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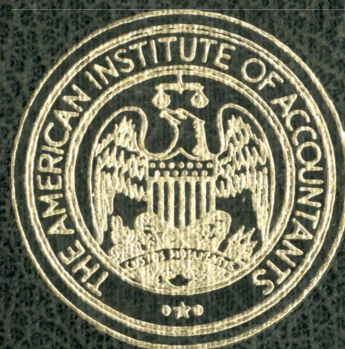
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C P A
HANDBOOK

VOLUME 1

AMERICAN INSTITUTE
OF ACCOUNTANTS

C P A
HANDBOOK



CPA HANDBOOK

Volume I

Edited by
ROBERT L. KANE, JR.



AMERICAN INSTITUTE OF ACCOUNTANTS
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AMERICAN INSTITUTE OF ACCOUNTANTS

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PREFACE

THE CPA HANDBOOK is a reference work designed for use by practitioners engaged in the public accounting profession, their staff and office personnel and students who expect to engage in public accounting.

The division of the material into two volumes has no organizational significance, but is merely a division based on convenience and quantity of material. Since Chapter 1 presents the general objectives and intent of the book and provides some background as to the thinking which resulted in the present publication, readers may find it helpful to refer to that discussion prior to making use of the book as a reference on specific areas.

A considerable amount of the material in many of the chapters is based on information obtained from accounting practitioners and accounting firms, either by the use of questionnaires or by interviews which the authors had with many public accounting firms. The co-operation of thirty firms which completed lengthy questionnaires for sixteen of the chapters, and in many instances supplied forms and comments on procedures, was particularly helpful. Several hundred practitioners completed one or more questionnaires. Several firms made available to the editor and the authors complete manuals and their entire system of procedure together with all pertinent forms. The unlimited co-operation received is clear evidence that public accounting is truly a profession wherein the membership is interested in improving the procedures and standards of all of its members for the benefit of the public that uses the profession's services.

Special recognition is due those who served as consultants on the various chapters. Their suggestions have contributed substantially to the comprehensiveness and usefulness of the various chapters.

While this Handbook was made possible in its present form only because of the contributions made by this very substantial segment of the profession's membership, the major contribution has been made by the authors of the various chapters. From previously existing literature, from questionnaire returns, from discussions with fellow practitioners and from their own experience they have selected, summarized and presented the material in the area which they have covered. Both credit and responsibility for the material is theirs. The contents, except for that reproduced from previous Institute publications, have not been approved by the Institute or by any of its committees. Users of the Handbook should remain aware of the personal nature of the views expressed, which may or may not coincide with the views and practices of a majority of the Institute membership. To make the material more useful, in many cases a variety of procedures has been given, frequently along with the author's personal interpretation and preference.

PREFACE

Maurice H. Stans was not only primarily responsible for developing and promoting the idea of the Handbook, but has served for over two years as chairman of the committee charged with the basic responsibility for its production. In that capacity he has done far more than that responsibility normally requires. He has been instrumental in locating many sources of material, in planning the coverage of the chapters, and in guiding the entire undertaking. As to all chapters, he has served as co-editor, and as to many he has been the principal editor. He has reviewed all manuscripts two or more times as they developed into final form and has made many major contributions of material.

Special acknowledgment is due to many members of the staff of the Institute, including Louis A. Sigaud who has served as assistant editor throughout the entire period of work on the book, and to Agnes Moger who has worked on the details of editing and publishing. Among the other staff members who have been especially helpful are Harold Howarth, Dick Lytle, James Bennett, Miriam Donnelly and Elsie L. O'Mara.

ROBERT L. KANE, JR.

New York
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CHAPTER 1

THE PROFESSION OF ACCOUNTING

Part I

PUBLIC ACCOUNTING, PAST AND FUTURE

History of the Profession (Prior to 1900; 1900 to Date). Significance of Growth. Influences for Growth (Demands on Accounting; Professional Contributions). What is Public Accounting (Definitions; Public Impressions). Need for a Philosophy (Individual Attitudes; The Real Objectives of Accounting). Responsibilities and Obligations (Professional Responsibilities; Ethical Obligations; Legal Obligations; Social Responsibilities). The Future.

Part II

INTRODUCTION TO THE CPA HANDBOOK

Purposes of the Handbook (Beginning a Practice; Expanding a Practice; Need for Accumulated Data; Objective of the Handbook). Limitations and Uses (Limitations; Applications; The Audience; General Content; Classification of Accounting Services).

APPENDIX

Types of Certified Public Accountants' Professional Services.

CHAPTER 1

The Profession of Accounting

BY MAURICE H. STANS

PART I: PUBLIC ACCOUNTING, PAST AND FUTURE

THE GROWTH of the profession of public accounting is one of the outstanding phenomena of the Twentieth Century!

In the United States, this growth has been especially pronounced. Following slow gains in the early years after 1900, the number of those engaged in the profession began to increase rapidly around the time of World War I at a rate which has accelerated with each succeeding decade. In the ten years from 1940 to 1950 the number of public accountants approximately doubled — with a numerical increase much greater than the gains in the older professions of law and medicine, and in the newer engineering and scientific professions.

Even more striking than the expansion in number of practitioners is the continued broadening of the scope and influence of public accounting. It has evolved from a mere policing operation to a constructive social force.

By its contributions to the advancement of the economic processes, the profession is repaying its obligation to the industrial revolution which gave it birth and early impetus. As an independent medium in economic relationships, it is becoming an important factor in the movement toward social understanding. By a simple projection of the past into the future, it stands on the threshold of vaster opportunity.

That the profession should undertake a work of the magnitude of this Handbook, with the primary objective of improving its service to the public, is in itself a sign of maturity. The Handbook offers the occasion, in this opening chapter, for a review of the development of the profession and of its work, its contributions, its responsibilities, its place in the environment, and its future.

History of the Profession

The great American philosopher, Ralph Waldo Emerson, once wrote that "the use of history is to give value to the present hour and its duty." The history of the accounting profession, from its genesis to the present time, gives outstanding proof of the soundness of this proposition. In this history, the fact of great growth, while impressive, is of much less

significance than an understanding of the forces that gave the profession momentum and brought it to its present size and stature.

Prior to 1900

The history of the profession of independent public accounting prior to 1900 is sketchy and sparse. The name of the first public accountant is undoubtedly lost forever, but he probably was an able bookkeeper, employed by an early Italian venturer of the Fifteenth or Sixteenth Century, who achieved such a reputation for technical skill in his work as to be consulted by others for advice in handling their records of transactions.* In terms of the art of accounting as it then existed he was a person skilled in accounts and, when he made himself available to more than one employer, he became a public accountant. The earliest recognition of financial record-keeping as a specialized occupation occurred in Venice in 1581, when the first College of Accountants was organized. An applicant was required to serve a 6-year apprenticeship with a practicing accountant and pass an examination. Thereafter, he became an "expert accountant," but since businesses were small and mostly owner-managed his functions were principally in the field of bookkeeping assistance.

In those days, therefore, public accounting was little more than public bookkeeping. No doubt there were occasions, perhaps many of them, when partners in the spice trades or in silk importing disagreed among themselves over their shares of profits, or creditors disagreed with debtors over amounts due, and an independent person with skill and experience in accounts was called in to learn the facts and render a decision. Their names, too, are lost to history, and literature gives them little recognition.**

* The earliest written work on bookkeeping, which set the stage for public development of the accounting art, was the Italian "Account Keeping" by Lucca da Borgo Paciolì, published in 1494.

** A. C. Littleton, in his scholarly work, "Accounting Evolution to 1900," discloses the names of one of the first public accountants in England from an epitaph, taken from a slab in the chancel of St. Mary's Church, Chesham, Buckinghamshire: "Here lyeth part of Richard Bowle, who faithfully served diverse great lords as auditor on earth, but also prepared himself to give up his account to the Lord in heaven . . . He died on 16th December 1626, and of his age, 77." Littleton points out that except for the auditing of municipal and government accounts as early as the Fourteenth Century by selected local members of the public, who could scarcely be called public accountants, there was no record of any public auditing by experts until the practice arose, probably early in the Seventeenth Century, by the lords of the large manor estates, of employing specialists such as Bowle to check their accounts. When the center of economic life began to shift from the agricultural manors to the towns with the beginnings of manufacturing, the earliest signs of a recognized public profession emerged. The city directory of Edinburgh, for the first time of any in the British Isles, in 1773 listed seven persons as accountants serving the public. At the beginning of the Nineteenth Century less than fifty public accountants were recorded in the directories of all of the large cities of England and Scotland.

Nevertheless, it is clear from the brief notes that history provides that public accounting can trace its origin back to the early days of trade and commerce. But, in comparison with the law and other established professions, it was wholly insignificant until the development of the industrial revolution and, in particular, the institution of the "limited company" or private corporation, first in England and later in this country. The greater capital and size of these expanding entities naturally caused more accounting problems to develop, but the real need for an independent accounting group sprang from the fact that absentee investors, now an important and growing class, came to want impartial and unbiased reports from time to time on the safety of their investments and the outcomes of their ventures.

When British capital came to the United States in the latter half of the Nineteenth Century, public accountants followed, and the profession in this country originated with a definite English and Scottish stimulus. Many of the early American railroads and utilities were thus financed and the investments thus watched. In time the profession was augmented by the creation of new firms in this country, as the opportunities grew and the number of practitioners enlarged.

1900 to Date

Despite the many years since its birth, the public accounting profession by the year 1900 was (in terms of subsequent growth, at least) still in infancy. In the United States there were only 243 individuals who had achieved the right to call themselves certified public accountants under recently enacted state laws. Of these, ninety-two had become members of a professional organization, the American Association of Public Accountants (predecessor of the American Institute of Accountants). The entire profession of public accounting, including noncertified practitioners, staff members and clerical employees, in all probability numbered little more than 1,000 persons. Their services consisted largely of the independent auditing of the accounts of large corporations, although they also undertook some work of installing accounting systems. Emphasis was principally on the mathematical aspects of accounting rather than on its broad character and potential uses.

In the succeeding fifty-two years the profession has grown spectacularly. The table here shows the numbers of certified public accountants in the United States at the end of each decade:

1900	243
1910	1,712
1920	4,997
1930	13,560
1940	20,169
1950	38,104

In 1952 the total passed 45,000, pointing toward a probable 60,000 certified public accountants in this country by 1960.

But these figures tell only part of the story of the profession's gains. To the current count of certified public accountants must be added a vast group of licensed and unlicensed public accountants. And to measure the real size of the profession, it is necessary to include the thousands more who make their living within it — staff members, trainees, clerical and office workers, stenographers and typists.

From a 1950 survey of the United States Department of Labor¹ come these estimates:

Individuals (1951)

Individuals, engaged professionally in public accounting	90,000
Professionally trained accountants in private accounting work	150,000
Total of all professional accountants (including those in industry, government and all other activities)	300,000*

Accounting Practices (1947)

Sole practitioners	19,000
Partnerships (including 11,000 partners)	4,400

* From 1900 to 1950, while the population of the United States doubled, the total number of lawyers increased from 115,000 to about 190,000 and the total number of doctors from 132,000 to about 180,000.

If the latter figures as to practices were brought up to 1952, they would probably turn out to be at least 24,000 partners and 5,500 partnerships, respectively. If the estimate of 90,000 professional accountants in public practice is expanded to include nonprofessional employees, the total number of individuals engaged in public accounting probably becomes nearly 150,000.

Significance of Growth

There must be fundamental significance to an expansion of such extent and rapidity in the demands upon a new profession. What forces account for its spectacular expansion in the space of a little more than half a century until its size has increased to one hundred and fifty times its proportions in 1900? Has society merely found it necessary to introduce a new type of police force to help regiment and discipline its economic activities? Is this development merely the addition of more and more sleuths and checkers to keep trial balances in balance, scare cashiers into honesty, and detect peculations by bookkeepers? Many laymen still believe so. It is unfortunate but true that the expansion in size of the profession, when recognized at all by those outside it, is usually associated

¹ See references at end of this chapter.

with ideas such as these. The expansion in scope of the profession's functions, and the extent of its contributions to business progress in the last fifty years, are not well recognized by the general public, to whom public accounting means auditing and auditing means a policing operation.

It is not surprising either that, under the pressures of increased calls for their services, most accountants have little time to take stock of the importance of their own actions to the profession and the place of the profession in the broad scheme of things. The day-to-day work and decisions are the trees so numerous that they obscure the forest. It is all too natural for one with a growing clientele to concentrate on his own financial progress, and to pay but token respect to the position and standing of the profession of which he is a part, and with which his own present stature and future prospects are closely tied.

