operation at all. The accountant will then be concerned only with the determination of the facts, and not at all with their interpretation. When this is accomplished, we poor laymen will then know that working capital is working capital, that inventory is just pure inventory, without the adulteration of anticipated and doubtful profits, that net profit is final profit, and not subject to this, that or the other deduction, tangible or intangible.

You may very well argue that the adoption of any such rigid system of principles would involve you in serious differences of opinion with your clients, and perhaps serious loss of business to yourselves. If you so argue, I would remind you that you are today in continual conflict with your clients. I venture to say that it is the exception rather than the rule when your audit pleases every one concerned. This client thinks you have valued the inventory too low, and that one thinks that your reserve for depreciation is outrageously high, and still another one flays you for revealing some rottenness which he would rather conceal. I fully believe that if you can tell these critics that your audit is governed by certain fundamental rules, laid down by your own Association, concurred in by every banker, and understood by every investor; that you cannot possibly depart from your rules, and moreover that they cannot find a reputable accountant in the country who will certify other than you are proposing to do; then you will get rid of a great many of the annoyances of your business, and the banker, the investor and the business man will understand exactly what your certificate means.

I have before me at this moment an excellent example of the confusion that arises in the layman's mind over the differences that exist in accounting methods. The accounts of a large manufacturing corporation have just been audited by two of the most prominent firms of public accountants in this country. The audit embraces the same assets, the same operations and the same periods of time. One firm values the manufactured products on hand, not at cost price, but at selling price, less certain reserve for expenses incidental to delivery, this on the theory that the product in question is sold under contract to responsible concerns at stated prices, and that the profit belongs to the year in which the product was manufactured. The other firm values the manufactured product at cost price, on the theory that while the product is sold, it is still held in the company's warehouse at the company's risk, that the company has not received its pay for the same, and that it is improper to anticipate the profit before the selling price has been actually realized.

I do not pretend to suggest which of these firms is right and which is wrong—it may even be argued that both are right—but I do maintain that the American Association of Public Accountants should give a definite ruling on the point, and its members should accept that ruling; there is no excuse for accounting methods that permit of so wide a latitude, in this case amounting to over $12 per ton of product in the profits, working capital and surplus of this company.

Another example of this lack of uniformity in accounting methods is to be found in the treatment of bond discount and organization expenses. One firm of auditors maintains that the discount in question is properly a part of the cost of plants and properties acquired by, or produced from, the proceeds of the bonds. Another firm asserts, with equal authority, that the discount is a charge against the future operations of the company, and must be written off from earnings over a series of years. Even when accountants agree that the discount must be written off against earnings, they totally disagree as to the methods of so doing, one maintaining it should be written off in equal annual installments over the life of the bonds, the other asserting that it should be treated as an additional interest charge on the amount of bonds outstanding in any year.

Another subject of interminable dispute among auditors themselves is the question of depreciation on various types of structures and equipment. This, in my opinion, is totally inexcusable. Ample data are available to enable you to define, almost exactly, the probable commercial life of a particular structure or machine. Some attempt has already been made to standardize these depreciation ratios, and there is no reason why your Association cannot, out of the vast experience of its members, construct a table of depreciation values which should be absolutely fair, uniform and satisfactory to all.

There are many other items in the audit which are the subject of much difference of opinion among auditors, but I have quoted you examples enough to show you how really serious is this lack of definition and uniformity. When you have promulgated proper scientific laws for the guidance of your members and when you have adopted uniform means of expressing the result of these laws, you will have removed the most potent and common cause of the abuse of the audit. You will have removed the practice of accounting from the plane of a mere system of varying opinions to its proper place as an exact science. You will have taken away from the dishonest banker and the dishonest promoter the principal cloak under which they are now able to cover their frauds.

The Remedies.

In dissecting the main causes of the abuse of the audit, I have already necessarily suggested the main remedies. I would summarize them, however, as follows:

First—Let this association appoint a committee to investigate and report to it as to the feasibility of adopting exact and uniform principles and expressions of accounting. This committee will collect from the members of the association all data necessary to create a working basis for its findings. It may have to divide assets, businesses and operations into many general heads having a common function, and it may have to subdivide these classes into many subordinate groups, and it will have to study their operations with the greatest care in order to find a common basis for accounts. The committee will have to attempt to define a uniform basis for the valuation of inventory, for the depletion of natural resources, for the uniform handling of depreciation and reserves, and it will have to define exactly what constitutes working capital and under what headings the various items of the balance sheet shall be grouped. All of this sounds very much more complex than it really is. You already have among yourselves all the data necessary to the establishment of fundamental rules of auditing; there is no kind of business under the sun that has escaped your experience. The information is in your hands and all it needs is careful, painstaking work and the hearty co-operation of your members. When you have agreed among yourselves on these fundamental rules, publish your findings and send them to the members of the American Bankers Association and similar bodies, and ask for their concurrence or criticisms.

Second—When your certificate is misquoted or misinterpreted, in public announcements to the investing public, you must, at all costs and by all means at your command, correct the abuse. Your action may have to take the form of a public notice to investors, of a suit in the courts, or even of criminal prosecution for fraud.

Third—You must be careful to give your certificate in such form that it will be the least capable of misinterpretation. Hence, wherever your certificate is concerned at all with the issuance of securities, it will be well for you to adopt a uniform form of certificate, which the investing public will learn to know and recognize and honor.

Fourth—See to it that membership in your association is *prima facie* evidence of efficiency and integrity. Publish a list of your members every year and send it to bankers, and other interested parties. Quite recently I had occasion to ask a prominent firm of public accountants to inquire into the standing of another public accountant whose certificate was before me, but whose reputation was unknown to me. I received the astonishing reply that little was known of the party in question, and that while he was recorded as a member of the American Association of Public Accountants, that fact in itself meant nothing.

Other remedies occur to me in the line of federal legislation to prevent the abuse of the audit by the promoter in selling securities through the mails. My views on the subject are not at all well defined, and I can only suggest the matter for your discussion. In any event, it is quite certain that if your honorable body will, first of all, energetically proceed to remove the causes of the abuses of the audit that are within your own doors, you will be making a good start in the right direction and you will be in a fair way to a proper realization of the importance of your function towards the business community.