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## CHANGING LEGITIMACY NARRATIVES ABOUT PROFESSIONAL ETHICS AND INDEPENDENCE IN THE 1930'S *JOURNAL OF ACCOUNTANCY*

*Abstract:* The 1930s in the U.S. were marked by an economic crisis, governmental regulatory response, and a significant audit failure. This paper examines the profession's struggle for legitimacy during these times through its choice of narratives regarding professional ethics and independence as revealed in the national professional organization's monthly, the *Journal of Accountancy*. Initially "ethics is a state-of-mind" or narrative of character was used but transitioned to a more objectively determinable narrative of technique as the decade progressed. To counter governmental regulation, the profession attempted to shift the independence discourse away from regulation of accountants to regulation of client companies.

### INTRODUCTION

Occupational groups that apply specialized knowledge and skills to complex tasks and claim to serve both their own and the public's interest seek to define themselves as professionals. A code of ethics is one of the most important attributes defining a profession [Montagna, 1974] and has been termed a "unique, dynamic record of the movement of an occupational group toward professional status" [Casler, 1964, p. 8]. This paper tempers this functionalist view of the code of ethics with the consideration that the effectiveness of such a code depends upon its reflecting cultural mores. In the process of changing the code of ethics in response to social and political events, professional groups attempt to influence members of the profession, the public, and regulators through discourse on components of its code. This discourse is in the form of narratives that allow society to define the criteria for competence and to evaluate performance. As such, narratives act as legitimating devices [Preston et al., 1995].

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The form or content of these narratives changes over time, as does the code of ethics itself, and at the beginning of the 1930s, the phrase “ethics is a state of mind” [Richardson, 1931, p. 15] encapsulated the profession’s narrative of character. Character is “a core constituent of personal identity” [Preston et al., 1995, p. 521] to be developed through moral education both at home and at school. The state-of-mind of the upright individual so developed provided the moral guidance that could be relied upon to direct his or her actions in an ethical manner. A corollary to this is that unethical behavior resided in the flawed individual instead of in the profession or its self-governance and, consequently, a limited number of rules were needed to constitute an ethics code.

By contrast, the narrative of technique uses legal and technical rhetoric in a specialized and esoteric subject as the means of legitimation. In this narrative, moral guidance is replaced with rules and professional judgment. Preston et al.’s [1995] study of U.S. accountants’ professional ethics found that a 1917 narrative invoking the legitimacy of character had shifted by 1988 to the legitimacy of technique. Their study does not address when this shift occurred; however, the transition is apparent in discourse in the American Institute of Accountants’ (AIA) official magazine, the *Journal of Accountancy (JA)*, in the 1930s.

The 1930s opened in the aftermath of economic crisis caused by the stock-market crash in October 1929, followed by the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. Abbott [1988] argues that the extent of the shift from legitimacy of character to legitimacy of technique varies among professions depending upon the relative use of science and social structures for legitimation. The social structure of greatest significance is regulation, and the 1930s found the accounting profession subject to significantly enhanced regulation by the Securities and Exchange Commission (SEC). The profession was still coping with this increased regulatory attention when the fraud at McKesson & Robbins (M&R) was revealed in December 1938. This fraud was the “first time accounting practices were subject to significant public and governmental disclosure, comment, criticism and judgment” [Barr and Galpeer, 1987, p. 160]. The SEC held hearings with testimony from 12 expert witnesses from accounting firms. The repercussions from this fraud closed the decade and pushed the profession further toward the use of the narrative of technique to attain legitimacy.

Auditor independence was not a component of the code of ethics in the 1930s; however, the *JA* featured considerable

discourse on the subject. Similar to changing legitimacy narratives, independence was originally viewed as an integral part of character and later was conceived as an economic commodity [Williams, 1992]. Accountants of this era vigorously resisted inclusion of independence in the code not only through legitimacy narrative strategies, but also by reframing the independence discussion in terms of client regulation. Initially, reframing the discussion focused on regulating client-auditor relationships through how auditors were appointed to the engagement. In response to the M&R fraud, accountants continued reframing the discussion through advocating a variety of regulations for client companies and education for financial-statement users. Simultaneously, accountants attempted to regain legitimacy through use of the narrative of technique as articulated through enhanced accounting principles and auditing methods.

This paper does not debate whether accountants were professionals in the 1930s or not, but instead considers accountancy to be a profession. The focus is how the accounting profession constructed its narratives of legitimacy and responded to increased governmental regulation.

The remainder of this paper is organized as follows. The next section describes the primary sources and is followed by a section describing the U.S. audit environment in the 1930s, including the code of professional ethics. Sections on independence as an ethical construct in the 1930s, the engagement of auditors, and the M&R audit failure follow. The last section provides concluding comments.

## THE *JA* AND ITS SPONSORING ORGANIZATION

Articles and editorials in the *JA*, the official publication of the AIA from October 1929 through 1939, are the main primary sources used. The history of the *JA* and that of its sponsoring organization are intertwined. While the *JA* had a single name change, its sponsoring organization went through multiple mergers and name changes. The *JA* started life as the *Auditor*, the journal of the Illinois Society of CPAs, in 1904 [Zeff, 1987]. The Federation of Societies of Public Accountants in the United States (the Federation), formed in Illinois in 1902, rivaled the AIA as a national organization. Robert Montgomery, in his then capacity as secretary of the Federation, acquired the journal in 1905 and renamed it the *JA*. The first issue was published in November 1905 after the Federation's merger with the American Association of Public Accountants (AAPA) [Zeff, 1987].