This CPA Handbook is intended as a working tool for the practitioner. It seeks to assist him by outlining in "how-to-do-it" terms the experiences of others who have had to deal with the problems he faces. It may seem, therefore, that a philosophical discussion of public accounting is some-

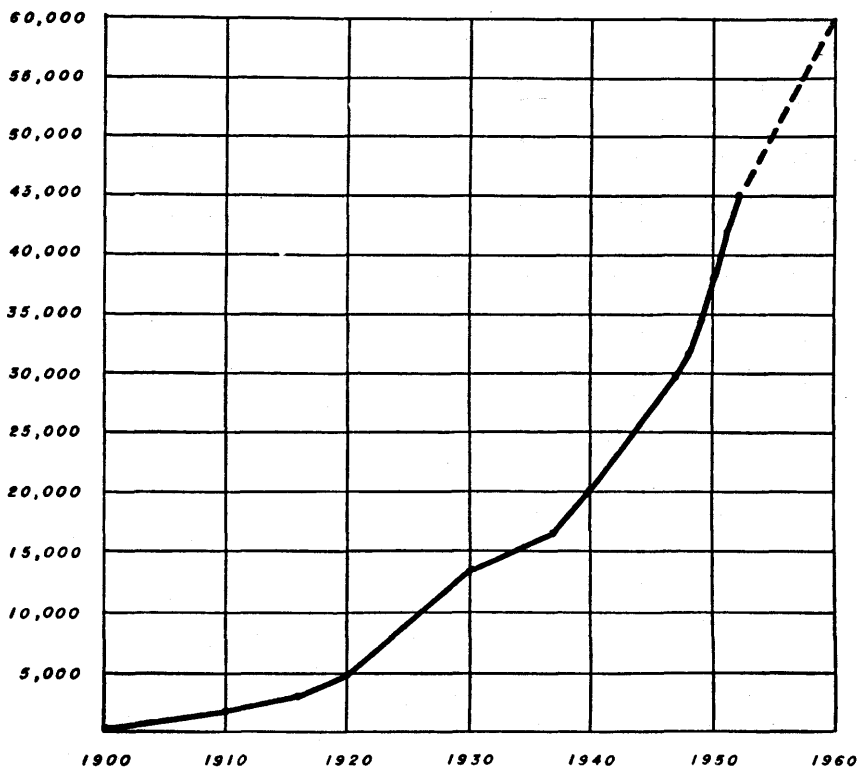


Figure 1. Growth of Public Accounting Profession in the United States
(Number of Certified Public Accountants Only)

what out of place. But the application of any tool to a job is best accomplished if the end product — the over-all structure — is first envisioned. The individual public accountant can serve his clients more ably if he has a broad concept of the importance of his profession, its obligations and its opportunities and — in simpler terms — how it fits into the workings of the whole of society. If he understands his professional responsibilities, his social responsibilities, his ethical obligations and his legal obligations, he will be a better accountant and, with advantages to him and to his profession, a better citizen.

Influences for Growth

In broad terms, economic forces have developed the profession at such a rapid pace because the last half century has been a dynamic period. Since 1900 the forces unleashed by the industrial and social revolutions

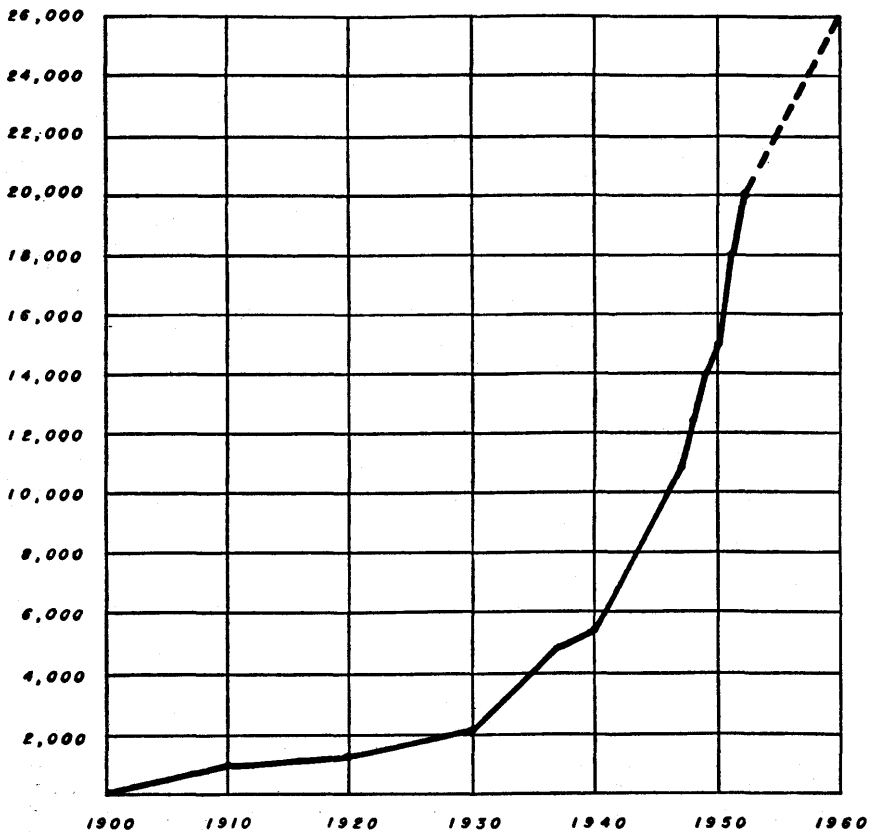


Figure 2. Membership in the American Institute of Accountants, Including its Predecessor

have brought the profession to its present standing — and these same forces provide the challenge which it faces in the years ahead.

In order to appraise the future more fully, some specification of these growth influences is necessary. With an enumeration and evaluation of the individual forces that have cumulated their demands upon the profession in the last fifty years, the future course is more predictable. In this analysis, the development of the art of accounting and the development of the profession of public accounting are sometimes indistinguishable, because the relationship of cause and effect frequently shifts position between them.

Demands on Accounting

In broadest terms, three highly significant trends have brought about the increased importance of accounting since 1900:

1. The great expansion of industrial activity, based largely upon the products of scientific research, with widespread ownership of large corporate enterprises and with greater demands on accounting for financial control.
2. The increase of government influence in the affairs of business, especially through taxation and regulation.
3. The search for increased productivity in industry, through the development of mass production systems, with their great emphasis on cost control and efficiency.

In viewing these trends, Percival Brundage² spells out the important "milestones on the path of accounting" during the last fifty years as follows:

- "1. The consolidations and mergers of the early years of the century with their effect on accounting;
2. The beginning of government regulation of accounting in 1907;
3. The growth of accounting with high taxation during World War I and the beginning of the shift of emphasis from the balance sheet to the income statement;
4. Adoption by the New York Stock Exchange of standards of accounting disclosure in 1932, further developed by the Securities Acts;
5. Emphasis on accounting during World War II — in research bulletins, in price fixing, and in cost inspection, repricing and renegotiation;
6. Postwar developments in accounting, particularly those due to inflation and enhancement of the position of organized labor and the farmer."

His following summation of the place of accounting in this period is eloquent:

"During the 50 years of the Twentieth Century . . . the developments of business and of accounting have been great and have reacted upon each other. Without the aid of accounting machines, improved methods of internal control, and adequate reporting, large-scale operations by business would have been impossible. The economies of mass buying and distribution through chain outlets might never have been realized. The statement, frequently heard, that 'accounting is a tool of business' is true, but not the whole truth. Accounting is also a partner of business."

Professional Contributions

The ways in which the profession held up its end of the partnership by meeting the challenges of these milestones were many and complex. They are part of an impressive history too long to be detailed here. They include the growth and geographical expansion of some of the early accounting firms; participation in the development of a working structure for the tax laws; the organization and combination of professional organizations into the present American Institute of Accountants; the evolution of a professional literature, of standards of examination and qualification, and educational curricula; the institution of research committees to deal with accounting principles, auditing standards, terminology, disclosure and other technical areas; co-operation (to the same end) with the stock exchanges, the Securities and Exchange Commission, and other public and governmental bodies; assistance to the government in budgetary matters, in wartime accounting problems and in many other fields; the training and graduation of several hundred thousand skilled accountants for the ranks of industry and government; and aid to industry in meeting the innumerable problems of expansion, taxation, regulation, financing, creditor and stockholder relationships, cost control, operating efficiency and profit making.

It is a history of which every accountant-participant can be proud, because it helped to build the most productive industrial system the world has ever known. This could not have been accomplished by business without the teamwork of accounting, private and public.

The result in stature of the accounting profession is told in this quotation from an official government publication:

"Accounting is an indispensable tool of modern business organization and management. Professionally trained accountants (numbering about 300,000 in 1951) set up the accounting systems which make it possible for even the largest corporation to record, classify and summarize its myriad daily financial transactions. They also analyze and interpret business records and prepare reports showing companies' financial standing and the profit or loss on past operations. Financial statements prepared by accountants enable business men to plan future activities in the light of past experience. Investors frequently rely on accountants' reports in deciding to buy or sell the stocks and bonds of particular companies. Banks use them as a guide in approving or rejecting applications for loans. Public service commissions find these reports essential in approving or disapproving requests for rate increases from telephone, gas and electric, and bus and streetcar companies. Even the smallest business firms need financial statements prepared in accordance with professional accounting standards in order to compute taxes owed to the Federal, state and local governments."¹

But this is not the ultimate. There are more milestones ahead, even though their shapes are not yet clear. The widening road leads into a long and distant horizon, far beyond view. In such a circumstance, the varying problems ahead can best be met by the generation of a fundamental philosophy, founded on an objective of creative usefulness and geared to the needs of a dynamic economy under democratic processes.

What Is Public Accounting?

Definitions

One place to seek for a philosophy for public accounting is in its definitions. These definitions take their roots, of course, in definitions of accounting itself. The well-known English philosopher, John Locke, once said, in a different context, that "accounting is a business of reason, not of arithmetick." A committee of the American Institute of Accountants has described accounting as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof." ³ One of the general dictionaries defines it merely as "the art or science of keeping accounts." In more eloquent terms, one writer called accounting "that elegant discipline." To the accountant, the more significant of all these expressions are those that characterize accounting as a process of reasoning or interpretation, for it is these qualities that lift his work above the level of the mechanical.

With the addition of the qualifying adjective "public," to define an area of service and also a profession, there are added to accounting two connotations — one of service to a general clientele, the other of responsibility to the public interest. It is the second of these that is least understood.

Public Impressions

Edward B. Wilcox once defined the certified public accountant as "the guardian of the conscience of the business community." This expression, and others of similar vein sometimes heard, are correct as partial characterizations, as was intended in the context employed, but they do not reflect the whole area of service or of responsibility. They lean too heavily on the early function of the accountant as a verifier, and correspond too much with the layman's conception of public accounting, which has lagged far behind its actual development. To too many of the public, the public accountant is the auditor of Elbert Hubbard:

"The typical auditor is a man past middle age, spare, wrinkled, intelligent, cold, passive, noncommittal, with eyes like a codfish, polite in contact, but at the same time unresponsive, calm and damnably composed as a concrete post or a plaster of paris cast; a human petrification with a heart of feldspar and without charm of the friendly germ, minus bowels, passion or a sense of humor. Happily, they never reproduce and all of them finally go to Hell."

Too many members of the public, too, have heard and remembered the indicting voices of certain labor leaders, leveling accusations like this one:

"Many of the financial statements being issued are really understatements of income accounts. This practice must cease. . . .

As a result of these kinds of shenanigans . . . income accounts have come to be not true representations of profits and income. They have been referred

to by some labor economists as subtle interpretive summaries. Many of our people have come to completely mistrust most of the published accounts of corporations. . . ." ⁴

Addressed as they were to accountants, these remarks carried the implication that accountants, and public accountants in particular, were responsible for the alleged misrepresentations. These and many similar statements and implications are almost wholly unfair and unrealistic, and in some cases they undoubtedly spring from ignorance or from deliberate fiction, but they point up the facts that (1) a single ill-conceived action by one public accountant can bring damage to the entire profession and (2) professional consciousness of responsibility and professional organization are necessary to establish and maintain the certified public accountant's reputation for integrity and independence.

Need for a Philosophy

Individual Attitudes

In too many instances individual members have seen the profession grow up without recognizing its organized achievements and without participating in them. A casual attitude toward organized research projects, a rugged resistance toward their conclusions and a smug satisfaction at individual success conspire frequently in the accountant's philosophy to cause him to overlook the fact that his is not an individual effort but a participation in a profession. The unfortunate result is that some practitioners lag, in philosophy, far behind the professional organizations that are trying to lead them. They fail to grasp the primary fact that the evolution of public accounting is part of a revolution in economic and social thinking — a revolution which accounts for the profession's growth in the past half century and particularly in the last twenty years.

No one individual can pretend to know or to put together all the relationships in this complex civilization in which public accounting is so important. Yet it requires little more than a single quotation like this to recall the origin, the purpose and the end objective of the accounting process:

"Great economic and social forces flow with a tidal sweep over communities that are only half conscious of that which is befalling them. Wise statesmen are those who foresee what time is thus bringing, and endeavor to shape institutions and to mold men's thought and purpose in accordance with the change that is silently surrounding them." ⁵

To this need be added only one sentence: Accounting is the principal means of measuring economic relationships. Since accounting is the language of business, it is the best means of conveying public understanding of the economic facts of life.

The Real Objective of Accounting

A subtle test of the public accountant's function in the workings of the broad economy is to ask for a definition of the work of a doctor or an engineer. Is a doctor merely a man who administers pills and cuts out infection? Is an engineer merely one who builds bridges and designs tools? Or is a doctor a part of a learned profession that is continuously seeking to extend the life and health of man? And is an engineer a member of an educated profession that is aiming to advance the physical comfort, convenience and safety of man? The analogy should be clear. Is an accountant merely one who writes debits and credits and checks trial balances, or is he in the important sense a member of a skilled profession the ultimate objective of which is to accumulate and interpret the facts that measure the contributions and rewards of the various groups that make up our industrial-commercial society?

Recognition of this distinction is all that is necessary for the accounting practitioner, large or small, to recognize that he is an important cog on a big wheel in the socially powerful economic machine.

Responsibilities and Obligations

The public accountant, in his capacity as a professional man, assumes the responsibilities and obligations general to all professions. He also undertakes certain social, ethical and legal obligations arising specifically from the unique character of his work and its relationships to the public.

