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Ram S. Sriram

Gloria Vollmers

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Ram S. Sriram
GEORGIA STATE UNIVERSITY

Gloria Vollmers
UNIVERSITY OF MAINE

# A REEXAMINATION OF THE DEVELOPMENT OF THE ACCOUNTING PROFESSION - CRITICAL EVENTS FROM 1912-1940

*Abstract:* This study reexamines the accounting profession's response to opportunities and incentives given it during three unique periods in its history to foster reliable accounting, reporting and auditing practices. By profession, we mean the auditors of publicly held companies as represented by the American Institute of Accountants and its predecessor, the American Association of Public Accountants (AAPA). We use two models of professionalism, the Functionalist and the Conflict models, to interpret the profession's response to these events. We find that both self interest and the public interest may have motivated many of the actions taken. These motivations are not, however, mutually exclusive and both may be used to interpret the same behavior.

## INTRODUCTION

The accounting profession in the United States developed into its modern form by 1940. The American Institute of Accountants (AIA) was the national organization of accountants. A code of ethics was in

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place and the AIA had disciplinary authority over its members based on that code. The AIA's Committee on Accounting Procedure, forerunner to the Accounting Principles Board and later the Financial Accounting Standards Board, was responsible for setting accounting standards, albeit not mandatory at the time. A workable, sometimes uneasy, relationship existed between the profession and the Securities and Exchange Commission. The state societies had licensing control over new CPAs, setting educational and experiential requirements, although most used the national examination written by the AIA [Miranti, 1990]. Annual audits of publicly traded companies were legally mandatory.

At the beginning of the century, little of this was in place. There was no national organization of accountants of any size or influence [Previts and Merino, 1979]. The first state licensing legislation was passed in New York in 1896. Other states followed but licensing requirements varied, ranging from substantial experience, educational and examination requirements to virtually none. The minimal amount of regulation over accounting and auditing practice may be explained by the relative simplicity of accounting and a fairly small securities market.

An explosion of mergers and consolidations at the beginning of the twentieth century accelerated the growth of accountancy. Knowledgeable and competent accountants were needed to handle these complex accounting transactions and the status of the fledgling discipline began to rise [Littleton and Zimmerman, 1962; and Previts and Merino, 1979]. Growing companies and expanding manufacturing industries also needed accountants to set up financial and cost accounting systems. With the later passage of tax legislation, accountants carved out a permanent place for their skills in the tax area.

Until the passage of the Securities Acts, public corporations faced little independent oversight. Audits were largely voluntary despite spreading public ownership of stock although companies increasingly engaged auditors to attest to their annual financial reports [Merino et al, 1994]. A large portion of audit work prior to 1920 was the balance sheet audit attesting to a company's collateral and liquidity to satisfy bankers who supplied most corporate financing [Chatfield, 1974]. Companies sometimes requested auditing services for their own information [Miranti, 1990]. The auditor's role was therefore strikingly different from that of today. Francis Pixby, at the 1904 World Congress of Accountants, said that the auditor's duty was to the company not to stockholders [Previts and Merino, 1979, p. 180]. In 1933, the accounting firm Seidman and Seidman wrote that neither audits nor financial reports were for the benefit of stockholders [Letter, 4/6/33]. Many prominent

people, including accounting practitioners and academics, criticized audited financial statements as unreliable for investment decisions [Smith, 1912; Kohler, 1926 & 1932; Berle, 1926; Hatfield, 1927; Ripley, 1927; Couchman, 1928; Robbins, 1929; Farr, 1933; Pecora, 1939]. Management could choose from a variety of alternative practices and valuation methods without disclosure and could count on the support of their auditors. Changes of method were not reported. Despite criticism, the business sector was not interested in promoting a stringent monitoring system over their activities and were indignant at the suggestion. "Every businessman used his own accounting principles and fought like hell to sustain them" [Previts and Merino, 1979, p. 219].

The voluntary nature of the audit, the absence of authoritative accounting rules, and the weakness of auditors worked against the presentation of financial statements in accordance with accounting conventions considered to be sound according to textbooks and other guides of the time [Montgomery, 1926].

> So long as the discontinuance of audits or change of auditors passes without comment from stockholders or creditors, the auditors are hampered in their efforts to make accounts as accurate and their certificates as complete and informative as possible. If auditors take too rigid a stand the directors will simply publish unaudited accounts or perhaps seek some more amenable auditors [May, 1915, p. 251]

Twenty years later, Littleton [1935, p. 285-6] believed little had changed: "(Q)ualified to serve these men may be, but free to serve with a real independence they are not...When their powers of persuasion are exhausted, auditors have but little choice except acquiescing or resigning."