The initial issue evinced the practitioner participation featured throughout the magazine's history with an article by Montgomery on professional standards [Zeff, 1987]. An editorial in the initial issue proclaimed the journal's objective as "establishment of accountancy in law and opinion as a learned profession" and noted that "much, however, still remains to be done before accountancy can take the stand on the plane of medicine and law." The editorial closed with three requests of its readers: "(1) Subscribe; (2) praise The Journal publicly and criticize us under the cover of a two-cent postage stamp; (3) tell us how to improve The Journal" [Anon., 1905, pp. 57-59].

The AAPA was organized in 1887 and primarily operated in New York City [Previts and Merino, 1998]. Its name changed in 1916 to Institute of Accountants in the United States of America and then to the AIA in 1917 [Roberts, 1987]. Membership was concentrated in urbanized states, and its leaders were often from large, prosperous firms. Throughout the 1920s, the AIA's emphasis on the independent audit distanced it from accountants in rural states who considered the AIA elitist [Previts and Merino, 1998]. In December 1921, accountants primarily located in the Midwest founded the American Society of Certified Public Accountants and had a bitter rivalry with the AIA "until threat of external intervention in the thirties forced unification" [Previts and Merino, 1998, p. 243]. The merger in 1936 left the AIA as the national voice for accountants in the U.S. [Montgomery, 1936]. The AIA adopted its contemporary name, the American Institute of Certified Public Accountants, in 1957 [Cook, 1987] and continues to publish the *JA* monthly.

By the 1930s, the magazine's masthead included the sub-heading "Official Organ of the American Institute of Accountants" and the disclaimer: "Opinions expressed in the *Journal of Accountancy* are not necessarily endorsed by the publishers nor by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors." This disclaimer appears to have been for legal purposes more than an indicator of divergent views. (Note that divergent views are "*merely* those of individual authors." – emphasis added) Authors tended to come from the ranks of business, legal, and government leaders. The list of expert witnesses who testified before the SEC about the M&R audit failure (or "case" as the *JA* termed it) featured many prior contributors to the journal. A rebuttal article generally accompanied the rare article critical of accountants or some facet of accounting practice. The *JA* was used to construct narratives for

the profession and in so doing fulfilled its function as the “Official Organ” of the AIA. Far from being objective, disinterested, or independent sources, these articles are reflective of the AIA’s positions and are thus good sources for the narratives this influential segment of the profession desired to communicate in its quest for legitimation.

The initial editors of the *JA* were business academics [Zeff, 1987], but during the decade of the 1930s, the *JA* had two non-accountant, professional editors – Alphyon Richardson and John Carey. Richardson was a professional journalist who assumed the editorship in 1912 [Edwards and Miranti, 1987]. He was also the AIA secretary (chief of operations) until he retired from the post in 1930 and assumed only editorial duties [AIA, 1938]. Carey joined the staff of the AIA as assistant secretary after receiving his bachelor’s degree in English from Yale University in 1925 [Zeff, 1987]. He became the AIA secretary in 1930, and in January 1937, he became managing editor of the *JA*. His tenure in this position lasted until 1949, after which he became editor from 1949-1954 and publisher from 1955-1966 [Zeff, 1987]. Both editors ran unsigned editorial columns in each issue that commented on the accounting issues of the day. Whether the editor wrote each editorial is problematic in Richardson’s case as George O. May, an AIA leader and partner in Price Waterhouse, may have authored many editorials published during Richardson’s tenure as editor [Previts and Merino, 1998].

Each issue of the *JA* featured editorials that were often lengthy with sub-headings to denote the wide-ranging topics covered. Commissioned works on particular topics, texts of speeches delivered to various professional bodies, and problems from previously administered CPA exams were published. As the decade progressed, discussions of both proposed and enacted governmental regulation were featured. The decade closed with excerpts from expert testimony before the SEC regarding the audit failure at M&R. As the actual words of the past are cited, it should be noted that the language of the 1930s was not gender-neutral. Gender-neutral language will be used when not citing historical works. Those editorials and articles that pertain to professional ethics and the issue of auditor independence were examined for the type of narrative they employed.

## THE ACCOUNTING AND AUDIT ENVIRONMENT

In the 1920s, demand for accounting services increased significantly and brought changes “in the position of the pub-

lic accountant in the community” [Olive, 1929, p. 252]. These changes were attributed to the implementation of federal income taxes in 1917, increased recognition of the importance of an independent accountant’s report for credit purposes, the merger and consolidation of small business units into larger corporations, and an increased amount of public ownership of stocks [Olive, 1929]. Montgomery [1937, p. 270], then president of the AIA, attributed these changes to the impact of World War I: “It may be urged that men killing each other has little to do with our profession, but it has much to do. It was the World War which made business cost-conscious; it was war profits which made tax saving attractive.”

In an editorial in November 1928, Richardson [1928, p. 359] noted: “The incorrigible optimism of the investing public continues. Warnings issued by authorities have no effect and the public buys and buys; stocks rise to a market value altogether out of proportion to the companies’ earnings.” The Dow Jones Industrials Index on December 31, 1928 was 300 points, but after the October 1929 crash, the Dow recovered to end the year at 248.5. While the change may seem small by contemporary standards, a drop of seven points in 1928 corresponds to a drop of 350 points when the Dow is at 10,000 [Wright, 2002].

The stock-market crash of October 1929 opened a period of economic crisis that would last through most of the 1930s. Previts and Merino [1998, p. 270] consider the impact of this period on America to be “second in importance only to the years 1776-89 (from the War of Independence to the inauguration of George Washington as president).” Auditors were not blamed for the crash, which was instead attributed to margin buying, stock speculation, and manipulation of stock prices by corporations [Nouri and Lombardi, 2009].