It is generally understood that three elements must be present before a man's activities can be called professional:

1. Special knowledge and appropriate skill.
2. Moral and economic independence.
3. Recognition of an inherent public interest.

These elements of professional standing are in turn the responsibilities of any member of a profession.

Professional Responsibilities

An essential obligation of a professional man is that of competence. He must not undertake to offer his services to others generally unless he has reason to believe that — through education, training, experience and personal characteristics — he is able to serve effectively. To undertake an assignment which is "over his head" is as unfair to his profession as it is senseless from a wholly practical standpoint, since the risks of failure are too great.

In the field of auditing especially, the accounting profession has undertaken to spell out the applicable standards of competence and workmanship. The excellent exposition on this subject in Chapter 13 makes it unnecessary that these fundamentals be repeated here. Of course, the same obligation of professional competence that applies in auditing work

applies to work undertaken in all other areas of practice, including the handling of income tax matters, accounting system installations, the broad field of business counselling and all other services.

It is a point so logical that it need not be belabored. To each business operator or other person who seeks out the services of a public accountant, the one he selects is the accounting profession. His impressions of the profession are based on his experiences with his public accountant. In the composite views of all such clients lies the reputation of the profession. The weakest members, unfortunately, weigh heaviest in the balance in the appraisal of a profession, from the mere fact that competence is the essence of the professional function and incompetence is conspicuous.

The other elements of professional responsibility are really subtopics of competence and, like competence, also are ethical obligations. Maintenance of the highest possible quality of workmanship is one. Preservation of the confidences of clients is another. Continuous learning is still another, for failure to keep informed as to changes in the principles or techniques of the profession automatically converts competence into incompetence.

An important element of competence is good judgment. Being well informed as to accounting principles and auditing techniques, for example, does not alone establish the accountant's competence, because it is still necessary for him to exercise judgment in applying them to the facts and in formulating conclusions. To a large extent, the capacity of intelligent judgment is derived from experience.

Finally, one of the important professional responsibilities is participation in the advancement of the profession. It is the responsibility of any profession to seek new and better ways of service, through research, experimentation, development of techniques and similar means. No member can properly remain aloof from such activities by the professional organizations, in the expectation of benefiting from them without effort. As a member, it is his responsibility to assist in organized programs for advancement of the profession's capacity to serve, and to support and adopt the conclusions of such research once they are developed. A passive attitude does not fulfill professional responsibility.

Ethical Obligations

The certified public accountant who belongs to the American Institute of Accountants is bound by its code of ethics — its Rules of Professional Conduct. Chapter 5 of this Handbook is devoted to a practical explanation of these ethical obligations.

Rules of ethics and conduct are written into some of the state laws governing the practice of public accounting. Many state societies of certified public accountants, and some organizations of public accountants, have their own codes of ethics. Every practitioner should be familiar, of course, with those to which he is subject.

It is perhaps somewhat unfortunate, and probably characteristic of a young profession, that there is no uniform code of ethics for all who practice public accounting under a license or title. This may improve in the course of time. Meanwhile, all that need be said here, in supplement to Chapter 5, is that the rules of ethics and of conduct are to be viewed as minimum standards to be observed in dealings with fellow practitioners and the public. The real meaning of codes of ethics is found not in their words but in their spirit; in this concept, the entire ethical obligation is expressed, simply and adequately, in the Golden Rule.*

Legal Obligations

The public accountant, in his work, assumes numerous legal responsibilities. Apart from the obligation to comply with licensing and other provisions of state laws governing the practice of accounting, there are many enactments fixing civil and criminal penalties for acts that he might commit in the course of his work. Examples are the penalties under the Federal Securities Acts and under the Internal Revenue Code. No recital of these statutory provisions could possibly be complete, and none should be necessary here.

In addition, the public accountant assumes certain obligations at law to his client, and is charged with others as to third persons. A highly competent and thorough analysis of these legal responsibilities of the professional accountant appears in Chapter 6.

Social Responsibilities

In one sense, the social responsibilities of the public accountant are the sum of his professional, ethical and legal obligations. They express his duties and responsibilities to his profession, his clients and the public.

But there is another and broader sense, in which responsibility becomes synonymous with opportunity — the opportunity of service in the cause of the advancement of society. The essence of this concept was expressed in the first pronouncement of the Institute's committee on accounting procedure in 1939:

"The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole — not from that of any one group of interested parties." ⁶

Earlier in this chapter, reference was made to the need for a broad philosophy for professional accountants. This quotation supplies its

* Another expression of this is contained in a quotation from a medical society report: "Any system of ethics . . . that seeks to distribute a profession's services on any other basis than the welfare of humanity invites the loss of that profession's right to survival." *Journal of Optometry*, February 1947.

basis. The "tidal sweep" of social and economic change in the last fifty years has built a profession, which in turn has helped to build an outstanding free-enterprise economy with the world's highest standard of living.

Unfortunately, that system (and the democratic structure under which it grew) appears at times to be in jeopardy. Two circumstances bring recurring threats to its permanence—the violent class struggles for greater shares in the productive output, and the irregularities and uncertainties of the boom-and-depression cycles.

The "economic illiteracy" of the public has been deplored by many writers as the underlying cause of the labor-capital-management controversies. One corporate executive expressed the problem in these words:

"It is the responsibility of the corporate system to undertake on its own account and to aid others to develop sound economic thought.

The conditions of every new period, especially one which has seen so much change as the last century and a quarter, are strange and unfamiliar. But changes in old theories, developed to explain the new conditions, must be based not on assumptions but on solid facts, if they are to have any value and not lead us into harmful actions. In the development of modern, sound, economic thought, industry and business might well take more initiative.

The corporation has a responsibility to study the present-day economic situations of which it is both an effect and a cause, to cooperate with others in this task, and to make economic truth as widely known as possible."⁷

If this analysis is correct, the dissemination of economic understanding and of economic truth is the means of insuring the preservation of American progress. Accounting is in a leading position to help in creating understanding of the system's workings and advantages because of the knowledge of the economic processes which its members possess. The profession has a unique capacity to help in improving the means of communication of business facts in order to create a better understanding of business operations; in developing improved methods of measuring and increasing productivity in order to build a bigger economic "pie"; and in providing facts to substitute for emotion in differences over the division of the economic "pie."

This is true because, as pointed out earlier in this chapter, accounting is so important a means of measuring the flow and the effects of economic forces and economic relationships. In the hands of its experts, accounting can well become an even more important means of creating understanding, confidence and rationality in economic affairs. In this prospect lies the real hope of eliminating the recurring dangers to the permanence of the American system.

This is an imposing proposition and a long-range one. Much has been said and written about it^{8,9,10} and more consideration is needed. The important thing at this point is that this tremendous area for service be recognized by the public accounting profession as a social responsibility — and as an opportunity.

The Future

It would be wholly unreasonable to expect that the powerful influences that have caused the building of a great profession should suddenly diminish, for mankind has never retreated from its objective of abundant living. It would be absurd, too, to expect that an imminent achievement of a philosophical Utopia will bring man's individual satisfactions and ethics to the point where he no longer sought accountability from others. For many centuries, certainly, accounting will be an essential component of an increasingly complex social system.

The future, then, is evident. Professional accounting will continue to grow in numbers and in responsibilities, and in terms of history the spectacular progress of the last fifty years is merely a brief prelude to that still to come. The ultimate destiny of accounting will be measured by the vision and capacity of its practitioners.

PART II: INTRODUCTION TO THE CPA HANDBOOK

Purposes of the Handbook

However profound their philosophy of public responsibility, it is not to be expected that public accountants, contrary to any other group in a profit system, should forswear the idea of working for profit. "Art for art's sake" is too much to expect, when personal standards of living are at stake. Therefore it is assumed without much risk that every certified public accountant who hangs out his shingle does so with the hope of financial success.

Beginning a Practice

His problems begin the moment he makes the decision to embark on his own practice. With little to guide him except his own judgment and powers of observation, he has to make innumerable choices of action. Every step, from the selection of office space to the choice of stationery, from the employment of a typist to the selection of carbon paper, and from establishing rates of charge to deciding how to keep his own books, must be considered and settled promptly and effectively. These countless business details are joined at the outset by a myriad of technical questions — the style of statement presentation to employ, the form of reports to write, the review techniques to use, the technical reference materials to have available, and so on. Except in isolated snatches of professional literature, impossible to comb for so imposing a list, he has usually found no alternative to trial and error. Anyone who has experienced the process has found it frustrating, expensive and time-consuming. There should be an easier way.

Expanding a Practice

Even if he surmounts all of these difficulties and, by determined effort and skill, succeeds in getting himself successfully established, he finds the going no easier. Procedures which once served a particular purpose now result in administrative chaos and confusion. Oral communications between staff members which were at one time quite adequate no longer let the right hand know what the left hand is doing. The file cabinets which at first easily took care of correspondence, working papers, reports, and so on, begin to look like "Fibber McGee's closet." The procedures that once turned out reports smoothly and on schedule may break down and cause all sorts of problems of preparation and review. Every increase in staff or office force adds to red tape — measures usually improvised under stress of time and with no source to turn to for quick help. It all ends in a paradox. The practice of the accountant, that master of efficiency and system, grows up while its own procedures get as much attention as the shoes of the shoemaker's children. Many times he wishes

there were some way to find out how others solved the problems of staff hiring, training, utilization, compensation, and so on at each stage of expansion. It is difficult to exaggerate these complexities.

Amid all this there is the problem of keeping up with new tax laws and regulations, with accounting developments, with new business machines and new office procedures, with new auditing techniques and new government regulations. For the public accountant to neglect these is to fail to serve his clients properly; to give them full attention is to neglect his own task of earning an income.

Need for Accumulated Data

A saving fact is that every problem of starting, building and serving a clientele has been met and solved many times by others. Every large or medium-sized firm of public accountants once started small. With their growth came every one of the difficult questions that the small practitioner faces. Through experience they evolved answers that proved workable. What the small practitioner could use most of all would be the knowledge derived out of the experience of others who thus developed these solutions. A distillation of this composite experience would be an invaluable guide. A compendium of much of the written, and a great deal of the unwritten, material on the practical phases of operating a practice would be invaluable to the small practitioner. But its value would not stop with him. The medium-sized practice (most of whose internal procedures probably grew by force of necessity rather than design) would find it valuable as a reference for planning improvements. And the larger firms would find it handy as a checklist.

Objective of the Handbook

A summation of the inter-relationship between internal operation, professional standards and the earning of an income was aptly made by one of the planners of this Handbook, Marquis G. Eaton, in an early stage:

"New developments in accounting and auditing principles, procedures, and standards have been numerous in recent years and promise to continue to be so. The profession is anxious that the highest standards be uniformly observed. Keeping up with these developments is a time-consuming task. A good deal of sub-par auditing performance is attributable to the time necessary to keep up, and to the fact that many fringe problems have not yet been the subject of formal treatment by the profession.

It is to our advantage that high-standard accountancy services be extended as far down the scale of business size as we can manage to do so, while still maintaining adequate levels of professional compensation. The further they are extended the greater the influence of the accountant, the greater the public acceptance and support of the accountant, and the greater the area in which he may find work for himself.

The extension down the scale of business size must be accompanied by high-standard performance and adequate professional compensation. These go hand in hand only when application of high standards is reduced to the least possible time consumption.

What we want to do, then, is to set before the 'small' accountant a statement of high standards (as applied in practice) in such a way as to make them so readily accessible to him that he can find and apply them quickly. In this way he can take a *small fee* from a small business enterprise and still attain a *professional rate of compensation* without sacrificing high-standard performance.

Anything the profession can do to improve the financial soundness of the separate accounting firm is in the profession's interest and in the public interest. Certainly, we can not serve unless we stand financially able to serve.

And the profession must compensate its people on such a basis as to attract the best minds to it. The manual, then, should deal with all things that help the accountant to run his own office, cut down his costs, reduce waste of time and tighten his procedures."

This is the objective of the Handbook.

Limitations and Uses

Limitations

As is to be expected in so great a task, in its first execution the Handbook will be found to have limitations. Despite the careful precautions of the authors and editor, through questionnaires and extended researches, there will be omissions of information; subsequent editions may remedy these. In this edition (or in any subsequent one) there also will be the effect of dating, for nothing in an accounting practice is static and new developments are continually occurring. In all cases, the opinions expressed as to preferences and alternatives are those of the authors, and opinions may differ. While every possible effort has been made to present practical "how-to-do-it" and "where-to-find-it" information, in the form of style manuals and specimen forms and other material actually in use by others, much of it will not be wholly applicable without some changes to fit the actual circumstances.

Applications

These expectable limitations need not materially decrease the usefulness of the volumes. Knowing how someone else handles a procedure or uses a form is an important start. Modifying it to new requirements is almost always much easier than starting anew. The extensive scope of the volumes should be adequate to provide answers to most, even though not all, of the day-to-day operating questions. Wherever feasible, alternative practices are reported, and the reader is given his choice of several or an opportunity to build a new composite from the features he likes.

In order to make more accessible the important releases of the Insti-

tute on accounting research, auditing research, internal control and similar subjects, these are reprinted in full text as supplements to the chapters to which they relate. The advantage of having all such material in one place is obvious.

As a reference book, the Handbook is therefore designed to be valuable to all public accounting firms and practitioners, regardless of size. Many of its chapters, too, should be usable to advantage by professional accountants in private employment, and by teachers. There is reason to believe that a large part of it will be helpful to students interested in the practical business aspects of public accounting, in which event schools of accounting may find it a suitable textbook for more specialized courses in professional accounting than now are generally taught.