## PURPOSE

This study examines the accounting profession's response to opportunities and incentives given it during three unique periods in its history to foster reliable accounting, reporting and auditing practices. By profession, we mean the auditors of publicly held companies as represented by the AIA and its predecessor, the American Association of Public Accountants (AAPA). We use original correspondence between the AIA, the New York Stock Exchange (NYSE), and other published materials as evidence.

The profession's responses to these opportunities for change may have been motivated by self interest rather than by protection of the public interest as suggested by the rhetoric of the time and by some modern historians. Wootton and Wolk [1992], for example, offer a nonproblematic account of the development of the accounting profession that obscures the profession's battles to preserve its independence and extend its power.

## EVENTS TO BE DISCUSSED

Three extended events in the profession's history provide the focus for this discussion. The first event is the reaction of the profession to the demands and regulatory threats posed by bankers, the Federal Trade Commission (FTC) and the Federal Reserve Board (FRB) from around 1912 to 1917. The second is the collaboration between the NYSE and the AIA as they worked to improve reporting practice in the face of impending regulation in the early 1930s. The third is the response of the profession to the Securities and Exchange Commission (SEC) from 1934-1939. All three events threatened accountancy's professional identity. Two models of professionalism are used to interpret the profession's actions.

## APPROACH USED TO ANALYZE THE EVENTS

The functionalist and the conflict models of professionalism [Kultgen, 1988] help interpret the actions of accounting's emerging leadership within the AIA. Sociologists have used both models to study professions [e.g. Durkheim, 1957; Collins, 1979] and Hooks (1992) applied similar models in her analysis of events occurring more recently in accounting history.

The functionalist model explains and predicts the behavior or characteristics of either an individual or a group but it is group activities that are of particular interest in this research. The primary assumption of this model is that the profession is devoted to the public interest, to human welfare. The service offered is important and complex requiring extensive education, training, experience and a commitment to lifetime learning. However, mastery of technical skills is not enough. The professional must develop and exercise judgement because client needs are highly individual and not amenable to textbook solutions. The complexity of these efforts means that only a professional can assess the quality of the work performed by another (Kultgen, 1988, p. 79, 81, 91, 95).

Professional groups form to ensure quality. They determine what technical skills are needed, set standards for admission to the profession, provide opportunities for continual education and monitor the work of members through peer review and investigations of complaints. They write codes of conduct that describe the behaviors professionals should exhibit in their work and toward clients and other professionals. The desire to preserve quality leads the group to lobby for licensure to prevent the unqualified from practicing and harming the public (Kultgen, 1988, p. 74, 85).

Society gives the profession a license and a monopoly over practice because it values the service and believes that this will help the profession ensure high quality performance. Sustaining high quality is the duty of a profession that wishes to maintain its license, but it is also its desire so it willingly engages in self-monitoring activities. The benefits of monopoly are status and high fees but these are secondary to the rewards derived from a love of work and a desire to help others. The professional is judged therefore, not by the fees commanded but by the quality of the service provided (Kultgen, 1988, p. 84, 85, 95).

The conflict model, which focuses on group behavior, assumes that self interest is the dominant motivation of a profession whose purpose it is to monopolize control over practice to secure status, power and economic gain. It predicts that practitioners will organize and, as a group, position themselves as a profession to secure the benefits of monopoly.

Organizing, unrelenting promotion of the value and need of their services, writing a code of conduct and setting standards for admission are actions taken to convince those in power that a profession deserving a license is in place and, once acquired, that it deserves to keep it. Codes of conduct may be unenforceable and disciplinary mechanisms weak, but the group can point to them as evidence of their concern with the public welfare. Prohibitions of contingency fees, competitive bidding and advertising serve to create a professional appearance but also protect the elite professionals from losing market share to newcomers, even those admitted to the professional group. Limiting access to the profession through examination and other requirements is not motivated by public welfare but by securing economic gain [Kultgen, 1988, p. 122, 123, 130].

Relationships with third parties are important. "The status of the individual professional and the entire profession is tied to the status of those served" [Kultgen, 1988, p. 128]. The social standing acquired from proximity to corporate management or other influential groups, as well

as the fees generated, limit the willingness of the profession to jeopardize those relationships by imposing too restrictive standards of practice upon them.

In conclusion, the key to both models is motivation. It is possible for an action to be in the public interest while at the same time be an element in the profession's negotiation for market power. Since motivation is unobservable, and the models predict behaviors that are not mutually exclusive, they may be used as alternative explanations for the same events.

## THE EVENTS AND INTERPRETATIONS OF THEM

### *Event 1: Bankers and Federal Agencies Demand Change*

Bankers in the second decade of this century asked for improvements in auditing and accounting. They accused small businesses in particular of issuing misleading and unreliable financial statements out of either ignorance or deceit without resistance from their auditors [Smith, 1912; AIA Special Committee Reports, 1912-1914]. Bankers wanted certain auditing procedures to be consistently and universally applied [AAPA, Yearbook-1913:159ff] and offered to support the AAPA in its attempts to standardize practice. Colley [1914] and Peple [1916], representatives of the banking community, strongly supported the audit of financial statements and expected auditors to examine carefully accounts receivable and inventories not only for their numerical accuracy but for their value.