The crash’s economic after effects caused deep decreases in stock prices and offerings. In 1929, new capital public offerings totaled \$700 million a month according to the *Commercial & Financial Chronicle* [cited in Haskell, 1938]. The Dow’s lowest point was 41.2 points in 1932; it peaked at 194.4 in March 1937 [Wright, 2002]. During 1936 and the first ten months of 1937, the public offerings shrank to \$100 million a month. The market contracted further in November and December of 1937 and January of 1938 to \$40 million a month [Haskell, 1938]. By December 31, 1939, the Dow was at 150.2 points, a 40% decrease from its December 31, 1929 level [Wright, 2002].

Judge John Knox of the bankruptcy court, addressing the twelfth annual fall conference of the New York State Society



of Certified Public Accountants (NYSSCPA) in October 1934, reminded accountants of the impact of their work [Staub, 1936, p. 209]:

The power of an accountant for the service of good and evil is no whit less than that possessed by the lawyer and physician. The accountant's nimbleness of mind and his dexterity of hand can reveal truth or they [sic] can conceal it. They may also furnish safeguards for the preservation and increment of the nation's wealth; or they may be so used as to impoverish the land.

The "service of good and evil" is a rather heroic characterization of the accountant that is indicative of the lack of objective or divergent views represented in the *JA*. The economically stringent times did call for prudent and well-considered financial advisors, accountants among them.

Companies were "moved by the exigencies of uncertain times" [Barton, 1933, p. 91] following the 1929 market crash to adopt independent audits as a business practice. Prior to the Securities Acts of 1933 and 1934, audits were voluntary for corporations that were not in governmentally regulated industries. The NYSE required all new listings as of July 1, 1933 to have independent audits, citing investor regard of audits as a useful safeguard as the reason. A survey of the 83 largest companies in 1933 found that 87% did have audits, and those with no audits were often under governmental supervision, such as banks, utilities, or railroads. Seventy of the companies had outside auditors for an average of 18 years. To be truly valuable, the NYSE determined that audits had to be adequate in scope and the responsibility of the auditor defined [Barton, 1933].

Although there was regulatory pressure to conduct audits, accountants still had to contend with some adverse client reaction to audits even at the close of the decade [Retzlaff, 1939, p. 85]:

We are only too familiar with the attempts of some businessmen to restrict the scope of our engagements, to cut fees, and generally belittle the accountant's work. The objectionable practice of asking for bids is an outgrowth of this attitude. To many executives, audits are just a necessary evil – why spend money for reports on last year's operations which, after all, are 'water over the dam?' Were it not for bankers and stockholders, a good many audits would never be authorized.

Passage of the Securities Acts gave CPAs a "legally defined



social obligation: to assist in creating and sustaining investor confidence in the public capital markets” [Previts and Merino, 1998, p. 274]. They deem this social obligation necessary to justify the claim to professional status. Attainment of the “learned profession” status of medicine and law was a stated objective in the initial issue of the *JA* [Anon., 1905]. Law, medicine, and accounting are professions “in which the articles offered for sale are advice, counsel, and personal abilities” [Richardson, 1936, p. 316], with all of these based on both the technical and the intrinsic, moral components of the practitioner. As law and medicine had codes of professional ethics, accounting likewise had an ethical code as a legitimating device.

### PROFESSIONAL ETHICS AT THE DAWN OF THE DECADE

By June 1931, the AIA had formulated ethics rules that covered 12 basic areas but did not include independence. These rules comprise the self-regulatory base line at the beginning of the decade and are the context for the narrative surrounding professional ethics that appeared in the *JA*. At this time, the ethics is a “state of mind” concept was still held and “was also used to limit and then justify the small number of written rules” [Preston et al., 1995, p. 518]. The areas covered by the rules are as follows (the full text appears as Appendix A) [Richardson, 1931, pp. 155-159]:

1. use of the title “Member American Institute of Accountants”
2. certification of statements which contained essential misstatements
3. prohibition of a non-AIA member from practicing in the name of a member
4. commissions
5. incompatible occupations
6. certification of statements not verified under supervision of an AIA member
7. efforts to secure legislation without notification of the Institute
8. solicitation or encroachment on the practice of another member
9. offers of employment to employees of fellow members
10. contingent fees
11. advertisements
12. participation in activities of educational institutions whose promotional activities were discreditable to the profession.

The rules are listed in the order of adoption and reflect the profession's strong need for self-regulation instead of a systematic analysis of ethical issues. The code's principles were commandment-like in nature as they were phrased as "thou shalt not" prohibitions. They did not attempt to imbue a higher purpose in accountants since character or the accountant's state of mind was considered sufficient to provide moral guidance.

The ideals of a gentleman were an underlying linchpin for rationalizing the narrative of character [Haber, 1991]. The professions whose status accountants aspired to attain shared these ideals: "Every lawyer, every physician, every accountant, and every man in every other professional field should be imbued with a spirit of righteousness and the ideals of a gentleman," Richardson [1936, pp. 313-314] stated in an "Ethics in Retrospect" editorial published in the *JA's* twenty-fifth anniversary issue. However, he noted that individuals who did not possess these gentlemanly ideals were entering the profession, but that ethics could be learned:

It has been said repeatedly (and the remark, we believe, was originally made by an eminent member of the accounting profession) that ethics is a state of mind and he who has it not will never acquire it. This is not literally true, because it is well known that some of the accountants who have entered the profession without a conception of its real character have been so impressed by the importance of observing the code of ethics that they have gradually acquired a conception of the profession totally different from that which they possessed at the time of their entering in.

Character as an essential professional quality was still advanced, but the ability to learn aspects of the profession, previously deemed impossible to learn, was acknowledged.