The Audience

There may be criticisms that the Handbook contains too much material beyond the needs of a small practitioner. It is quite true that some of the subject matter deals with procedures not required by a sole practitioner. Not only would it be wholly impracticable to compile a volume solely for one level of practice; it also would be unrealistic for anyone of that level not to plan ahead for growth and expansion, as employees or partners are added, and not to be aided in such moves by the previous experience of others. And the problems of public accounting practice are not readily divided into strata. The sole practitioner with one employee may well need information as to vacation policy, bonus plans, review procedures, staff training and so on. Large firms are not unique in needing information on the usefulness of electric typewriters, the sizes of report stationery, the ethics of solicitation, and the set-up of working papers. A scanning of the index and of the chapter subheadings of the Handbook should provide adequate evidence of its usefulness to anyone concerned with the operating problems of an accounting practice.

General Content

Chapters 2 through 6 are intended to deal with the development of a practice from its beginning. They describe the means of building a clientele, and the important features of relationships with partners, the profession and the public.

Chapters 7 through 12 outline methods of dealing with internal operating questions. Features of office organization, procedures, and records are described; these are followed by practical discussions of staff selection, training, compensation and utilization; and by a chapter on review procedures and one on the important subject of fees.

Chapters 13 through 20 relate to auditing and accounting services for clients. Separate authors describe auditing standards, audit procedures, working papers, internal control, accounting principles, statement presentation and report writing. The final chapter in this group points out

some of the principal special problems to be found in specific types of businesses.

Chapters 21 through 25 deal with other types of services to clients. Included are discussions of income tax practice, accounting systems, cost accounting, special investigations and the broad field of consulting and advisory services to clients.

The Handbook concludes with two chapters on duties of the junior accountant and the senior accountant, respectively. These are written in somewhat different style, being directed to the staff men in these capacities, as guides to their work and progress.

Supplemental material in the form of illustrative working documents is included wherever feasible. It is intended that such material as the style manual, partnership agreements, review checklist, office forms, specimen reports and similar items can be used with such changes as the practitioner desires to meet his own personal ideas and needs. Many of the alternatives he may want to consider in making necessary adaptations will be found in the expository material of the respective chapters.

Classification of Accounting Services

A statement of the types of services currently rendered by certified public accountants, prepared by the Institute for publication to non-technical readers, appears as Appendix A to this chapter. While its explanations may appear to be somewhat elementary to the practitioner, the statement as a whole is a good illustration of the way in which public accounting services must ordinarily be described in order to make them comprehensible to the layman. It can be a very practical document for use in discussions with the less sophisticated bankers, clients and others with whom an accountant must sometimes discuss his services, their objective and their limitations.

The statement illustrates the relatively large extent to which services other than auditing can be rendered by the public accountant and his staff, and the wide scope of such special services. Within these classes of services are the greatest opportunities for the public accountant to be constructive, for they include the many prospective areas of business planning and counsel. It is in these areas that the greatest potentials may well exist for the growth of the profession and for ultimate recognition of its practical effectiveness. Chapters 21 through 25 explore these possibilities in considerable detail.

Conclusion

This Handbook breaks no new ground in accounting principles or audit procedures. It is a work by twenty-seven individual members of the profession, helped by many hundreds of others who assisted in researches and in review of data. The views and expressions are those of the authors, without official endorsement of the Institute.

This is the most comprehensive task ever undertaken by the profession, and it has been done voluntarily and gratuitously. The many thousands of hours devoted to its production represent a monument of generous service toward the future of the profession by a great many members of the profession.

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Appendix A

TYPES OF CERTIFIED PUBLIC ACCOUNTANTS

PROFESSIONAL SERVICES

(A statement by the research department of the American Institute of Accountants for publication in nontechnical references)

This statement describes briefly the types of professional services offered by certified public accountants. It has been prepared by the research department of the American Institute of Accountants to explain the scope of the different services which CPAs render their clients.

Basically, the services performed by CPAs are:

1. Those which are substantially of an auditing nature.
2. Those which involve principally accounting work.
3. Those pertaining to income taxes.
4. Special services.

All four types of services are closely interrelated, and are often rendered in the same engagement. The classification which follows should not be interpreted as imposing any limitations upon the free operation of clients' wishes regarding the services to be performed.

In many instances, the services desired by a client will not fit precisely into the classes presented, and the certified public accountant must abide by his client's wishes in that respect. The exact nature of the services to be performed in any engagement must be determined specifically for that engagement by the parties concerned.

Once an understanding is reached, it is frequently set forth in writing to eliminate misunderstandings regarding the scope of the work, its cost, or the responsibility of the certified public accountant. If the services are to be performed at the instance of some person or group other than the company — for example, a prospective purchaser or investor, an interested stockholder, a trustee in bankruptcy or petitioning creditors, or some investigating committee — it is as important to the persons authorizing work as to the certified public accountant, and also may be important to the company on whose accounts work is to be done, that there be no question regarding who is to pay for the work.

The CPA usually submits a report, or a memorandum, upon completion of the engagement. In it, he presents his findings and conclusions.

The characteristics of the report or memorandum will vary depending upon the purpose of the engagement. However, when financial

statements are presented in the report, or appear on the stationery of the certified public accountant, a statement should be included as to the character of the examination, if any, made by the CPA in relation to the statements, and he should either express an opinion as to the fairness of the statements taken as a whole or should state that he is not in a position to express such an opinion. When the CPA is unable to express an over-all opinion, the reasons should be stated. The purpose of these assertions by the CPA is to indicate clearly the responsibility he is taking, since in many cases the client may not wish, or need, an examination of sufficient scope to provide a sound basis for an opinion on the statements.

Types of Services

The classification of CPAs' services which follows is divided into the four basic types of service listed on the first page of this appendix. It is worthy of repetition, however, that this division is intended only as a rough guide. The services performed by certified public accountants frequently cut across the somewhat arbitrary lines drawn here.

Auditing Services

Management, stockholders, bankers, government agencies and others to whom financial data is submitted frequently require the report of a certified public accountant. In many cases, the report is based upon an audit or examination of the financial data submitted.

Financial Examination

The financial examination type of audit is the most widely recognized auditing service performed by CPAs, both for reports to stockholders and for reports for credit and management purposes. Its objective is the expression of an opinion as to the fairness with which the statements of a business present its financial position at a specified date and the results of its operations for an indicated period in conformity with generally accepted accounting principles consistently applied. It is based upon tests of records and upon inspection and confirmation of selected transactions.

In general, a financial examination contemplates:

1. A general review of the accounts and records, and comparison of the figures shown on the statements with the sources from which they are drawn.
2. A review of the system of internal control, and of the accounting principles regularly followed by the business, and consideration of any departures from those principles.
3. Independent sampling (through inspection, correspondence, or other means) of the existence and dollar amounts of assets.
4. Application of various audit tests to determine so far as reasonably possible that all liabilities are reflected in the balance sheet in actual or approximate amount and are appropriately stated.
5. Analyses, tests and over-all review of the income and expense accounts.

6. Test procedures designed to determine the authenticity and general reliability of the financial statements prepared from the accounts, including adequacy of headings, notes, et cetera.

A financial examination is designed to satisfy the certified public accountant as to the general fairness of the financial statements. It is not primarily designed (hence, it cannot be relied upon) to disclose defalcations and other similar irregularities. The extent of the testing is decided by the certified public accountant in the light of his independent judgment as to the amount required to constitute a fair sampling of the records being tested.

In deciding upon the character of the tests to be made, and the extent to which they should be applied, one of the most important factors taken into consideration is the apparent effectiveness of the system of internal control. Thus, in the case of a business where the internal control is not well developed, a financial examination would require more detailed tests than would be required in the examination of a business in which the internal control is more effective. In general, the audits of smaller businesses tend to be quite detailed, though they usually consist of testing procedures. Other factors influencing the CPA's decision as to the testing required include the materiality of the item to be tested and the likelihood that significant errors exist.

The financial examination type of audit is sometimes referred to as a "balance-sheet audit." However, that term is no longer considered fully descriptive. Under current practice, a balance-sheet audit in most instances now contemplates sufficient tests to enable the certified public accountant to form an opinion as to whether the financial statements present fairly the results of operations as well as the financial position of the business.

The audit report on a financial examination usually consists of a balance sheet and statements of income and surplus, together with a concise statement of the scope of the audit and the certified public accountant's opinion as to the fairness of the financial statements. This concise statement is usually referred to as the short-form accountant's report or certificate.

Frequently the certified public accountant submits a more detailed report. In addition to presenting the usual financial statements and opinion thereon, it may outline the audit work performed, comment at some length on the organization's financial position and operations, and present schedules showing details of various accounts or other information considered to be of use to the management of the business. This is usually called a long-form report.

The financial examination type of audit also is the kind customarily performed in connection with registration statements and reports filed with the Securities and Exchange Commission. However, the Securities and Exchange Commission requires the expression of a public accountant's opinion with respect to considerably more information than is

usually presented in reports to stockholders. In order to express an opinion on this additional information, the certified public accountant may have to extend the scope of his examination in some respects. He also may be required to review certain transactions of prior years, though this review would not generally be as extensive as an audit.

Specific arrangements should be made with the public accountant if it is anticipated that the financial statements will be filed with the Securities and Exchange Commission. This will enable the public accountant to plan his work so as to provide the information required.

Audit of Details

An audit of details, like a financial examination, also has as its objective the expression of an opinion on the fairness with which the financial statements present the financial position and results of operations of a business. However, an audit of details is more comprehensive than a financial examination in that it contemplates an extensive examination of the details of the books of account (including subsidiary records, and supporting vouchers) for a period of time. Some minor testing may be employed, but it must be sufficiently exhaustive to satisfy the certified public accountant as to the details.

Only in unusual cases would the value of an audit of all details for an entire year be commensurate with its cost. In modern practice such an audit is seldom made.

The audit report is usually similar to the long-form report described under "Financial Examinations." It often includes a specific description of the detailed audit procedures performed.

Audits of Special Accounts

This class of service may cover the examination of any particular account, or accounts, of which the following are examples:

1. Cash
2. Securities
3. Payroll
4. Manufacturing costs.

A report on this type of audit may take the form of a statement of the account or accounts audited, together with appropriate comments as to the purposes of the audit and the information sought to be developed. In many cases, an informal letter or memorandum is submitted rather than a formal report.

Accounting Services

Although the auditing types of services are usually considered the certified public accountant's primary function, he is called upon frequently to render services in which the emphasis is on accounting work. This type of service constitutes a very large proportion of many CPAs' practices.

There are many ways in which certified public accountants are particularly well qualified to render accounting services. The following comments should not, therefore, be considered to be definitive or restrictive, but rather they should be considered to contain general information regarding the various types of accounting services which certified public accountants perform.

Technical Accounting Assistance

Certified public accountants are sometimes engaged to prepare and record routine bookkeeping entries. More often, however, they are called upon to perform more technical accounting duties, such as adjusting the books to reflect good accounting practice in regard to accrued and deferred items, and the preparation of opening and closing entries.

Preparation of Statements without Audit

Many certified public accountants are called upon frequently to prepare financial statements from the client's books or other records without audit. In performing this service, they are acting more in their capacity as expert accountants than in their capacity as auditors. The statements are usually intended only for management purposes.

If the accountant submits a report in connection with statements prepared from the books or other records without audit, the report should state clearly that he is not in a position to express an opinion on the statements. However, if statements are presented on his stationery without comment, a warning such as "*Prepared From the Books Without Audit,*" appearing prominently on each page of the financial statements, is considered sufficient notice in lieu of a specific disclaimer of an opinion.

System Services

System services may cover:

1. General accounting systems:
 - a. Conducting surveys.
 - b. Devising and installing systems of account and of reporting.
2. Cost systems:
 - a. Conducting surveys.
 - b. Devising and installing cost finding and reporting systems.

Budgetary Services

Budgetary services may consist of investigation and survey work, assisting in preparing budgets, designing budget procedures, and offering counsel with reference to budget policies and procedures.

Opinions

This class of service consists of preparing and rendering opinions having to do with technical accounting and financial matters.

Tax Services

Tax services consist in part of preparing and reviewing tax returns; dealing with proposed assessments and presenting tax returns before tax officials, boards and the Tax Court of the United States; preparing or rendering opinions on past or prospective tax matters; acting generally as advisor or agent for clients in tax matters or transactions with tax implications; or making special tax surveys or examinations.

Special Services

The certified public accountant is often in a position to render special services to his clients. The examples which follow are illustrative of such services.

Investigation of Specific Matters

Such investigations comprehend examinations of one or more specific features or a business, and may be undertaken in connection with such matters as suspected fraud; disputes regarding payments of royalties, et cetera; the reasons for increases or decreases in profits; financial policies; adequacy of internal control; determination from an accounting viewpoint of possible extent of civil liability; measurement of contract obligation; insolvency; bankruptcy; measurement of ratemaking factors of utilities and carriers; and other financial or administrative matters.

In each case the accountant's instructions from his client should be specific as to the objective of the investigation. The scope of each investigation is determined by its objective and the extent to which the certified public accountant considers it necessary to go in order to accomplish the objective.

The certified public accountant's findings in an investigation are usually communicated to the client in the form of a detailed report or memorandum.

Miscellaneous

This class includes services not comprehended in the foregoing classes. It includes such services as acting as advocate in the arbitration of commercial disputes, as arbitrator in commercial disputes, as umpire in accounting controversies involving accountants or clients, giving testimony as an expert witness in court and arbitration cases, interpreting financial data, instructing bookkeepers, checking statements, consulting and advising on accounting and financial matters, and other appropriate financial and statistical activities.