Edward Hurley, chairman of the Federal Trade Commission (FTC), supported these views. Hurley called for auditing instructions: "Which would serve as a guide to accountants, bankers, credit men and the business public...that...would at least show clearly the level below which the accountant could not go and certify the alleged verity of the accounts" [Editorial, 1929, p. 357]. He [1916] also recommended to the Chairman of the Federal Reserve Board (FRB) that a federal audit bureau check the credentials and reliability of audit practitioners who wished to practice before the FRB and name those approved, zone experts.

Hurley also favored uniform accounting, believing that it would make financial statements easier to understand and comparable within an industry. Uniform accounting meant an industry-wide chart of accounts, a standard definition of what was to enter into those accounts and uniform cost accounting standards. Many anticipated that cost

accounting standards would end cutthroat competition believing that businesses recklessly and ruinously cut prices because they did not know their costs [Jordan and Harris, 1921; Dohr et al., 1935].

Cost accounting standards did not disturb financial accountants but Hurley went further, he wanted to set rules for asset and liability valuations. This appalled accountants who believed that such standards would grossly misrepresent companies operating in different economic environments. They worried that standardization would degrade the profession to mere bookkeeping [Previts and Merino, 1979].

The 1915 - 1917 Minutes of the AAPA and the AIA show that the leadership resolved to deflect this potential regulation. To do so, they had to demonstrate control over the level of competence of their own practitioners. The AIA was formed (and the AAPA dissolved) in 1916 as a national organization of accountants. Practitioners could gain admission and certification by passing a qualifying examination and acquiring experience. The Institute elected a board of examiners, published "Rules of Professional Conduct," and established a committee on professional ethics to exercise disciplinary powers over the membership.[1]

To meet the challenges to audit practice, the AIA gave the Federal Reserve Board a document called *Uniform Accounting* which the Board later published in the Federal Reserve Bulletin of 1917.[2] While its title and preface suggested that it standardized accounting methods, it did not.[3] The FRB reissued the document in 1918 under the title *Approved Methods for Preparation of Balance-Sheet Statements* deleting all references to uniform accounting. As a result of these actions, Hurley dropped the idea of federal registration of accountants [Carey, 1969].

[1]It is probably an exaggeration to assume that the FTC and FRB dropped these proposals solely because of the efforts of the profession. The Wilson presidential campaign and the entry of the U.S. into World War I necessarily deflected the interests of the administration.

[2]It was an adaptation of a Price Waterhouse internal control memorandum that dealt with auditing procedures for small and medium-sized firms [DeMond, 1951].

[3]Both Chatov [1975] and Carey [1969] believe that the AIA took advantage of Hurley's confusion over the difference between uniform accounting and uniform auditing.

Wootton and Wolk [1992, p. 6] claim that this document "hastened the establishment of minimum auditing standards by many accounting firms." In fact, *Approved Methods* reduced them [Merino et al. 1994]. It gave management an authoritative source with which to avoid procedures that many thought were vital [Carey, 1969; Chatov, 1975; Previts and Merino, 1979]. The auditor was to rely upon client assertions for most asset-related information including inventories - despite bankers' requests [Smith, 1912; Colley, 1914; Peple, 1916]. *Approved Methods* [10] told auditors to confirm accounts receivable "if time permits and clients do not object." Internal control evaluations were made optional and large companies were largely exempt because good controls were presumed to exist. Deference to management was made official.

*Approved Methods* recommended a short, standard audit certificate despite banking community complaints that the short form audit report conveyed little or no information about scope limitations or other deficiencies of the audit process.[4] The AIA maintained that a short form report was less confusing than the longer, unstandardized report that smaller audit firms preferred which often contained the audit procedures followed and actions taken. The AIA claimed that the excessive verbiage in these reports had at times concealed the absence of major auditing procedures.

*Functionalist Theory Interpretation of Event 1*

Until this time, accountancy only loosely met the definition of a profession. Under criticism by creditors and facing possible regulation by Federal agencies, AIA welcomed these incentives to professionalize practice as predicted by the functionalist model. It was unthinkable that a government agency, ignorant of accounting, might determine who was qualified. It should be noted that these were only first steps. The AIA was weak. Although the leadership of the AIA was composed of partners from the largest accounting firms, it did not represent the majority of practicing accountants and, in fact, many resented the organization for its elitism [Previts and Merino, 1979; Miranti, 1990].

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[4]The recommended report read as follows: "I have audited the accounts of Blank and Co. for the period from ___ to ___ and I certify that the above balance sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at ___ and the results of its operations for the period" [Uniform Accounting, 24].