The public interest of the profession is intertwined with the private or self-interest aspect of professional ethics [Parker, 1994]. Public-interest objectives are to protect society by safeguarding the economic interests of clients and third parties, delineate client-profession relations, and orient the profession towards social responsibility. Parker [1994, p. 509] defines private interest as "the latent motivation of ethical codes to protect the interests of the professional accounting body corporate and its individual members." Elements of the private interest are self-control, development of self-professional authority, definition and maintenance of exclusiveness, and preservation of socio-economic status and political power.

Only one strong, primarily public-interest rule existed in the 1931 Code – certification of statements which contained essential misstatements (#2). As bad audit work would impair an accountant's reputation, there was also a private-interest element. Just compensation of the accountant was the private-interest aspect served by rules on commissions (#4) and contingent fees (#10). These rules also had a public-interest aspect as the separation of payment from work outcome potentially reduced bias. The contingent-fee rule was passed in 1919 in response to the Treasury Department's threat to regulate the many contingency-fee-basis, self-styled "tax experts" who opened shop after the federal income tax was enacted [Previts and Merino, 1998].

The private interest of self-regulation of the profession was evidenced in the rules on solicitation or encroachment on the practice of another member (#8) and offers of employment to employees of fellow members (#9). Both rules constrained competition for clients and employees within the profession. Rule #7, efforts to secure legislation without notification of the Institute, serves the private interest of maintaining political power. It also established the AIA as the sole custodian of narrative with regulators and legislators. Exclusivity of audit services was the private interest established by the rules on use of the title "Member American Institute of Accountants" (#1), prohibition of a non-AIA member to practice as a member (#3), and certification of statements not verified under supervision of an AIA member (#6).

Maintenance of social status was the private interest served by the rules dealing with incompatible occupations (#5), advertisements (#11), and participation in the activities of educational institutions whose promotional activities were discreditable to the profession (#12). Professional advertising was condemned since law and medicine, the professions to whose social status accountants aspired, did not allow advertising. Richardson [1936, p. 315] averred that "no man who is a gentleman can claim for himself any superiority over his fellow."

The lack of an independence rule may be explained because independence was considered "intrinsic to the character of the professional and not easily subject to formal definition" [Preston et al., 1995, p. 526]. Alternatively, Parker's [1994] private-interest model of professional accounting ethics holds that creation of a professional mystique that renders the profession immune to evaluation by outsiders to be a crucial, private-interest goal. If only the accountant could ascertain independence, then the profession had sole claim to evaluation of a central facet of its

operation. Absence of an independence rule served the private interest of insulation from external monitoring.

### INDEPENDENCE

Auditor independence was not in the code of professional ethics, but it was the subject of considerable discourse in the *JA* and of regulatory attention throughout the 1930s. The stock-market crash “may be viewed as a catalyst, mandating some form of action to restore confidence in the securities markets” [Merino et al., 1987]. Frederick Hurdman [1931, p. 303], then president of the AIA, attempted to improve the perception of the profession by introducing in 1931 the following resolution mandating auditor independence from the client:

Whereas the relations between a client in the form of a corporation and the auditor for that corporation should be one of entire independence, and

Whereas it does not appear to be practicable for the auditor consistently to hold a dual relationship as auditor and executive of the corporation, and

Whereas the public interest and confidence will best be preserved by complete separation of these two functions, therefore be it

Resolved that the maintenance of a dual relationship of director or officer of the corporation while acting as auditor of that corporation is against the best interest of the public and the profession and tends to destroy that independence of action considered essential in the relationship between client and auditor.

This resolution, which focused on activities and relationships to remove external indicators of lack of independence, was defeated in 1932. However, it did not address the full range of incompatible relationships since ownership of an audit client was not included. The profession’s failure to pass the proposal was a strong indication of the depth of adherence to independence as character. Although not enacted, the resolution indicated an acknowledgment of stakeholders in financial reporting since public interest and confidence were cited as reasons for the adoption of an independence rule.

It is difficult to reconcile acceptability of stock ownership in a client and incompatible relationships with the independence aspect of the 1930s ethics code’s ban on commissions. The prohibition included giving commissions to secure engagements and receiving commissions from stationery purveyors and other providers of services to clients. Commissions were prohibited

as “a professional man who would give his best services must be absolutely uninfluenced by external matters” [Franke, 1930, p. 360]. Ironically, the profession acknowledged the possibility of influence or loss of independence from recommending a seller of business products but simultaneously felt an ownership interest in a client would not create a similar conflict. The narrative of character was used to explain the inconsistent positions. Hurdman [1931, p. 304] noted that bankers found a dual relationship of auditor and director, or auditor and officer, to be troubling unless “the reputation of the accountant involved was of such a high character that they felt reasonably certain the dual relationship did not work harmfully.”

Use of insider information in reorganizations, underwritings, new issues, and stock dividends was also deemed to reduce independence as it placed the accountant in the position of receiving a favor from management. Hurdman [1931, p.304] concluded that no fixed rule regarding stock ownership could be instituted but did note that the accountant “should keep in mind the necessity at all times of preserving an independent relationship and so arranging his investments that he does not take advantage of the public or permit any hoped-for gain in market values to influence in any degree his impartial review and presentation of the facts.” The amount of ownership interest should be immaterial to the accountant and was to be left to the accountant’s individual discretion. Hurdman [1931] advanced the notion that it was unlikely on a practical basis that an accountant would risk potential future earnings and goodwill by making an inappropriate decision swayed by stock ownership in a client. This view is consistent with the ethics is a state-of-mind argument of the narrative of character in which independence was an intrinsic characteristic of the accountant.

Then, as now, the SEC did not endorse independence as character but instead favored an objectively determinable approach. SEC rule 650(b) was instituted in 1934 and read as follows [Carey, 1937b, p. 244]:

The commission will not recognize any certified accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is connected as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions.