The CPA's report should, in each case in which a report is presented, include an accurate description of the work undertaken.

Appendix B

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CHAPTER 2

BUILDING AND KEEPING A CLIENTELE

STARTING THE PRACTICE

Desire to Serve. Education. Previous Experience. Financial Requirements. Appraising the Community. Time of Year. Associates or Partners. Obtaining Office Space. Opening an Office. Public Relations. Other Occupations.

OBTAINING CLIENTS

New Clients. Extension of Present Service. New Services. Merging Practices. Acquiring a Practice from a Retiring Principal. Purchase of a Practice. General Comments as to Obtaining Clients.

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CONCLUSION

CHAPTER 2

Building and Keeping a Clientele

BY ROBERT E. WITSCHY

WRITERS ON ACCOUNTING SUBJECTS comment frequently on the rapid growth of the profession of public accounting in the United States during the past fifty years. One of the most significant features of that growth has been the increasing awareness of the need for the services of certified public accountants by the managements of small businesses. There are numerous factors which have brought about this trend and which will assure its continuance. First, the growing complexity of tax laws is causing not only managers and owners of small businesses, but also many individuals as well, to realize their need for competent advice. Now every professional man, every farmer, every business man and many employees are potential users of the services of the certified public accountant. Second, bankers and other credit executives are requiring more frequently, of both business men and individuals, financial statements that have been verified independently. Third, the operation of even a small business is becoming more and more complex, and management is seeking increasingly the assistance that can be provided by public accountants. Fourth, accountants practicing alone or in small offices are taking the initiative in bringing to the attention of the managements of small businesses the many ways in which the certified public accountant can be of valuable service.

The natural result has been that many new accounting practices are being established successfully to serve clients other than large national corporations. Many of these new practices are in communities once considered too small to support a public accountant. Unfortunately, there has been a rather high mortality rate as well, since all too many practices have been started without sufficient planning and foresight.

Since the decision to open a public accounting office is one of the most important which the CPA will make during his professional career, he should know as much as possible of the experiences of those who have been successful and of those who have failed.

The accountant who plans to start his own practice may be an employee of another firm, a teacher who has been doing some accounting work as a sideline, an accounting employee of a corporation who has had an opportunity to observe the procedures of public accountants, or a govern-

mental agency representative employed on accounting or income tax matters. Whatever may motivate him to consider developing his own accounting practice, he should make a careful study at the outset of those factors the possession of which are likely to mean success and the absence of which may mean failure. How much training is needed? How much previous experience is necessary? How much money will be required? What type of practice is anticipated? Which community should be selected? At what time of year should an office be opened? These and many other problems should be considered well before the new practice is undertaken. If they can be answered satisfactorily, and if the accountant is willing to apply the high standards of conduct and professional skill established by the profession, his new venture can provide a successful and satisfying future.

STARTING THE PRACTICE

Desire to Serve

The profession of accountancy owes its remarkable growth in no small part to the fact that so many of its members have had as one of their foremost ideals that of service, not alone to the business community, but also to the profession. This ideal has been such an outstanding quality of so many certified public accountants as to mark it as one of the primary qualifications for success in the profession. The young man who contemplates the establishment of his own office should first take inventory of his own qualifications of character, temperament, aims and interests. He should resolve to conduct his practice in a way that will lend dignity and respect to his profession. His new venture should be approached, not with the idea that it is a springboard to immediate financial success, but rather as a profession which can provide a good and satisfying future in work well done and in friends acquired — a profession in which he can acquire the respect of his community.

However, there are many other things to consider. Except in rare instances, financial returns will seem discouragingly slow in the early years, as is the case with most professions. The accountant will have to prove himself in the beginning, and this in itself is a slow process. Those clients who will first come to the new office may want only bookkeeping jobs which may not test the full qualifications of the accountant. This type of job must be anticipated and the accountant should endeavor to keep it from dulling the vision of his original aims and ideals.

A practice of his own provides an opportunity for the independence that accompanies self-employment and for the exercise of leadership. But it also provides its burdens. It will require self-reliance, self-discipline and the ability to struggle through many discouragements. It requires the courage to exchange a regular monthly pay check with sick leave, vacation pay, bonuses, and social security benefits, for an uncertain future.

It means exchanging supervised employment where difficult decisions can be passed to higher authority for the acceptance of personal responsibility. If the accountant has the qualifications, the courage and the will to serve, the establishment of his practice has an excellent chance of success.

Education

The accountant's possibilities for success are enhanced greatly if he has received a CPA certificate and can practice as a certified public accountant. There is general agreement also that a 4-year college course with a major in accounting and study in related fields is extremely important. Many accountants without a college degree have established practices, just as many lawyers still practicing obtained their training by "reading law" as an apprentice with a law firm. However, with the problems confronting the accountant becoming increasingly more complex, it also is becoming constantly more difficult for him to render competent service without a sound basic education.

Accounting concepts and procedures have shown continuous development over a period of years, increasing the need for continuing education for the accountant. Many young accountants have supplemented their basic education by taking night school courses or correspondence courses. Since tax laws and interpretations change constantly and since much of the early business of the new practice will grow out of income tax return preparation, as much time as possible should be devoted to the continuing study of income tax regulations.

In a sense, the accountant who would progress never finishes his education.

Previous Experience

One of the chief causes of the failure of new accounting practices has been the lack of sufficient experience. The problems confronting the management of a small business can frequently be as difficult of solution as those of a large enterprise. Small businesses as a rule do not have the ablest of internal accountants, budget directors, financial advisors and tax specialists. The management of a small business frequently has little or no knowledge of the importance of records or the value of financial reports. When problems related to these matters confront these business men, their best source of help is the certified public accountant. It is essential, therefore, that the accountant obtain as much background experience as possible if he is to perform a proper service.

A questionnaire prepared to gather data for this chapter requested comments from accountants as to the necessity for, and extent of, previous experience on the part of a person starting a practice. A majority of those replying to the questionnaire were individual practitioners or small local firms. There was complete agreement that previous practical experience in the field of public accounting is an absolute requisite for

anyone planning to start a practice, either in his own behalf or as a partner.

Although there was complete agreement that previous experience was an absolute requisite, those replying were divided about equally as to whether or not the essential amount and extent of minimum experience can be indicated. While the amount and extent of experience needed is somewhat difficult to define and can be established only within rather broad limits, some of the essentials of adequate experience can be described. The questionnaire brought forth the following factors as being the most important in this respect: (1) quality of experience, (2) diversification of experience, (3) length of experience.

The consensus of the replies to this questionnaire was that as to experience the most important factor is quality. This attribute will be determined in considerable measure by the type of office in which the experience was obtained, the qualifications of the supervisors, and by the character and ability of the accountant himself. The accountant should have the quality of experience that would result in promotion to the position of senior accountant at the least. The quality of experience can be gauged to a considerable extent by the types and extent of the assignments which the employer has been willing to entrust to the accountant, by the responsibilities which the accountant has been required to assume, and by the decisions he has been compelled to make. A good measure of the quality of experience is whether or not the accountant has had complete charge of numerous engagements of reasonably substantial size.

A second important factor as to experience is diversification. Unless the accountant plans to devote his time to a specialized field, he soon will find that he will be dealing with widely varying kinds of businesses. Therefore, it is obvious that he should have had as general and comprehensive a participation as possible in the providing of accounting service for many types of business.

Ideally, the accountant should try to determine the kind of community in which he hopes to establish his practice and then endeavor to gain his experience in an accounting office in a similar type of community.

The replies to the questionnaire previously noted indicated that the minimum length of time required to obtain sufficient experience is generally considered to be three years. The time factor is affected by the training and ability of the accountant himself, by the quality of services performed in the office in which he is employed, and by the rate at which greater responsibilities are passed on to employees. The time required to obtain sufficient experience can be held to the minimum if the accountant has had the supervision and guidance of an experienced certified public accountant.

Financial Requirements

It is important for the accountant who hopes to establish his practice to determine as accurately as possible his financial requirements for a

period of twelve to eighteen months. Financial requirements will include provision for living expenses, office fixtures and equipment, office rent, operating supplies and expenses, salaries and contingencies. While these requirements will vary with different communities in different sections of the country, some assistance can be gained from the results of the questionnaire replies. This survey was based on the assumption that an individual will begin his practice with a one-room office, with a typist as a sole assistant, and in a community with a population of approximately twenty thousand.

It was assumed further that he has no definite assurance of any clients at the outset, but that he has appraised the community as potentially capable of supporting a paying practice for an additional public accountant within a reasonable period of time. Firms of all sizes* participated in the survey in the following percentages: individuals and small firms 61%, medium-size firms 30% and large firms 9%. The individuals and firms participating estimated the minimum funds which an individual establishing his own practice would require, until his practice furnished adequate return, in four general categories: personal living expenses, operating expenses, office equipment and fixtures, and personal and business contingencies, as shown in the following table:

	<i>Size of Firm Replying</i>	<i>Range</i>	<i>Average</i>
Living expenses per member of family	Small	\$ 400 - 5,000	\$1,850
	Medium	600 - 3,000	1,400
	Large	1,000 - 3,000	1,950
Operating expenses	Small	400 - 5,000	2,000
	Medium	500 - 5,000	1,800
	Large	2,000 - 5,000	2,300
Office equipment	Small	250 - 2,500	875
	Medium	500 - 1,500	775
	Large		500
Personal and business contingencies	Small	250 - 4,000	1,300
	Medium	250 - 1,000	800
	Large		1,500

* For analyses of this questionnaire, as reported in this and other chapters of the Handbook, firm sizes were defined as follows in terms of staff size (including partners, but excluding nonaccounting personnel:

Small	1 - 15 Persons
Medium	16 - 35 Persons
Large	Over 35 Persons

On the basis of the data in the foregoing table, a young accountant with a wife and one child could reasonably expect to establish his practice successfully, insofar as capital is concerned within the following ranges:

Personal living expenses	\$4,200 – \$ 5,850
Operating expenses	1,800 – 2,300
Office equipment	500 – 875
Personal and business contingencies	800 – 1,500
Total	<hr/> \$7,300 – \$10,525

Of course, these figures must be modified to give effect to such factors as the number of clients immediately available and the income that may be anticipated therefrom, the keenness of competition, the individual's capacity for making sound contacts, and the good fortune to obtain new work in the early months.

Replies to the survey indicated that the amount of time required for a new practice to become self-supporting averages from six months to two years, with the consensus being about eighteen months.

The purchase of an existing practice is discussed later in this chapter.

Appraising the Community

In past years young accountants setting out on their own frequently have opened their practices in the town in which they were employed, in the community where they were reared, or in their wife's home town. This choice had the advantage of providing a wide acquaintanceship at the outset, but this initial advantage was offset frequently by many disadvantages. The community so chosen might not otherwise be a good prospective community for a public accountant. Frequently it was difficult to compel a healthy respect for professional ability among lifelong friends. Also, it was extremely difficult to maintain a fee scale on a professional level with friends of many years standing.

If the possibility of some compelling reason for selecting one particular community is excluded, then the individual should select several communities in the general locality in which he would like to live and the potentialities of each should be determined by as thorough a survey as is possible. Such a survey should include such questions as:

1. What is the population of the community and the subordinate areas?
2. What is the trend of growth of the community as compared with other communities of comparable size?
3. What are the potentialities of the community for growth, and what is the attitude of the community toward growth?
4. What is the degree of prosperity of the community in comparison with other communities surveyed?

5. What is the relationship of prosperity of the community to that of the state and nation?
6. What is the ratio of business to the population in the community and the subordinate area?
7. How diversified is business and industry? Does it consist of a few large or numerous small businesses?
8. What is the trend of growth of business and industry — has there been steady growth through the years, a downward trend, or erratic development?
9. Is the general nature of business and industry such that it will expand, slowly decline, or perhaps eventually move to a more suitable locality?
10. Is there general full-time employment, seasonal employment, or is employment relatively unpredictable?
11. Are there any businesses of the type in which the accountant is especially interested or in which he may have specialized knowledge?
12. To what extent is business and industry without local accounting service but requiring such service to some definable degree?
13. What would such required service, if performed, conservatively yield?
14. How many individuals and firms are engaged in the practice of public accounting in the community and what is their ratio to the volume of business and industry?

Some of this information might at first glance seem difficult to obtain, but diligent effort with the telephone and city directories, together with friendly conversations with bankers, lawyers, the director of the credit bureau, the director of the Board of Trade or of the Chamber of Commerce, and secretaries of trade and professional associations, should yield a reasonably complete appraisal of the potentialities of the community.

Having completed an appraisal of the community, the final problem is to determine just how well, if at all, the community can support the new practice. Some attempts have been made to determine a reasonable gross return in accounting fees per capita of population. These attempts have produced ranges from \$1 to \$5 per capita, depending on whether the community was industrial or nonindustrial, progressive or settled. On this basis, there are many towns of five thousand population that could support an individual accountant with one or two employees, depending on how intensively the accounting service potential is developed.

The size of a locality which will support a certified public accountant was the subject of a speech on June 5, 1952 at the Mountain States Accounting Conference by Dixon Fagerberg, Jr.¹ From his own observations, he believes that there are many communities in his locality which need competent accounting services, and he further concludes that a young accountant who is willing to display some pioneering spirit could well take advantage of such an opportunity. There is a considerable variance of opinion as to the number of businesses required to support an accounting office, the number ranging from ten to one hundred. From observation and experience of many individual practitioners and small firms, it is thought that a progressive community with fifty businesses,

¹ See references at the end of this chapter.

counting even the smallest, can support a small accounting office. The successful establishment of accounting practices in such small communities is the best proof that it can be done.