Accounting knowledge had arrived at a level of complexity that called for education and experience. In view of the complaints of incompetency and collusion voiced by the banking community, and the wide variations in certification requirements of the state bodies, the AIA's board of examiners recommended that candidates for certification complete a 'preliminary education' (a controversial requirement left undefined), five years of experience (with exceptions) and an examination. Certification would give the public assurance that these practitioners possessed a level of competency upon which they could rely, an assurance unavailable in some states where certification standards were low. These controls may be construed as the first attempts of the profession on a national basis to contract with the state (represented by the FTC and FRB). In the long term, only licensure would ensure that the profession could control the quality of the services offered.

The AIA did not attempt to set accounting standards or to limit management choices. The leadership placed a high premium on expert judgement and expected the professional to oppose management only rarely, using powers of persuasion. Since audits were voluntary, there were few other options. There was no process in place where practitioners might debate accounting practices and find consensus. Given the AIA's lack of influence over a wide range of practitioners, limitations on management choice would have to wait until power was consolidated. Until then, the AIA could only begin to control the qualifications of its own members, build their reputations and increase the confidence of the public. As for auditing practice, the AIA again relied heavily on professionalism. *Approved Methods* offered guidelines but retained professional judgement as the preserve of the auditor who alone could act in the interest of outside users.

### *Conflict Theory Interpretation of Event 1*

Many of the actions taken by the AIA may have been motivated by self interest, as attempts to gain market control and limit audit practice. The examination was controlled by an elite group and could restrict the number of those admitted and the type of person admitted. Indeed, there were many complaints [Previts and Merino, 1979; Miranti, 1990]. A national organization could dislodge competitors and avoid competition. By successfully negotiating with federal agencies, the profession not only avoided regulation but gained status. Though not a true license, the perception of AIA members as purveyors of higher quality service,

would disadvantage those practicing outside of the purview of the national organization.

The code of ethics prohibited advertising and competitive bidding. While leading practitioners advanced compelling arguments in support of the bans [Editorial, 1914 & 1915], smaller firms viewed them as deliberate constraints on the expansion of their practices [Letter to the Editor, 1914; Shorrock, 1914]. The code, while a symbol of professional practice, functioned to preserve the market power of the elite firm.

Advocacy of a standardized short form report also worked to the detriment of the small firm. Those desiring membership in the AIA were barred from differentiating their services in a positive way. Byington and Sutton [1991] said that buyers rely on brand names as a surrogate for quality and recent research shows that a differentiation of quality is perceived by buyers of auditing services between the Big 6 and non Big 6 firms. Indeed, banker J. Cannon wrote ". . . we strongly advocate and prefer to buy the paper of those concerns whose accounts are audited by established firms of accountants" [Colley, 1914, p. 425]. The AIA effectively cut off most of the avenues available to the small firm to attract audit clients.

Claims of specialized knowledge and expertise may mask a self interest motivation. The profession cultivated the perception that they possessed information difficult to acquire and reliably exercised and monitored only by themselves. Educational requirements, examination and an esoteric vocabulary perpetuated this notion. The idea that these practices might be standardized was understandably anathema. If accounting could be standardized then it was a technical discipline which could be performed by anyone, threatening the emerging profession.

With the support of bankers and the federal agencies, the accountancy profession might have made progress in setting accounting and auditing standards. But the leadership resisted, arguing that uniform accounting practices would mislead and that uniform auditing practices would reduce audit practice to the lowest common denominator. Only the experienced professional could understand the audit requirements of a unique accounting system and pass on the appropriateness of the accounting choices made [AAPA Yearbook, 1916]. If these functions could be exercised by rote, then accountancy was not a profession.

Deference to corporate management maintained the profession's relationship with those with whom there were social and financial linkages. Claims that egregious practices would be dealt with in a period when there were no authoritative standards can hardly be taken seriously. Approved methods provided protection against liability by giving

auditors a defense against non-performance of tasks and for reliance on management.

*Event 2: Collaboration of the AIA and the NYSE from 1931- 1933*

Although George O. May, representing the AIA, had established an advisory relationship with the NYSE in 1927 (May, 1962), it was not until it was clear that the depression was unlikely to abate and that the public anger directed towards business was rising [Krooss, 1970] that the Exchange awoke to the value of instituting change. Some form of federal regulation over corporate reporting practices appeared imminent [Kohler, 1934]. Hoxsey [1931, p. 2ff], executive assistant of the Committee on Stock List of the NYSE, wrote to the AIA and warned that "some form of regulation is inevitable. . . if we act now. . . we may retard unwarranted intrusions."

The extant correspondence reveals that neither organization was anxious to take the lead. Hoxsey [1931] asked the AIA's Special Committee on Cooperation with Stock Exchanges[5] to assume responsibility for the suitability of management-selected accounting principles and for a definition of full and fair disclosure. The AIA responded that "the primary responsibility for selection of principles and scope of disclosure must remain that of directors and officers of the corporation" [AIA, 1931].