The AIA passed an independence standard in 1934 when

pressure from government and the financial press made its passage almost involuntary [Previts and Merino, 1979]. The AIA's adopted version of the independence standard read [Carey, 1937b, p. 243]:

Resolved, That no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest.

The SEC rule was more comprehensive than that adopted by the AIA in the same year as it covered both financial and employment relationship aspects. Both substantial ownership of a client and incompatible relationships (e.g., director) were banned. The profession still endorsed independence primarily as character or a personal attribute since the dual relationship of auditor and director was not banned in the AIA standard. Neither did the profession address incompatible services offered by accountants.

The character/intrinsic-moral-attribute approach to independence and ethics was still held by accountants after the Securities Acts. After the passage of the Securities Act of 1933, Frederick Andrews [1934, p. 59] wrote:

Rarely in this country does the public accountant have such a relation to the stockholders as to give him other than a moral duty to them, and it is to his everlasting credit that he recognizes this moral duty so clearly that he is not infrequently required to suffer direct financial loss in the performance of it.

The reference to the accountant's "moral duty" harkens back to the character narrative. A self-recognized moral duty but not a legal or professional one was acknowledged, thus illustrating the degree to which accountants urged the public to rely on their moral commitment to serve the public interest.

While specialized education enhances further technical development and thus is a necessary component of legitimacy of technique, the narrative of character was not abandoned in the classroom. Warren Nissley [1937, p. 114] lectured at the new School of Public Accountancy at Columbia University. He told his accounting students on December 8, 1936 that the most important of seven essential traits for a successful accounting career was a character with the highest ethical standards. Although a highly ethical accountant is necessary for the pro-

tection of the public interest, ethical behavior was also seen to have a private-interest aspect. It was noted that for “a public accountant to perform his work dishonestly would be to commit vocational suicide.”

The SEC did not accept this argument and held a rather skeptical attitude expressed by James Landis, then SEC chairman, in a speech: “The impact of almost daily tilts with accountants, some of them called leaders in their profession, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor” [quoted in Nissley, 1937, p. 101]. This reaction had some validity as the profession articulated its disagreements with the SEC in the *JA* on the topics of dual auditor-director relationships and ownership interests in clients.

The profession considered that there were three acceptable exceptions to the ban on dual auditor and director status. These three exceptions were in the cases of (1) closely held corporations, (2) auditors employed by a bank to make a credit examination, and (3) non-profit organizations [Carey, 1937a]. The profession’s conclusion on the dual relationship issue was that “it can not flatly be said to be wrong in all cases, is clearly a thing to be avoided whenever possible” [Carey, 1937a, p. 245]. The individual accountant’s character was the factor that would make the dual relationships acceptable in some cases, thus involving once again the narrative of character.

Both the SEC and the AIA versions of independence banned a “substantial” financial/ownership stake in a client, but exactly what constituted “substantial” was a subject of debate. In the SEC’s second accounting release issued on May 6, 1937, the Commission stated its position on independence. In addition to reiterating its opposition to auditor dual relationships, the release indicated that stock ownership in excess of 1% of an accountant’s net worth would impair independence [Broad, 1938]. The profession did not consider this a fair rule since accountants were “recruited from those in moderate circumstances whose incomes are relatively large in relation to their fortunes” [Carey, 1937b, p. 410]. The word “independence” did not appear in the code of ethics until issuance of *Opinion No. 12: Independence* by the AICPA’s Division of Professional Ethics in 1961 [AICPA, 1970]. Adherence to the personal attribute approach spanned the Atlantic. Upon learning of the ownership prohibition, English accountants expressed surprise that the Americans would “permit the inference that their integrity might be impaired by the dual relationship” [Carey, 1975, p. 80].



## ENGAGEMENT OF AUDITORS

While the SEC attempted to achieve auditor independence by regulating the profession, the profession's own independence efforts were aimed at regulation of the client through altering how auditors were appointed. Debate centered on two methods of appointment of auditors, termed the director and the shareholder (or English) methods [Richardson, 1932]. The director method was predominately used in the U.S. The directors, an elected board of management, appointed and compensated the auditors without shareholder oversight. The shareholder method was a legal requirement in England where the auditors were elected at the annual meeting by the shareholders themselves. The shareholders were considered the true owners of the company and were empowered to select their independent investigator "who might almost be called also an arbiter" [Richardson, 1932, p. 321].

Unlike SEC rule 650(b)'s ban on substantial ownership and incompatible relationships, the shareholder method did not create constraints on the accountant but instead improved the auditor's position vis-à-vis management and the board of directors. The focus of discussion shifted from regulation of the accountant to regulation of the client company without further limitations on accountants themselves. While the discourse concerning independence utilized the narrative of character, discussion regarding engagement of auditors used the narrative of technique. In an editorial in the *JA*, the AIA endorsed the shareholder plan in 1932. It was noted that when the auditor "is engaged by the people who are under investigation his personal independence may be jeopardized and the affairs of the corporation itself may not always be given the complete, objective analysis which they should have" [Richardson, 1932, p. 326].

Some regulatory sentiment concurred with the AIA position as expressed by Milo Maltbie, chairman of the New York Public Service Commission [Barton, 1933, p. 98]:

Auditors who are selected by officer are much less inclined to be independent than those selected by stockholders, which is the English plan. In other words, the value of an 'independent audit' depends more upon the standing of the auditors and the thoroughness of their investigation than upon the fact that the auditors are not upon the regular staff of the utility which they are investigating.