Time of Year

The time of year at which the new office is opened is particularly important to the accountant who starts with few or no clients. Generally, more new clients are obtained in a small office between January 1 and March 15 than in any like period, since many accounting engagements will stem from tax return preparation. It is at this period that management must give special attention to its records, not only because its banker or other creditors may want financial statements but because of the requirement for filing income tax and other tax returns. This is the time when management is most likely to think of calling on the CPA for assistance. The office should be opened sufficiently ahead of time to gain advantage offered by the heavy amount of tax work.

The consensus among small firms surveyed is that the office should be opened in September. This will provide a period of three months in which to get the office organized and to make many personal contacts. These contacts should result in some employment for tax return preparation. On his initial engagements, the alert accountant will find many opportunities for analyzing the clients' needs and perhaps for obtaining engagements that can be performed in the slower months to follow, thereby substantially shortening the period required to get the practice on a self-supporting basis.

Associates or Partners

The young man considering the opening of an office should consider well the advantages of associating himself with one or more other accountants, either as an association or a partnership. The greatest handicap to practice as an individual is the lack of opportunity to discuss with other accountants the many problems that arise. This difficulty has been alleviated partially by the efforts of the American Institute of Accountants and of state societies of certified public accountants in making available the skilled advice of highly trained men at many area and local accounting conferences and meetings. This has been of invaluable assistance to many individuals, but it can solve the problem only partially. An association or partnership with others of comparable skill provides a community of professional interests and skills so that accounting in all its aspects can be freely and readily discussed. Another important advantage to a partnership or association arrangement is that it provides an opportunity to give and secure mutual aid within limits that are appropriate to the agreed nature and extent of the association. In addition, this kind of arrangement, making possible as it does the sharing of expenses, reduces

substantially the financial burden on each individual in the early months of the new practice.

Quite frequently, a partnership or association appears, in the public estimation, to be a professional entity of more responsible and enduring nature than a one-man enterprise. This is particularly true of the business man who, when selecting an accountant, is looking forward to a continuity of service which, in his estimation, can be obtained better from a partnership or association.

The appearance and arrangement of the office has some effect on prospective new clients at the beginning of the professional relationship. An association or partnership makes possible a larger, better arranged and more impressive office. An association provides also an opportunity for intensive development of professional and personal relations with accountants who may prove eventually to be excellent partnership material. There is the further advantage of the possible retention of the practice of an associate who may become incapacitated or of ready sale of a practice to an associate upon the occurrence of any event which necessitates termination of activities.

Many firms believe that the accountant would do well to form a partnership rather than an association at the very outset, pointing out such factors as:

tireless workers, fully aware that the practice must be cared for at all times.

Obtaining Office Space

The individual establishing a new practice should be interested in a number of factors as to office location which can be of more importance than the rental which is charged. Assuming that the maximum rental which can be paid has been fixed, the accountant can take up the consideration of these other factors. A locality should be selected which is as consistent with the dignity of the profession as circumstances will permit. Preference should be given to a well-kept business area of good repute, most likely to furnish clients, and in reasonable proximity to any actual clients. The building selected should be an appropriate one for the practice of accounting.

It has been well said that "business comes where business is." While the young man with limited capital may have to conserve in all possible ways, it is thought that he should not be too niggardly in the acquisition of office space. If at all possible, at least two rooms should be obtained since once the business begins to grow the services of a stenographer will be required. Privacy for consultations is extremely important and provision should be made, if possible, at the outset for growing room.

If the accountant has made a complete analysis of his available capital and has determined that circumstances are such that he cannot afford to rent an office at the outset, there are other alternatives available. Some practices have been started successfully in the accountant's home. While this procedure will eliminate office rent, it also has such disadvantages as not being accessible readily to prospective clients, the possibility of numerous interruptions to handle personal matters, and the failure to establish what appears to be a professional entity. A more satisfactory alternative is obtaining desk room in an office where the nature of the work is not incompatible with the practice of public accounting. Perhaps the best location is in a law office, since it may provide an opportunity to obtain engagements from the attorney's clients who may be referred to the accountant. Another acceptable alternative would be desk room in the office of another certified public accountant of good repute. This alternative provides at least three distinct advantages: (1) the possibility of performing work for the firm from which he leases desk room, (2) the opportunity to discuss accounting with others, and (3) the very helpful guidance to be obtained from an experienced certified public accountant who has himself faced the many problems of establishing a practice.

This by no means limits the opportunities of desk space to law or public accounting offices. It might be obtained in dignified real estate offices, in insurance offices, engineers' offices, and so on, if suitable privacy is assured. The important thing to remember when obtaining desk space is for the individual to limit himself to a choice of such types of offices

as are engaging in activities neither incompatible nor inconsistent with the activities, standards and ethics of the accounting profession. This point is further developed in Chapter 5 of this Handbook, "Practical Applications of Professional Ethics," by John L. Carey.

Announcements

Once the preliminaries of getting the office opened are completed, the accountant should be prepared to send out his formal announcements. The announcement should be a dignified, engraved card stating the accountant's name, his intention to practice public accounting, and his location. Many CPAs believe that the individual should begin to send out his formal announcements about two weeks before he commences to practice. The announcement should omit the date that the practice will actually begin so that for some months to come it can still be sent to additional persons without the appearance of delay, oversight or afterthought. They should be addressed by hand with the idea that this will insure a greater possibility of the announcement receiving personal attention. They should be sent only to persons with whom the accountant is acquainted.

The new practitioner should use extreme care to avoid sending announcements to clients of other public accountants, particularly officers and executives whom he has come to know in the course of his employment by other accountants. Of course, there is no objection to his making known to such persons that he is practicing in his own behalf, if the opportunity arises in the course of conversation. The accountant should never take the initiative in such situations. Announcements should not be prepared and mailed until the accountant is thoroughly familiar with the contents of Chapter 5 of this Handbook.

The following are a few samples of typical announcements which may serve as a guide:

JOHN A. JONES, CPA
Member of the American Institute of Accountants

Announces
the Opening of an Office
for the Practice of Public Accounting
in
New Martinsville, West Virginia
210 Main Street

JOHN A. JONES
Certified Public Accountant

Announces
the Opening of an Office
for the Practice of Accountancy
with Offices at
410 Main Street
Clarksville, Ohio

JOHN A. JONES, CPA and WILLIAM R. BROWN, CPA
Members of the American Institute of Accountants

Announce
the formation of a Partnership for the Practice
of Accountancy under the Firm Name of

JONES AND BROWN
Certified Public Accountants
with offices at
642 Main Street
Grantstown, Georgia

A similar announcement may be published in the press, subject to limitations of size prescribed in the Rules of Professional Conduct.

In addition to the formal announcement, the accountant establishing a new practice may make personal calls upon all of his friends and acquaintances to bring his new activities to their attention. He should not call upon those who he knows are already employing the service of a public accountant. Personal calls may begin even before the sending of the formal announcement, and the practice should continue for a considerable period thereafter. Care should be taken that nothing done or said will detract from the accountant's prestige or that of the profession.

Public Relations

Many practitioners believe that, along with technical skill, the accountant who succeeds most rapidly also must have the qualities of a competent salesman. The type of salesmanship is vastly different from that

of a person engaged in the selling of merchandise or tangible property. The accountant must sell personal service and to do that he must find ethical ways of bringing his name before the largest number of prospective clients in a manner that will establish professional prestige. There are numerous activities in which the accountant can engage which will prove extremely helpful in developing a new practice. A substantial number of firms were questioned as to the forms of activity which they considered definitely helpful in building a practice. Those activities, as listed, are in the general order of importance as reflected in replies received:

1. The development and maintenance of pleasant and helpful relations with lawyers. The practices of law and of accountancy are very closely related, particularly in tax matters, and the lawyer is frequently in position to refer accounting matters to the accountant whom he knows and in whom he has confidence.
2. The development and maintenance of helpful relationships with bankers and other credit executives. The accountant should use every opportunity to discuss with them financial statements, the bulletins published by the American Institute of Accountants, and articles concerning financial statements contained in bankers' journals. No opportunity should be missed wherein the accountant can point up the value of an independent examination of financial statements to the credit grantor.
3. Joining and taking an active interest in the affairs of a civic club. In most communities many of the business and professional men belong to a civic club such as Rotary, Kiwanis, Lions, Exchange or one of several others. One purpose of such clubs is to help members become acquainted with each other. This factor enables the accountant to become acquainted quickly with a substantial segment of the business community.
4. Joining professional and trade associations and taking an active interest in the problems of those groups. In many communities there are chapters of tax associations, accounting groups, credit associations and other organizations made up of men whose daily problems are closely allied with accounting and tax practice. Here again the accountant is provided an opportunity to build his acquaintanceship rapidly.
5. Engaging in definitely useful and recognized community service such as participating in fund-raising campaigns. Many practitioners have expressed the thought that the accountant should not attempt to solicit funds but rather should devote his energies along the lines for which he is best equipped, such as auditing receipts, preparing financial statements and preparing budgets. If the accountant has school-age children, he can sometimes make sound business acquaintanceships through active participation in parents-teachers associations.
6. Joining at least one reputable social club or organization and working as effectively as possible on any job that may be assigned.
7. Serving enthusiastically and effectively on committees formed for the purpose of carrying out worthwhile community projects.
8. Keeping in constant and purposeful touch with all friends and acquaintances along lines of mutual interest. The accountant should endeavor to keep such friends and acquaintances informed, within the limits of courtesy and good taste, of his professional progress and achievements. He should display an equally sincere interest in their business successes.
9. If the accountant has the ability, he should accept speaking engagements before local groups. He need not be a polished orator, but he should de-

velop ability to present points in a pleasing and concise manner. If possible, such speaking engagements should center around tax problems, since there is almost 100% interest in the subject among the members of any audience of adults. Considerable assistance can be obtained from the Public Relations Department of the American Institute of Accountants in speech preparation. That department has prepared a number of pattern speeches suitable for presentation before various groups. With the use of a little imagination, these speeches can be adapted to local interests.

10. If the accountant has some writing skill, he should devote some time to professional writing. Articles not only tend to bring the accountant's name before the business public but increase his professional qualifications because of the research involved.
11. The accountant should strive to remember his personal contacts with business and professional men and to remember circumstances of interest and significance in connection with his relationship with prospective clients.

In questionnaire discussions of this last point, all of the large firms replying indicated that it would be definitely helpful to keep a written record of personal contacts with individuals. In this record the accountant should note dates and circumstances of the original contact and should use the record tactfully in the development of his business and personal relationships. Small and medium-sized firms were divided almost equally for and against the necessity for keeping such a record. The pattern of the replies seems to imply that in smaller communities contacts are usually rather frequent and more personal; therefore, a written record of acquaintanceships would be of little use in such circumstances. By the same implication, it would appear that the larger the city the more it becomes important to keep some sort of written record of business acquaintances who are seen infrequently.

Other Occupations

There are numerous other activities in which an accountant creating and developing his own practice can engage which will be particularly helpful, not only in providing additional income at the beginning of the practice, but also in leading to new acquaintances and to the obtaining of additional clients.

According to the questionnaire replies, the most important sideline occupation from a financial standpoint is that of part-time bookkeeping. It is possible for the accountant to handle several bookkeeping assignments which do not involve too much detail.

Many successful practitioners, especially in small communities, will argue that some bookkeeping is an essential part of their practice from which they can never quite escape and, therefore, such work should not be treated as a sideline activity. The partial validity of their argument must be recognized. However, the degree of professionalism of the accountant is to a considerable extent a matter not alone of skill but of mental outlook. Certainly a well-trained and experienced accountant is qualified to deal with audits, systems, tax work, management counseling

and other types of service pertaining to his profession. Bookkeeping, while an important service, requires much less skill and is not a service which only a CPA can perform. For this reason, part-time bookkeeping always should be considered a sideline activity. When entering upon such work, the individual should be alert to the possibility of expanding and developing it to that point at which the bookkeeping can be turned over to a part-time or full-time bookkeeper, and the accountant can then be free to perform those services for which he is especially equipped.

The individual in accepting such engagements should be aware constantly of the disadvantages inherent in such work. First, it may establish him in the minds of businessmen as merely a public bookkeeper, thereby limiting his professional prestige. Second, it may involve him in detail work to such a degree that he will not have time for the types of engagements for which he is peculiarly qualified. Third, it is apt to engross the individual to such an extent that he will lose the perspective and vision required to handle major accounting problems. Fourth, it may lead to the delegation of all such work to subordinates or clerks, thereby causing the principal to lose that intimate touch with the basic problems of his clients which is so important in the development and retention of a clientele. Fifth, and of great importance, is that bookkeeping may occupy so much of the individual's time that he cannot keep up on his reading of current accounting literature, professional articles, tax rulings and other matters, and he may have little or no time to devote to his professional organizations.

Another supplemental occupation in which the accountant can engage is per diem work for other accountants, particularly those in outlying communities. This work should be recognized for what it is — a source of money and experience, and should be entered into with the full understanding that it is not a source of clients.

A third supplement to income is part-time employment with former employers in businesses other than public accounting. The same disadvantages are inherent here as in public bookkeeping. The accountant should use care in obtaining such types of employment, so that nothing he does will be incompatible with the ethics of the profession of accountancy.

The individual may in some cases supplement his income, and in all cases he can increase his acquaintanceship, by serving as treasurer, auditor, or some other officer, of clubs and other organizations.

When engaging in sideline activities, the accountant should keep in mind that the rules of professional conduct of the American Institute of Accountants require that "a member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith." Further discussion of this statement is found in Chapter 5.