With income statement data becoming more and more important to stockholders, Hoxsey asked auditors to insist that stockholders be advised as to the sources of income, separately disclosing extraordinary items, and to discourage management from using reserves to smooth income. The AIA Committee replied that auditors lacked the power to mandate such disclosures [Letter, 5/19/31].

The AIA Committee in turn [Letter, 9/22/32] asked the Exchange to educate the public about the limitations of financial statements, particularly their historical nature, to require that accounting methods be disclosed and be consistently applied and that extraordinary items and subsidiary income be segregated from ordinary income. They recommended an annual audit and that every company adhere to five broad principles of accounting which they believed were generally

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[5] The member of the committee included Archibald Bowman, Arthur Carter, Charles Couchman, Samuel Leidesdorf, William Lybrand, and George May—all representatives of major accounting firms.

accepted (see Appendix). The Exchange accepted all of the Committee's recommendations but one, disclosure of accounting methods. Whitney, the president of the NYSE, wrote to the presidents of all listed companies that financial statements issued in connection with listing applications made after July 1, 1933 had to be audited. He added that, to serve as useful safeguards for investors, "audits should be adequate in scope and that the responsibility assumed by the auditor should be defined" [Letter, 1/31/33]. He asked all companies to secure from their auditors a letter addressing most of the points made by the AIA's Committee:

1) was the audit as extensive as that outlined by the publication *Verification of Financial Statements* (VFS) (the 1929 revision of *Approved Methods*),

2) had all subsidiaries been audited or their relative importance to the parent company explained,

3) had the auditors received all information requested,

4) were the financial statements fairly presented,

5) were accounting methods consistently applied and,

6) did the methods used conform to accepted accounting practices? (see Appendix.)

Nine major accounting firms jointly responded to the announcement. Although supportive of the specific points outlined above, they wanted to clarify the some of the limits of the audit engagement. They reiterated [Letter, 2/24/33] that the guidelines outlined by *VFS* were not intended to uncover fraud and that to do so would require an audit so expensive as to outweigh any advantages. To avoid fraud, management was responsible for establishing and maintaining an adequate system of internal control. They reminded the Exchange that the auditor traditionally focused on the balance sheet and would continue to do so, guarding against overstatements of income not by extensive testing of income accounts but by assuring the correctness of beginning and ending balance sheets accounts. They reemphasized the importance of consistency rather than uniformity of method. The audit report stated that management's representations were reasonable, not all inclusive nor necessarily optimal, in the auditor's view. The auditor could not replace

his judgement for that of management and could only qualify the report if the choices were very unsound.

Hoxsey was not satisfied by these circumscriptions of responsibility. He insisted that auditors "should satisfy themselves that the system of internal check provides adequate safeguards" and "accept the burden of seeing that the income received and the expenditures made are properly classified in so far as the facts are known to them" [Letter, 10/24/33]. He also asked the AIA to develop a clearer and more informative auditor's report.

The AIA found Hoxsey's income statement requests reasonable but were careful in their response to the question of internal control [Letter, 12/21/33]. "It is always a matter of executive judgment to weigh the risks against which safeguards are desirable against the cost of providing safeguards." Claiming that accountants evaluated internal control as a integral part of the audit, they cited *VFS*. "The scope of the work indicated in these instructions includes. . . an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check." It is noteworthy that the adverb "incidentally" which appears in *VFS* in place of the three dots is omitted in the letter to the Exchange. The use of the word "incidentally" weakened the guidelines. It suggested that checking controls was likely to happen during the examination, but not that it must happen.

The liability that might rise out of the wording of the audit report worried accounting firms. May sent a draft of a revised report to the major firms for comment and received responses from Leidesdorf, from Barrow, Wade and Guthrie, Haskins and Sells, and Peat, Marwick, Mitchell. Leidesdorf [Letter, 11/17/33] wrote that the statement "supplied with all the explanations and information which are necessary" be replaced by "based on our examination and information furnished to us." He warned that the former did not recognize the possibility that management might have withheld information leaving all responsibility with the auditor. Carter of Haskins and Sells [Letter, 11/24/33] wrote that the report should clearly state the relationship between the auditor and the client.

> I refer particularly to the theory of relationship which holds the client to be the author of the financial statements and regards the accountant as the reviewer of such statements..This position, in addition to having possible legal value, is, as we have learned . . . , an invaluable one when controversies arise with clients as to the disclosures which should be made.

The format of the standard unqualified audit report was finally approved at the beginning of 1934 after considerable debate.