However, by the end of 1933, only Massachusetts and Pennsyl-

vania had enacted corporation laws that required the auditor to be selected by the stockholders. The United States Steel Corporation had voluntarily had its auditors selected by the stockholders, an action that was seen to anticipate “future emergencies by establishing the auditors as independent advisors of the stockholder, co-equal for that purpose with the management itself” [Andrews, 1934, p. 60].

The shareholder method had additional independence advantages. The auditors had the right to attend and address the shareholders meeting and state their case before being dismissed [Hunt, 1935]. Under the director method, there was no forum in which an auditor who resigned an engagement due to disagreements with management could explain the reason for the resignation [Nissley, 1937]. In England, the auditor was also obligated by law to include in his/her certificate whether or not the directors had satisfied the auditor’s needs for information [Hunt, 1935], thereby reducing the possibility of audit-scope limitations. The auditor also had a statutory right to access the books at any time and to require the officers and directors to respond to auditor inquiries [Carey, 1938].

Some of the impetus for discussion of the English method came from the profession’s desire to avoid governmental or bureaucratic control of auditing and auditors. A governmental commission to appoint auditors was viewed as unlikely to be free from political interference with a corresponding negative impact on an auditor’s independence [Hunt, 1935]. The shareholder method was also viewed as a means to improve audit quality as “the English practice of fixing the auditor’s fee at annual meetings, might tend to remove restrictions on the scope of an auditor’s examination, from which he occasionally suffers because of the management’s desire to reduce expenses” [Carey, 1938, pp. 356-357].

The appointment of auditors was revisited in expert-witness testimony before the SEC regarding the M&R case and necessary accounting and auditing reforms [Anon., 1939c]. George Bailey testified that toward the later part of the 1930s, the directors initially selected auditors but managing officers reappointed auditors subsequently [Anon., 1939c]. Witnesses generally agreed that engagement by the board of directors or an audit committee was preferable to engagement by management. This view was shared by a committee established by the NYSSCPA to examine audit procedures in the wake of the M&R audit failure [Stempf, 1939].

Samuel Broad chaired the AIA’s committee that published

*Examination of Financial Statements by Independent Public Accountants* in 1936 which represented authoritative audit guidance at the time of the M&R audit. He noted that the shareholder method "is not a panacea because presumably under our American practice the stockholders, who support the management, either by giving them their proxies, or by voting for their continuance, would probably confirm the auditor of the management's choice" [quoted in Anon., 1939c p. 355-356].

### THE M&R AUDIT FAILURE AND THE NARRATIVE OF TECHNIQUE

December 31, 1937 was the date of the last financial statements issued prior to the revelation of the audit failure at M&R. This fraud came to light in late 1938 and engendered considerable public outcry that startled accountants [Carey, 1939a, p. 65]:

Like a torrent of cold water the wave of publicity raised by the McKesson & Robbins case has shocked the accountancy profession into breathlessness. Accustomed to relative obscurity in the public prints, accountants have been startled to find their procedures, their principles, and their professional standards the subject of sensational and generally unsympathetic headlines.

While accountants were disconcerted by the public's reaction, the fraud was far from a dry, technical problem. Initial reports of missing funds in the crude drug division run personally by company president, F. Donald Coster, were followed by the revelation that Coster was the false identity of a career fraudster, Philip Musica. Faced with an increase in his bail, Coster committed suicide [*New York Times*, 1938b]. Strong physical resemblances led to the discovery that his three brothers used aliases to collude in the fraud and that two of the brothers had significant posts at M&R [*New York Times*, 1938d]. Allegations of Coster's arms dealing, bootlegging, and blackmail by several people who knew his real identity followed.

Amid the human-interest aspects was a financial fraud case that involved \$19 million in fictitious assets, approximately one-fourth of the total assets shown on the financial statements [Vanasco et al., 2001]. While observation of inventory was not yet required, Price, Waterhouse & Co., M&R's auditors, checked the "inventory of every other department with extreme diligence, [but] they accepted the inventory of the crude drug department on the statement of the company officers in charge" [*New York*

*Times*, 1938c]. The crude drug unit inventories and the Canadian warehouses in which they were supposedly stored were non-existent [*New York Times*, 1938a].

Receivables were not confirmed as “either Coster said they were not necessary or because his success made them seem unnecessary” [*New York Times*, 1939a]. Coster’s files contained a copy of “private and confidential” audit instructions issued by Price, Waterhouse & Co. that “laid bare the scope and operations as well as the schedules that must be drawn up to satisfy the auditors” [*New York Times*, 1939b]. In testimony before the SEC, Ralph Thorn, the in-charge for the M&R audit, stated the audit instructions were given to the M&R controller as requested before each annual audit to show Price Waterhouse was not doing work for the sake of increasing the audit fee.

M&R was the first landmark case in establishing U.S. audit evidence standards [Vanasco et al., 2001] and set the precedent for the SEC’s relationship with the AIA over audit standard-setting policy. This fraud raised concerns about “the adequacy of audit procedures and financial reports at a time when post-depression investor confidence was just beginning to be restored in the stock market” [Previts and Flesher, 1994, p. 222]. While the fraud reduced the value of M&R’s stock, it did not have a depressive impact on stock-market prices as a whole [Wright, 2002].

The accounting profession’s response to negative reaction by the public and regulators was to engage in a narrative that emphasized the scientific, rational, and technical aspects of accountancy rather than the character narrative used by the profession at the start of the decade. The M&R scandal was such that a character narrative was rendered unsupportable and unlikely to be effective. The AIA’s press release stated the “case was an extraordinary one in which there was testimony indicating collusive fraud on the part of high officers and the forging of accounting records.” The press release framed the issue as “the problem of auditing was to find means of affording adequate protection at a cost which would not constitute an undue burden on honestly administered companies” [Carey, 1939b, p. 66].