Many accountants have found that part-time teaching provides an important supplement to their income. It also has provided an opportunity

to meet and deal with business and professional men who are seeking young graduates for their businesses.

Finally, an activity in which the accountant can profitably engage, although no immediate financial returns may be apparent, is that of occupying his free time with continued study and reading.

OBTAINING CLIENTS

New Clients

In the previous section of this chapter, methods of getting acquainted with potential clients were pointed out. It is the purpose here to set forth some of the specific situations which may result in obtaining clients. The accountant just starting his practice will find that in his community there will be many sources from which it will be possible to attract potential users of his service. A particularly satisfactory source consists of individuals and firms starting a new business. In these instances, the accountant is able from the start to point out the necessity for, and usefulness of, proper records. Quite frequently, in such situations the accountant recognizes the client's needs much more clearly than does the client himself. This recognition offers the opportunity for an intensive development of all of the client's potential requirements. The accountant should be alert to the establishment of new businesses by those whom he has come to know through outside activities.

Businesses which are reaching a stage where the management begins to recognize the need for some accounting service provide a second important source of clients. Many businesses of comparatively substantial size, particularly in smaller communities, have relied exclusively on their bookkeepers for financial statements, statistical information, tax return preparation, completion of various forms required by the government, and other services. Eventually, problems will arise which untrained personnel cannot handle, and at this point the accountant is called in. On this engagement, no matter how simple, the accountant must be prepared to demonstrate not only his ability but also his capacity to provide many services of especial value to the management.

A third source of clients includes those individuals or firms who are seeking help in connection with tax disputes with governmental agencies. This is a very common source of more permanent engagements. To utilize it the accountant must have a thorough knowledge of tax regulations and should have a Treasury Department card. Generally, this type of work provides an opportunity for the accountant to acquire a thorough knowledge of the client's records and their shortcomings. Frequently, he can acquire an audit engagement by discussing these matters with the client.

There are many other sources of new clients available, all of them providing many opportunities for development over and beyond the original engagement. More and more there are those who find that the

preparation of their own tax returns is becoming increasingly difficult. Lawyers, credit agencies and others will sometimes wish to consult the accountant in some specific case which may lead to an engagement to perform more extensive accounting service. Those who have become dissatisfied with their present accountants constitute another source of clients. This type of client, however, is frequently undesirable because, generally, a client dissatisfied with one competent accountant is likely to be dissatisfied with others.

Regardless of the sources available, many accountants say that most clients will result from recommendation. Some of the sources of such recommendations are, in the order of their reported significance:

1. Satisfied clients.
2. Lawyers.
3. Banks and other credit agencies.
4. Business acquaintances.
5. Personal friends.
6. Clubs and other organizations of which the accountant is a member.
7. Former associates.
8. Real estate and insurance agencies.
9. Secretaries of trade and professional associations.

According to the questionnaire replies, it is believed that it would be helpful to the new practice if the accountant were to have specific understandings with attorneys whereby, within the ethical standards of both professions, the attorneys would refer clients to the accountant on accounting problems and the accountant would refer clients to the lawyers on legal problems. It is thought that the possibilities inherent in this co-operative procedure, and particularly in cases involving both matters of law and accounting procedures as to taxation, have been mutually increased by the joint statement of principles approved in May 1951 by the National Conference of Lawyers and Certified Public Accountants whereby, if the problems involve both legal and accounting skills, lawyers are to encourage their clients to seek the aid of certified public accountants, and certified public accountants are to encourage their clients to seek the advice of lawyers. According to a majority of those responding to the questionnaire, further possible extensions and expansions of this statement on a mutually friendly basis should substantially increase the numbers of potential clients referred by attorneys.

Extension of Present Service

It has been well said that "we often fail to see the opportunities in our own back yard." In the speech noted previously, Dixon Fagerberg, Jr. makes the point of the importance of intensive development of clients already being served. Indeed, this method of increasing a practice is the very life blood of the small office. Frequently, the first engagement for a client may be little more than a bookkeeping job. The importance

of such an engagement is not the immediate financial return but the opportunity it provides for additional needed service.

New Services

Of a similar nature to expanding the scope of present engagements is the developing of new services to present clients. There are an almost infinite variety of services that can be provided in addition to the usual audit. A general discussion of some special services is found in Chapter 25, "The CPA as a Business Consultant" by Marquis G. Eaton. There also is a most informative discussion of the same subject in an article by the same author in "How to Improve Accounting and Tax Service to American Business."²

Merging Practices

An increasingly prevalent method of enlarging practices is that of merging already existing practices. This procedure brings to the business all the advantages of more economical operation, combination of skills, broadening of contacts, and others discussed earlier in this chapter. Generally, the same considerations and cautions are applicable as in the case of an original partnership.

Acquiring a Practice From a Retiring Principal

A method of development of a practice that appears to be growing in frequency is that of acquiring an interest in the accounting firm in which the accountant is employed. Many young men graduating from accounting schools now are seeking employment in practices owned by elderly principals with the idea of acquiring those practices eventually when the principal retires. In such cases the young accountant often becomes a partner without having to purchase an interest. Acquisition in this manner depends on the accountant's skill and his ability to develop sufficiently to make himself indispensable both to the principal and to the clients. An accountant who has obtained a part interest is obviously in a much better position to acquire the remaining interest in the event of the death of the principal.

Purchase of a Practice

One important method of starting a practice and obtaining a nucleus of clients is to acquire by purchase an already existing practice. This method is likely to become more prevalent in future years. Although the United States courts until very lately have been unwilling to hold that there may be a substantial goodwill value in an accounting practice, such practices, with their goodwill as the main ingredient of the sales, have been sold with increasing frequency in recent years.

There has been little effort in the United States to find a method of arriving at a reasonably accurate and fair computation of actual goodwill in any specific case. What has been done is to generalize as to methods in various classes of cases. What is most needed is a method of assessing accurately the effect of various possibilities upon the value of a practice to be acquired.

Generally, the method used to determine the goodwill of a practice has been based on a proportion of gross fees for a period of past years. In *The Journal of Accountancy* of September 1948,³ a correspondent relates that he was told goodwill is usually valued by taking 40% of the gross receipts for the prior three years. An article entitled "A Study of Accountants' Partnerships,"⁴ published in 1940 as a formal report of the committee on professional practice of the Syracuse Chapter of the New York State Society of Certified Public Accountants, contains various comments on goodwill valuation. Although these methods must be considered in the light of their relation to goodwill of practices where the valuation is concerned with the interests of deceased partners, they are pertinent where they are clearly meant to fix a value corresponding to the amount which the practice would bring if sold. One method suggested is the annual average fees of the last three or five years. Another provides that, in cases of dissolution, partners who are allocated accounts not originally brought in by them pay the partnership a value equal to one year's average fee. Another method suggested is an amount equal to gross receipts for six months. Several clauses found in partnership agreements, and a discussion of this problem from the partnership standpoint, are contained in Chapter 3 of this Handbook.

The method employed in the recent sale of a partial interest in a public accounting practice illustrates one approach, based upon past fees, to the problem of establishing a value for such an interest. The principal, a sole practitioner, sold a 25% interest to each of two employees. The parties listed all of the practitioner's regular clients together with the average annual fees received from them, exclusive of fees from nonrecurring or special engagements. A value was then obtained for each of the regular clients by applying to the average annual fees the following percentages:

- 100% for clients served for over 4 years
- 75% for clients served for from 3 to 4 years
- 50% for clients served for from 2 to 3 years
- 25% for clients served for from 1 to 2 years

No value was assigned to clients who were deemed to have no further value to the firm because of such circumstances as death of the client, dissolution, or transfer to another accountant.

Twenty-five per cent of all special fees received during the preceding four years was added to the value obtained for regular clients, as the principal believed that he had made enough contacts to insure contin-

uance of the special fees. To this sum was added the book value of equipment and furniture to arrive at a total which, when divided by four, was considered to be the value of a 25% interest in the practice.

The computations involved in this approach are illustrated below:

<i>Regular Clients</i>	<i>Average Annual Fee</i>	<i>Years Served</i>	<i>Applicable Per Cent</i>	<i>Value</i>	<i>Remarks</i>
xxxx	\$ 400	4	100	\$ 400	
xxxx	700	1	25	175	
xxxx	300	2	50	150	
xxxx	1,000	4	100	1,000	
xxxx	400	3	75	300	
xxxx	50	4	....	....	Deceased
xxxx	100	3	....	....	Dissolved
...	
Total value of regular clients' accounts				<u>\$44,000</u>	
Average of four years' special fees (\$4,000 @ 25%)				1,000	
Equipment and furniture at book value				5,200	
				<u>\$50,200</u>	
Valuation of 25% interest				<u>\$12,550</u>	

As stated previously, the available discussions of valuation on the basis of a proportion of past gross fees has been too general; and in these generalizations not enough consideration has been given to what is, perhaps, the most important factor. How many of the clients whose accounts are included in the practice sold will remain with the purchaser and to what extent will their value to him vary from their previous value to the accountant who is selling? This point is stated eloquently by the unnamed author of "On Buying an Audit" in *The Accountants' Journal* (New Zealand).⁵

"The most a buyer can expect to get when purchasing an audit is an assurance that the concern audited will allow the buyer to do in the future the work which the retiring auditor has been doing in the past. Until such assurance is given, any proposed purchase is a gamble."

As to the possibility of determining with reasonable precision what specific clients will remain with the purchaser of a practice, a ruling of the American Institute of Accountants' committee on professional ethics is of significance. This ruling, contained in the May 1949 committee report, reads:

"In no event has the practitioner who sells an accounting practice the right to transfer working papers et cetera of a client without first obtaining his permission."

An obvious result of that ruling is that an accountant selling a practice must either (1) acquire the consent of his clients to the transfer of the working papers before he makes the sale or (2) make the sale subject to acquiring such consent from each client affected. In either event, it

is possible, once the consents or refusals of clients have been received, to determine within reasonable limits which accounts will remain with the buyer and which are likely to go elsewhere. In any case, the consents should be received before the terms of sale are fixed.

This procedure will not foretell the annual future billings for accounts that can be counted on to stay with the purchaser. As was pointed out significantly in 1951 by R. Sproull of England in a special chapter on "Buying a Practice" in his book "Accountants' Fees and Profits,"⁶ further analysis of past gross fees is required.

Mr. Sproull indicates that the essence of valuation is to arrive first at the worth of a sound, even-going practice of the type for sale. Then there is added to or deducted from the worth appropriate values for whatever enhances or detracts to make it correspond to the actual practice being considered. The features involving addition and deduction (and their extent) should be capable of standardized enumeration, but it appears that considerable research will be required by the profession to arrive at such an enumeration. Meanwhile, drawing on experiences of accountants in many scores of sales and purchases in the last twenty years, Mr. Sproull makes many significant points. One is that "gross fees" is meaningless as generally applicable to a practice, or in comparing several practices. Having no commonsense or scientific basis, the term should be dropped from use and a more accurate phrase used — such as "trimmed total fees." Thus the list of past fees should be adjusted to reduce them to a uniform basis over a period of years by the examination of nonrecurring fees, special fees and fees from accounts with a discernible short life — for example, those in liquidation and those whose owner has died.

However, if an average of "gross fees" or, preferably, "trimmed total fees" is to be used as a basis for determining goodwill, this value should not be made a completely arbitrary determinant, as the amount of payment can be related to the actual future yield of the accounts. Where the accounts yield less than the average set as a standard, the seller, by appropriate provision in the sales agreement, can be made to rebate in proportion. If payments for the practice are to be made in installments, such adjustments can be deducted from installments due.

A good illustration of an American case in point is the sale of a practice which became the subject matter of the significant Wyler tax case.⁷ Wyler, selling his practice for \$50,000, consulted his clients in advance, secured their approval to the transaction, and transferred the working papers to the buyers. The contract of sale indicated his billings for the past three years (average about \$60,000) and provided that if billings to these clients by the purchasers for the next three years did not total \$180,000, Wyler would rebate a proportionate part of the \$50,000 sale price.

Another basis for evaluation of goodwill of a practice in the United States is to use the net profits of three to five past years. The use of this

method requires the same analysis of gross fees as discussed previously. In addition, a careful study must be made of costs to determine as nearly as possible how the purchaser's costs will compare with those of the seller. One method having received considerable support is to value purchasable goodwill at 167% of the amount of the average annual net profits. In the article previously cited, "A Study of Accountant's Partnerships",⁵ there is a suggestion of one-half year's purchase of the average net yearly profits since inception of the partnership. Other formulas are three or five times the average annual earnings.

Further pertinent discussion of valuation based on gross fees or net profits may be found in that section of Chapter 3 of this Handbook which covers the goodwill valuation of partnership interests, in "Valuation of Goodwill in an Accounting Practice" by Max Block,⁸ in "Organizing and Perpetuating an Accounting Partnership" by Ira N. Frisbee,⁹ and in "Goodwill in Accountancy Practices" (English author unnamed).¹⁰ The last mentioned article gives nine methods of valuing goodwill and outlines various methods of payment.

Mr. Sproull makes numerous other points to which a buyer should give serious attention. Some of these are: the location of the practice, date of establishment, number and types of clients, the last year's total fees, the price asked, and the last year's profits. Other useful information would be average rates charged for principal (and perhaps staff), relative chargeable days, reasons for sale, and any special features of the practice. All of this information should be accumulated by the seller as a preliminary to entering into negotiations for the sale.