*Functionalist Theory Interpretation of Event 2*

Affiliation with the NYSE gave the leadership a rich opportunity to serve the public. With the support of the NYSE, they could resolve some of the major issues of accounting practice and presentation and begin a process of expanding public knowledge. The leaders of the AIA knew that some investors misunderstood the nature of the financial statements and the audit report, assuming that the current valuations comprised the balance sheet and the report testified to an enterprise's future success. Understanding their historical nature was an important component in becoming an informed investor. However, the profession needed the Exchange's help in publicizing this perhaps because of a lack of funds or a lack of access to the public. Whether the Exchange actually embarked on a program of educating the public is unknown.

The profession's unwillingness to expand its responsibility for accessing internal control and the detection of fraud was not unrealistic, reflecting its knowledge that both were controlled by management. To ensure either exceeded their ability. It would not be in the public's interest to suggest otherwise. The AIA strongly preferred disclosure and consistency of accounting method over uniformity for two reasons. They believed that firms were unique and that corporate management could best determine which methods most clearly reflected performance and condition. Disclosure of methods should provide sufficient information for the informed user. They also argued that, taken over time, differences between accounting methods were unimportant if those methods were consistently applied. Although the AIA only convinced the Exchange to require a statement of consistency, at least they minimized a common method of manipulating financial statements. The Exchange also supported the AIA's opinion on significant issues, such as limiting the practice of smoothing income by using surplus accounts to bypass the income statement (see Appendix). In this way, the profession could protect the investing public from significant and common misrepresentations.

*Conflict Theory Interpretation of Event 2*

Collaboration with the NYSE benefitted the AIA considerably. First, the formal association with the Exchange was prestigious. Second, the NYSE's annual audit requirement granted a contract to accountants

ensuring future income. Although the Exchange did not limit audits to AIA members, it is likely that its relationship with the AIA bolstered member firm's relative power in the accounting market, at least among listed corporations. Third, recognizing *VFS* as the auditing standard distinguished the AIA as the authoring institution. Fourth, despite the rising profile of the AIA and auditing services, there was no increase in auditor responsibilities beyond those supported by the NYSE and therefore, no substantive change in the auditor-client relationship.

The public collaboration with the NYSE created a perception that the profession was working to improve the financial reporting function. However, little changed. The accounting principles agreed to were few, and although 'few' in and of itself is not negative adjective, many of the most controversial issues of the period including the treatment of depreciation, bond discount and no par stock remained unsettled and no mechanism for resolving these issues was put in place. Audits, though required, still left major tasks optional and corporate management retained the prerogative of preferability choices without disclosure. The profession had raised its profile, potentially increased the market share of major member firms, and appeared to be working in the public interest while minimizing any expansion of its own responsibility.

*Event 3: The SEC and the AIA 1934-1939*

The years 1934-1939 were critical ones. It was possible that the traditional practice of accountancy would not survive and the profession had to work to maintain its identity. The Securities and Exchange Commission, created in 1934, had absolute authority over accounting matters. It could determine who could practice before it. It could set accounting standards and could require auditors to take responsibility for the choice of accounting methods.

SEC members, inexperienced but determined to put the Act into operation, decided that the best approach was to work with existing professional bodies. They solicited the profession's help in designing the forms needed to satisfy the Act's regulations, in appointing suitable commissioners, and encouraged them to set accounting standards. The AIA was slow to act on the latter. Consequently, the SEC frequently and publicly criticized the profession for the accounting treatments found in submissions [Landis, 1936; Blough, 1937a]. Members [Landis, 1936; Blough, 1937c; Mathews, 1937; Healy, 1938] threatened that the SEC

might have to standardize accounting.[6] They displayed irritation at the profession's inability to monitor management, its unwillingness to take responsibility for accounting presentations, and its repeated issuance of uninformative or misleading audit reports. They complained that the often-cited generally accepted accounting principles did not exist and questioned the qualifications of some appearing before them [Blough, 1937a, 1937b, 1938; Werntz, 1939]. The SEC began issuing Accounting Series Releases (ASR) in 1937, setting accounting rules for registrants.

The AIA fought these encroachments. It supported corporate assertions that disclosure of sales, cost of sales, gross profit, and salaries would give too much information to competitors. The AIA's Committee on Cooperation with the SEC reproached the SEC for not accepting these claims. Chairman Wellington argued that this information "might be damaging to the company and therefore of injury to the stockholders" [AIA Minutes, 1936, p. 53].

Despite its threats of standardization [Landis, 1936; Healy, 1938], the agency eventually settled for consistency and disclosure of method [Merino and Coe, 1978]. Curiously, the SEC did not mandate that a statement of accounting policies appear in the annual reports to shareholders. Although such a statement was required in the 10K, the latter was not usually mailed to shareholders. Enforcing fair disclosure of accounting methods therefore made no sense [Kaplan and Reaugh, 1939].