Upon election as commissioner of the SEC, Jerome Frank issued a statement to the press that, “We want to be sure that the public never has reason to lose faith in the reports of public accountants. To this end the independence of the public accountant must be preserved and strengthened and standards of thoroughness and accuracy protected” [Carey, 1939d, p. 2]. Although the commissioner referred to independence as

a key issue, independence was not a key feature in the expert testimony from hearings before the SEC that the *JA* published in three succeeding issues starting in April 1939. Instead the profession's experts focused on (1) implementation of a natural business year, (2) early notification of the auditor's appointment, (3) increased explication of accounting standards, (4) a change in the form of the audit report, and (5) education of the public about what the audit signifies [Anon., 1939a, b, c]. All of these points focus on techniques rather than moral or ethical aspects of accounting practice. The client company and the public are the focus of the suggested reforms.

The natural business year is "a fiscal year which will close at that month-end which has been shown by experience over the years to be the one at which there is the lowest ebb of activity" [Anon., 1939b, p. 280]. C.O. Wellington testified before the SEC that adoption of the natural business year "would contribute as much, and perhaps more, than any other one change toward improving auditing practice" [Anon., 1939c, p. 357]. Accounts receivable and inventory fraud figured prominently in the M&R case, and it was considered that their balances would be lowest at the natural business year-end. Low balances would reduce the audit work on these accounts and reduce their percentage impact on the balance sheet.

The audit had to be completed after the closing of the books and before the stockholders' meeting, dates that were set by the company's charter at the suggestion of the company's attorneys [Anon., 1939b]. Scheduling the audit at the lowest point in the business cycle, the natural business year-end, would facilitate completion of the audit in a timely manner. The natural business year was deemed to allow accountants to manage better their practices by a more even allocation of work throughout the year. Staffing would be improved as auditors would be able to maintain a more constant staff, attract staff of greater ability, and require fewer temporary staff. The cost of audits would be reduced as well [Anon., 1939c]. Enhanced credit analysis of financial statements by banks was also claimed as all companies within a particular industry would be received at a non-peak time [Anon., 1939c]. The cure-all-ills claims for the natural business year are reminiscent of the profession's claims for the shareholder method of auditor appointment; however, neither item was likely to be the panacea the profession claimed. Both the shareholder method and the natural business year are evidence of narratives focused on technique that directed the postulated change away from the accountant's personal and professional conduct as the

means to cope with negative publicity and calls for reforms in the accounting profession.

The need for development and codification of accounting principles was reflected in the state of financial reporting as described by John Haskell [1938, pp. 296, 298], a member of the NYSE, who noted that “the annual reports of some are so brief that they could be printed on a postage stamp.” Further, some companies “have been unable to describe their practice as to depreciation as a policy, for the simple reason that they had none.” Frank Shallenberger’s [1939, p. 267] speech in October 1939 noted “the chief obligation of the profession to the public at the present time is the clarification of accounting principles.” While clear accounting principles were important, intangible personal characteristics of the accountant were deemed important as well. “No statement of principles can replace the good judgment and integrity of the professional accountant any more than floodlights and the radio beacon can be substituted for the experience and skill of the pilot. They can both serve as great aids to him” [Haskell, 1938, p. 300].

In statements that presage the expectation gap of the 1970s, the profession lamented that the public neither understood the meaning of the audit report nor what accountants do. The lack of understanding revealed “the growing tendency of the public to expect more from the certified public accountant than he can deliver” [Stempf, 1939, p. 23]. The public, it was felt, did not understand that the financial statements are the representation of the client rather than the accountant, and “that accountants merely express an opinion – expert to be sure – rather than ascertain inexorable facts” [Seidman, 1939, p. 120]. The problem was mainly framed as an educational or publicity issue that would benefit the profession if accountants would not be asked to perform functions to which they were not prepared to attest. Usefulness in the capital markets of public understanding of the audit certificate was also recognized: “The falling tree in the forest produces no sound if there is no ear to hear it; the painter creates no art if there is no audience to appreciate it; the accountant fails in his function if he does not convey true and sound reports which can be understood and used for the purposes for which they are intended” [Wilcox, 1939, p. 152].

The narrative of technique was invoked strongly to regain the profession’s legitimacy after this large and publicity generating audit failure. While rhetoric regarding accounting principles, audit procedures, and changes to natural fiscal year-ends were featured in the SEC hearings testimony, the *JA* cautioned that

character was necessary as well: "It must be understood that an audit report is the professional opinion of the accountant who submits it and that its value is in direct proportion to his personal competence and integrity" [Carey, 1939d, p. 194]. Technique trumps character as competence, a component of technical qualifications and accuracy, is listed before integrity, a personal moral component of the individual accountant's character.

## CONCLUSION

Print media was a primary means of communication in the 1930s, and the *JA* articulated issues that concerned the profession as defined primarily by leaders of its professional organization. The monthly *JA* was a serious news source about the profession. Printing the text of speeches given at professional meetings increased communication with the AIA's national membership. Both editors used their editorial platform to engage in dialog with external institutions. Carey's editorials in particular responded to regulators' public statements. The AIA was the surviving organization in the consolidation of professional associations that concluded in 1936, and the *JA* attempted to create a national, unified voice to cope with economic uncertainties and regulatory pressures.