The SEC's ASRs #1-3 were not new accounting standards but rather formalizations of the accounting rules written earlier by the AIA in agreement with the NYSE (Coffey, 1976). In 1938, they issued ASR #4. This stated that financial statements filed with them would be deemed misleading if they lacked substantial authoritative support and left the determination of authoritative support to the accounting profession. The SEC adopted the role of endorser and enforcer of the AIA rules (Coffee, 1976, p. 220).

Regarding audit practice, the AIA issued *Examination of Financial Statements* [1936]. It did not expand audit procedures over internal

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[6]"The impact of almost daily tilts with accountants, some of them called leaders of their profession, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor. Such an experience does not lead readily to acquiescence in the pleas recently made by one of the leaders of the accounting profession that the form of statement can be less rigidly controlled and left more largely to professional responsibility alone" (Landis, 1939).

control, inventories or accounts receivable. Samuel Broad, Chairman of the AIA Committee charged with revising *VFS*, said that *VFS* had been criticized as "too mandatory in its presentation" a defect eliminated in this document which emphasized flexibility and judgement [Broad, 1936, p. 58-9]. The document reasserted the profession's position that disclosure was a management prerogative and that the auditors would only rarely issue qualified reports. The audit procedures, the extent of disclosures and the accounting principles and practices set out in this document were "only those which we believed were pretty generally agreed to. . . we did not try to break new ground" [Broad, 1936, p. 59-60].

The AIA remained committed to the short-form standard audit report [Letter, 1935; Couchman, 1939]. The AIA Committee on Cooperation with the SEC debated the wording extensively [AIA Minutes 1939, p. 166, 170, 172]. The Committee wanted a format acceptable to the SEC which limited auditor responsibility. The Committee on Auditing Procedure made only a few cautiously worded changes to the audit report approved in 1939 (Kohler, 1941). The report minimized liability more than it provided information to investors.

Why did SEC abdicate its power? Some historians insist it did not. McCraw [1982] is persuaded that the SEC was entirely successful in negotiating substantive change on behalf of stockholders with both the accounting profession and the NYSE. Coffee (1976) is slightly less sanguine but overall remains confident that the results of the SEC and AIA collaboration were successful. Others, more informed about accounting, insist all changes were merely symbolic [Merino and Neimark, 1987; Chatov, 1975].

One reason is that the AIA strengthened itself. Attacked by the American Association of University Instructors in Accounting (AAUIA) [see Kohler's scathing 1934 editorial] which, with the blessing of SEC commissioner Robert Healy [1938], might have preempted the AIA in setting accounting standards, the AIA decided to reassert its leadership in this area. In 1936 the AIA completed a difficult merger with the rival American Society of Certified Public Accountants (ASCPA), a national accounting body of about the same size thereby deflecting a potential alliance between that group and the academics of the AAUIA. Now larger, representing about a third of accountants nationwide, and with a claim to expanded self-monitoring, the new AIA could act from strength. They formed the Committee on Accounting Procedure in 1938 to study and write accounting standards [Previts and Merino, 1979; Miranti, 1990]. Thus, the AIA acted in accordance with the agency's wishes.

Another reason may have been that the political tide was shifting to the right. Business found that it was again gaining power. The economy appeared to be improving, if slowly, and the Supreme Court had declared major New Deal legislation unconstitutional. All of business wanted to avoid further government regulation. In this atmosphere, it may have been expedient for the SEC to back off.

The AIA now represented a broader constituency and established a standard-setting body. The SEC retained their declamatory speeches keeping their real power as a constant threat. They continued to issue stop orders if particularly egregious accounting presentations were filed but, as of 1938, they left accounting matters to the accountants.

*Functionalist Theory Interpretation of Event 3*

The functionalist model predicts that professionals will actively protect the public interest but does not require the existence of a formal professional organization. The AIA, up until this point, trusted in the professionalism of individual practitioners, attempting only to ensure that they had been effectively educated and were experienced. Circumstances forced the AIA to move the profession to another level. The SEC could legally appropriate control over audit practice and accounting matters, a possibility which threatened placing nonexperts in the position of judging a complex discipline. To protect the public, it became necessary for the AIA to convince the SEC that it was best to keep auditing and accounting in the hands of professionals. To do so, it was imperative that they be able to influence and monitor practitioners since the status quo projected disunity and carried the stigma of competition. Unlike other businesses, competition in a profession is viewed negatively, suggesting that profits are more important than public interest. The merger with the ASCAP doubled the AIA's membership and probably included most of those who audited public companies. This gave the AIA the ability to monitor those likely to appear before the SEC.

The profession believed that unique environments call for varied accounting methods and that standardization across dissimilar industries would be misleading at best. Consequently, the leadership first fought the SEC's threats of regulation by arguing convincingly for consistency and disclosure of methods, which the SEC soon required, as opposed to uniformity.

The Securities Acts did not give power to the profession, but did confer on it responsibility and substantial liability. If the profession were to act in the public interest, it needed power. This it received, when the SEC delegated that authority in ASR #4. With few exceptions, the

agency has supported the AIA and the decisions of its successor bodies. With this in hand, accountancy's governing bodies could seek consensus on matters of general interest and this they tried to do by establishing the Committee on Accounting Procedure. Though in hindsight this Committee may not have been wholly effective (Previts and Merino, 1979, 269), its formation and purpose was in the public interest.

*Conflict Theory Interpretation*

The conflict model is also informative. The 1934 Securities Act handed accountancy a market.[7] The AIA wanted to monopolize it and it did so by professionalizing its image. The merger strengthened the AIA's negotiating position with the SEC. It now had influence over and appeared able to monitor a substantial constituency. Although often openly criticized by members of the SEC, the AIA turned some of the criticisms to their advantage. They requested, and the SEC agreed [Report, 1937], that questionable accounting questions and misleading audit certificates be forwarded to them for comment and resolution. This gave the AIA additional authority, bringing unsatisfactory reports of both member and non-member audit firms under their jurisdiction.

The formation of the Committee on Accounting Procedure was a unifying one. It included AIA members, ex-SEC commissioner Carmen Blough, and members of the AAUIA who had frequently criticized the AIA. The AIA thus eliminated by incorporation, its challengers to accounting setting while creating a body too large to come to consensus on controversial issues thus retaining many alternative practices (i.e treatment of bond discount and of gains or losses on retirement of bonds) and maintaining management freedom. They avoided proactive, positive improvements in audit practice. Improvements were to come subsequent to the embarrassment of McKesson-Robbins. No significant changes appeared in the auditor's certificate. The AIA therefore negotiated a successful relationship with the SEC, an agency that posed a definite threat and in doing so increased its prestige and consolidated its power without altering accounting, the audit function or the relationship of auditors with corporate management.

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[7]It is possible that the audit requirement was added as a result of back room lobbying [Miranti 1990].

*Postscript: McKesson Robbins Expands Audit Procedures*

Until the McKesson Robbins fraud came to light in 1939, auditing guidelines were ambiguous regarding receivables, inventories and internal controls. Even sophisticated users were unaware that auditors did not physically inspect inventories. Hoxsey, the Secretary of the NYSE, was furious to learn that the auditors had used the "testing" phrase to limit the scope of audit with respect to receivables and inventories [Correspondence, 1939].

> . . . it simply did not occur to me to doubt that inventories and receivables were spot-checked to a sufficient degree to make the auditors feel warranted in giving the financial statements approval...I did not know that the statement 'but we did not make a detailed audit of the transactions' covered such omission [Correspondence, 2/22/39].

The McKesson Robbins case resulted in increasing auditor responsibilities significantly. For the first time, a professional pronouncement, "Extension of Audit Procedures" (adopted by the AIA council on May 9, 1939) instructed auditors to go beyond the books requiring inventory verification, accounts receivable confirmation and an assessment of internal control.

## CONCLUSIONS

Historical evidence can be interpreted in a variety of ways. Motivation is not observable and formal statements may not be taken at face value. Certainly an interpretation that assumes that all change is evolutionary and that evolutionary change is progress towards the good must be challenged. So it is with the development of the accounting profession. One may interpret the adoption of a code of ethics, the establishment of educational standards, the creation of a national organization with power of self regulation as actions taken to promote the public interest. At the same time, these actions do control the profession, limit entry to it and secure high economic rents from so doing.

There is no doubt that accounting and auditing are learned skills that require the exercise of judgement. But the profession rarely articulated what audit services were meant to accomplish stressing instead what could not be done and repeating, rather unsatisfactorily, that audit

judgements were nothing more than opinions. The AIA was not proactive in setting audit standards for critical areas, resisted setting accounting standards, declined to clarify the responsibility of the audit firm and deferred to the desires of corporate management. Whether these choices were made because the profession sincerely believed that the auditor's professional judgement must always predominate over standards and regulations to ensure reliable reports or whether they were chosen in order to sustain the status quo in regards to relationships with corporate management is a matter of interpretation.

Accountancy today is without doubt a profession, carrying with it all the characteristics that one might choose to define a profession. It is also true that accountancy faces similar criticisms to those it received in the past. What is the auditor's responsibility? Has the auditor failed if a firm collapses and he or she issued an unqualified report just before the collapse? Are the battles to deflect liability attempts to avoid responsibility or efforts to restore justice in an unjust system? Should the accountant 'blow the whistle' or are quitting or issuing a qualified report still the only options available? There is still some doubt about the identity of the client. The responses to these questions made by the profession, as similar responses were made in the past, will likely be claimed by the profession as in the public interest and by critics as in the interest of the profession itself. The truth, whatever it may be, is likely to lie somewhere in between.

# APPENDIX

*Statement of Certain Accounting Principles Recommended by Committee of American Institute of Accountants on Cooperation With Stock Exchanges*

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there-against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

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