Alteration of narrative types did not drive the editor change at the beginning of 1937, but the type of narrative changed at about the same time. Richardson's editorship started in 1912 and covered most of the early period in Preston et al.'s [1995] study that found the narrative of character to be the profession's legitimacy strategy. Richardson advocated the ethics is a state-of-mind tenet in his *JA* editorials. His *JA* twenty-fifth anniversary editorial noted "the very substance of professional life depends upon adherence at all times to the moral code" [Richardson, 1936, p. 313]. However, this editorial also included comments indicating a transition to the narrative of legitimacy. Carey assumed the editorship after the economic crisis of 1929 and the regulatory watershed of the Securities Acts. While Carey's writings acknowledge elements of character, these two events made the narrative of character less viable as his editorials increasingly turned to the narrative of technique.

Transition to the narrative of technique was accelerated when the M&R audit failure occurred with its attendant negative publicity in the mainstream press. The profession reacted with discourse that focused attention away from the accountant as a person toward external professional elements, such as the



scientific and technical expertise of its members. There was no mention of any aspect of character in the portion of the nearly 1,500 pages of expert testimony before the SEC that the *JA* selected for publication. Expertise used on behalf of the public formed the narrative that validated the legitimacy of the profession. The profession also proposed regulatory changes to deflect regulation of the profession toward regulation of client companies. Reframing regulatory discussion diminished criticism of the profession while attempting to establish a better position for the profession with client companies.

Advocacy of the shareholder or English method of auditor appointment was the profession's first attempt to regulate the client during the 1930s. This effort predated the SEC's independence regulation and continued throughout the decade. Shareholders' appointment of auditors was touted as increasing auditor independence from management. This attempt to deflect regulation of the profession had both an ethical and a technical or practical component. Alternatively stated, it had both a public and a private-interest aspect. The natural business year was the client-directed proposal that arose towards the end of the decade and was emphasized during the M&R audit failure testimony. There was no character or independence aspect in the discourse surrounding the natural business year. The proposal was framed purely as a technique that would improve audit quality. The transition from character to technique that is reflected in the discourse in the *JA* is also evinced in the nature of the other reforms the profession proposed.

Claims to legitimacy were on the cusp of change from the overtly moral, or principles-based, narrative of character to an objective scientific, or rules-based, narrative of technique. While character and technique are at opposite ends of the spectrum, the profession needed both character and technique to serve the public interest. To fulfill its social responsibilities, "knowledge and courage are the stuff of which accountants must be made" [Shallenberger, 1939, p. 266]. While both character and technique elements are acknowledged, the technique element, knowledge, came first and the character element, courage, was the afterthought. Carey [1939c, p. 195] wrote in a 1939 editorial that "the personal character and integrity of the auditor is the prime factor upon which the profession rests. There must, of course, be common standards of procedure, there must be definition of his legal responsibilities of the scope of his work, but the public should be constantly reminded that these are guides to better performance, not screens to conceal superficial work."

Character and integrity were still primal, thus identifying a central problem that could not be regulated away. Abbott's [1998] contention that regulation is the most significant factor in the movement to use of the narrative of technique was evidenced in the accounting profession's experience in the 1930s. Both the 1929 market crash and the M&R fraud focused such significant regulatory attention on the profession as to render adherence to the narrative of character untenable and to require adoption of the narrative of technique.

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## **APPENDIX A**

### **Rules of Professional Conduct**

Adopted by the Council of the American Institute of Accountants with amendments in effect June 1931 [Richardson, 1931, pp. 155-159]

- (1) A firm or partnership, all of the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, all the individual members of which are not members of the Institute (or in part members and in part associates), or an individual practicing under a style demoting a partnership when in fact there be no partner or partners or a corporation or an individual or individuals practicing under a style demoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."
- (2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement of a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation of proof that such misstatement was either willful or the result of such gross negligence as to be inexcusable.
- (3) No member or associate shall allow any person to practice in his name as a public accountant who is not a member or an associate of the Institute or in partnership with him or in his employ on a salary.
- (4) No member or associate shall directly or indirectly allow or agree to allow a commission, brokerage or other participation by the laity in the fees or profits of his professional work; nor shall he accept directly or indirectly from the laity any commission, brokerage or other participation for professional or commercial business turned over to others as an incident of his services to clients.
- (5) No member or associate shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the executive committee or of the council is incompatible or inconsistent therewith.
- (6) No member or associate shall certify to any accounts, exhibits, statements, schedules or other forms of accountancy work which have not been verified entirely under the supervision of himself, a

member of his firm, one of this staff, a member or an associate of this Institute or a member of a similar association of good standing in a foreign country which has been approved by the council.

- (7) No member or associate shall take part in any effort to secure the enactment or amendment of any state or federal law or of any regulation of any governmental or civic body, affecting the practice of the profession, without giving immediate notice thereof to the secretary of the Institute, who in turn shall at once advise the executive committee or the council.
- (8) No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.
- (9) No member or associate shall directly or indirectly offer employment to an employee of a fellow member or associate without first informing said fellow member or associate of his intent. This rule shall not be construed so as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member or an associate for employment.
- (10) No member or associate shall render or offer to render professional service, the fee for which shall be contingent upon his findings and the results thereof.
- (11) No member or associate of the Institute shall advertise his other professional attainments or service through the mails, in the public prints, by circular letters or by any other written word, except that a member or an associate may cause to be published in the public prints what is technically known as a card. A card is hereby defined as an advertisement of the name, title (member of the American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service and address of the advertiser, without any further qualifying words or letters, or in the case of announcement of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories and similar publications cards shall not exceed one quarter page in size. This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among member's own clients or personal associates or the properly restricted circulation of firm bulletins containing staff personnel and professional information.
- (12) No member or associate of the Institute shall be an officer, a director, stockholder, representative, an agent, a teacher or lecturer,

nor participate in any other way in the activities or profits of any university, college or school which conducts its operations, solicits prospective students or advertises its course by methods which in the opinion of the committee on professional ethics are discreditable to the profession.