Numerous other pertinent factors are set out by Mr. Sproull. The buyer must inquire into the past ebb and flow of clients and attempt to estimate its range for future years. It seems to be higher in urban practices. Too many new clients in recent years can spell greater losses of clients ahead. Clients having less than three annual bills from the vendor are often worth less than other clients, and the shorter the term of connection with the accountant the poorer can be the client's value in relation to fee. The buyer should determine the seller's reasons for selling.

Mr. Sproull suggests also that to assist a vendor to survey the value of his clientele or to enable a prospective buyer to collate information furnished him regarding a practice, it is sometimes desirable to make a schedule listing essential data concerning each client. Some of its features are: date of acquisition of client, services performed, dates and places of performance of services, fiscal year, time and fees last three years, time and fees this year, time and fees estimated for next year, dates of billings and payments, other accountants possibly considered, financial status of client, possibility of future discontinuance or expansion, and reasons for loss of client, if applicable.

Prices paid for practices in England have varied widely. The variations depend on such factors as whether the practice is recently or long established; whether it is dynamic, static or declining; whether it has fixed

or variable fees, whether it has audit engagements which are very secure and easy to transfer, et cetera. In one example, a table is given listing total fees for an actual year (or average of several years) and showing the profit thereon. The price of the practice is then calculated at 300% of one year's profit.

A general comparison of valuations adopted in the United States and in England indicates that purchase prices are definitely higher in England. The basic reason for this appears to be that in the latter country accounting practices are more apt to remain integrated permanently, even when transferred from one practitioner or firm to another (90% to 95% of practice, usually). This may be due in part to the English concept of a practice as a whole being an old and well-established entity in itself from which there is a strong reluctance on the part of clients to withdraw. And it also may be due in good measure to the probable fact that in England there is appreciably less range of variation in professional qualifications and skill than in the United States.

With a higher prospect of retention of clientele, the English seem to consider it adequate to guard against overpayment for a practice by withholding a percentage of the purchase price so as to guarantee a refund for any excess valuation over actual fees earned by the practice for the new buyer over a stipulated period. In the United States, however, where retention of substantially all clients is somewhat less certain, there is a growing tendency to base the purchase price of practices on a percentage of future fees earned over a specified period.

For instance, in October 1948 George Rea asserted in *The Journal of Accountancy*¹¹ that the buyer's efforts alone create income after the purchase, no other foundation having been laid by the former owner except introduction to his successor and the good word spoken for him. Arguing that the services rendered to clients by the buyer have far greater value than the good word spoken by the former owner, Mr. Rea felt that the amount attributable to the good offices of the seller should be an agreed small percentage of the profits earned by the buyer on the clients taken over by him and effective for a stated term of years. A fair price was considered by Mr. Rea to be 25% of the profits earned from the former owner's clients in each of four years, plus an agreed price for furniture, equipment and so on. And he added that, of course, the buyer would not be expected to give the seller any share of the profits from new clients acquired after the purchase.

It is significant that there have been transfers of practices in the United States recently on a basis of a percentage of future fees for a specified period. Some valuations used were (1) 25% of fees for the next four years, (2) 20% of fees for the next five years, (3) 40%, 30%, 10%, 5%, 5% and 5% respectively of fees in the next six years, (4) 15% of fees for the next five years, and (5) 15% of fees for the next five years with 5% per year for a further period of five years.

The underlying reasons for basing such sales on a percentage of future

fees constitute broadly a realistic amplification of the grounds advanced by Mr. Rea. They are in essence as follows. Any speculation as to delivery of a clientele to a buyer should be at the seller's risk. If he has served his clients well and if he selects a responsible and competent buyer, he should be able to deliver a very substantial part of his clientele. If he does not have the best and closest possible ties with his clients and so cannot be certain that they will follow his recommendations as to his successor, he should get paid only on what he controls and can actually deliver. At the outset the seller should know more about the buyer than the clients do and, therefore, if he selects a poorly qualified buyer, he should assume the risk of client dissatisfaction occurring subsequent to the transfer.

Of course, sometimes a seller cannot deliver even to the most acceptable buyer some of his best clients with whom he is on excellent terms. In a relatively small community, for example, a client may be a close personal friend of one or more accountants. Therefore, this client probably would want to transfer his account to one of his friends rather than to have it go to a comparative stranger. Such an incident is known to have occurred in a city of approximately thirty-five thousand with an additional fifty thousand in surrounding areas. The seller transferred his practice to two competent employees who had been with him for four years. Although the young men were able to acquire a substantial nucleus of clients, a number of important clients transferred their accounts to other accountants whom they knew.

Mr. Sproull, in his discussion of transfers of practices in England, indicates that the transfer should be quick and clean and that the vendor should act only to the minimum extent of making introductions and insuring the buyer's familiarity with clients and details. He indicates further that the buyer is introduced generally by the vendor's letter, and that it is best that there be no personal attendance by the vendor in the majority of cases.

This appears to be at variance with American opinion, as indicated by numerous comments received in connection with this chapter. Some practitioners believe strongly, that in the interests of continuity, it is best for the vendor to remain with the business for as long as six months and only withdraw gradually from the practice.

A recent publication of the Society of Incorporated Accountants and Auditors deals with the general subject of "Valuation of Goodwill."¹² It includes a section on "Professional Goodwill" which indicates that the process of development with respect to such valuation of goodwill has followed in England a course practically parallel to that in the United States. There has been the same initial judicial reluctance to admit that transferable goodwill may exist in a professional practice, the same slow progression from general to definite methods of valuation, and even the adoption of the same basic patterns involving relation to past gross fees or net profits or to estimated future profits.

As a final consideration, both the buyer and the vendor should be aware of the tax consequences of the sale of practices and of interests in them. There have been a number of tax cases on the question of whether such funds acquired or expended are treated as relating to capital or, instead, involve ordinary income or expense. There is a discussion of this problem in Chapter 3 (Accountants' Partnership Agreements). There are voluminous discussions of the subject in other sources, and comment here will merely point out the basic authorities to which the buyer or vendor may refer.

As to court decisions on the tax aspects of sales or other transfers of practices or interests in practices, three are particularly significant. These are the Charles F. Coates case in June 1946,¹³ the Rodney Horton case in July 1949¹⁴ and the Richard S. Wyler case in 1950.⁷

Of further interest in connection with two of these cases are articles by Coates and Wyler concerning the cases in which they were involved. These articles are "Tax Aspects of the Partnership Agreement" by Charles F. Coates,¹⁵ and "Tax Court Says Goodwill Attaches to Accounting Practice, and May Be Sold" by Richard S. Wyler.¹⁶

Other pertinent discussions will be found in "The Federal Income Tax" by Joyce Stanley and Richard Kilcullen,¹⁷ and in an article discussing the English tax aspects entitled "Goodwill and Taxation" by Peter Whitworth.¹⁸

General Comments as to Obtaining Clients

No matter how the practice may be acquired, whether by building from nothing, by purchase, by merger or otherwise, the accountant should always be alert to every opportunity to develop his sources of potential clients. In smaller communities particularly, clients will often be acquired in unusual circumstances, at luncheon tables and other informal meetings. If the accountant is an interested listener to a business or professional man's problems, he will frequently find opportunities for making suggestions which will arouse the prospective client's interest in accounting service.

DEALING WITH CLIENTS

Use of Psychology

The intelligent use of psychology in client relationships can be most helpful. However, there is an indispensable preliminary requisite to the use of such psychology; that is that the professional work done for the client must be accomplished with the practitioner's utmost competence.

The first step in applying psychology to relationships with clients is to display sincere interest and professional enthusiasm in the performance of even the most routine engagements. No general rules can be set up for the application of psychology to client relationships, but rather the conduct of the relationship with each client should be based on careful observation of his personality characteristics and of his reaction to the

accountant. The accountant should learn well, and this is particularly true as to the small businessman, the client's personal characteristics. Knowing the client provides a basis for tailoring professional service to his needs and his desires, within the bounds of proper procedures.

Confidential Relationship

It hardly needs repeating that a positive confidential relationship between the accountant and client is essential, and that it involves considerably more than keeping knowledge of a client's affairs from coming through the accountant, directly or indirectly, to the attention of "outsiders." The replies received in response to a questionnaire produced several specific comments as to confidential relationships which are worth repeating. In the case of an individual client, the confidential relationship is solely between the accountant and the client; and the information obtained in such relationship is not to be divulged to any employee of the client, or to any relative of the client, including a wife or husband, without express and preferably written request by the client directed to the accountant.

In the case of a corporate client, the confidential relationship is between the accountant and corporation; and the information covered by such relationship is not to be divulged to any corporate officer or executive or any other individual (except those specified by the corporate authority making the engagement) without further express authorization, preferably in writing, by the same corporate authority. In the case of a partnership client, the confidential relationship is between the accountant and the partners; and the information covered by such relationship is not to be divulged to any other than a partner without express and preferably written request by the partner authorizing the engagement. Where information is desired by a partner other than the one authorizing the engagement, it is desirable to seek express authority for this from the partner authorizing the engagement. The accountant should review thoroughly the section on confidential relationships in Chapter 5 of this Handbook.

Continual Service

In the questionnaire prepared for this chapter, an attempt was made to obtain from firms of all sizes their ideas as to the importance of continual service. There was a unanimous agreement that the rendering of continual service to clients, apart from the performance of periodic engagements at relatively distant intervals, has a very tangible goodwill value from the standpoint of retaining the client and creating opportunities for more extensive service. In the questionnaire, an attempt was also made to determine by percentages the specific types of services rendered to clients.

The figures given were highly variable but the percentages are worth repeating here. One question requested approximate percentage of

clients (based on number rather than billings) for whom the following types of services were performed:

	<i>Size of Firm</i>	<i>% Range</i>
1. Only audits and tax returns with almost no service in between those assignments	Small	0-90
	Medium	10-90
	Large	5-65
2. Annual audits and tax returns and fairly frequent special work at other times during the year	Small	0-90
	Medium	2-85
	Large	10-75
3. Annual audits and tax returns with numerous additional assignments during the year	Small	0-64
	Medium	0-35
	Large	0-25
4. Semiannual or quarterly audits	Small	0-90
	Medium	0-20
	Large	0-39
5. Monthly statement preparation	Small	0-75
	Medium	0-20
	Large	0-25
6. Monthly statement preparation and some actual write-up of records	Small	0-75
	Medium	0-10
	Large	0- 9

The ranges indicate wide variations in types of service even as between offices of similar size. However, a further analysis of detailed replies indicated that not over 50% of the work of a small office falls in categories 1 and 2, about 30% in categories 3 and 4, and 20% in categories 5 and 6. Among medium and large offices the indicated percentages were: 64%-76% in categories 1 and 2, 18%-27% in categories 3 and 4, and 6%-9% in categories 5 and 6.

Firms replying to the questionnaire were requested to give also the percentage of their clients to whom they rendered various kinds of business and financial advice at fairly regular intervals. The replies indicated that small firms render such service to about 56% of their clients, medium-sized firms to about 50% and large firms to about 42%.

It is obvious that many firms recognize the importance of frequent and continuous service. Also of considerable significance is the result of the questionnaire as to types of services performed. That tabulation covered the approximate percentage of staff chargeable time during the past year in the following categories:

<i>Type of Work</i>	<i>Percentages by Size of Firm</i>		
	<i>Small</i>	<i>Medium</i>	<i>Large</i>
1. Annual or semiannual audits	34.5	57	67.0
2. Income tax work	29.0	25	19.5
3. Systems and special work	10.5	8	9.0
4. Monthly statements	12.5	7	3.5
5. Write-ups and monthly closings	13.5	3	1.0

These figures should not be considered entirely conclusive in view of the somewhat limited number of firms queried. Nonetheless, it does indicate that a substantial percentage by amount of billing of the work performed by small offices is done continuously through the year.

All sizes of firms state that there are numerous ways to keep in frequent contact with clients. Some of the more important methods are:

1. Consulting with client on costs.
2. Consulting with client on business matters.
3. Consulting with client on office procedures.
4. Consulting with client on accounting procedures.
5. Assisting with the financial planning.
6. Assisting client with personal financial matters.
7. Informing the client of tax and other changes affecting him.
8. Appearing at board meetings.
9. Encouraging phone calls from client's bookkeepers for information and advice.
10. Discussing with the client his monthly statements, when possible.
11. Assisting in office efficiency surveys.
12. Making comparisons of the client's figures with national or other averages secured through trade associations.
13. Discussing economic trends and government actions.
14. Assisting, where practical, in real estate matters.

Maximum Service to Present Clients

One of the most fertile fields for the development of a practice is the extension of service rendered to existing clients.

It is generally agreed among sole practitioners that most of their clients should have additional accounting services. In many instances there is an appreciable difference between the services actually performed for the clients at their request and the extent of the services which they actually need. It has been estimated that perhaps as many as 45% of the clients of the sole practitioner actually need more auditing services than are being rendered at their request. This is due chiefly to the fact that small businessmen in many cases have not been fully informed of the actual service which can be performed for them through an audit, nor the nature and benefits of such work. This is an excellent field for extension of service.

It is further estimated that perhaps as many as 35% of the clients need more accounting service (nonauditing) than they have requested the accountant to perform. Therefore, the accountant should take definite ethical steps to provide the services that the client should reasonably require. Some of the steps which the accountant may take are:

1. Pointing out to clients, in advance of performance of services, specific and significant deficiencies in the scope of services stipulated by them in relation to the objectives of the services.
2. Explaining to clients receiving nonopinion reports the fundamentals involved whereby an engagement restricted in scope makes it impossible for the accountant to formulate or express an unqualified or qualified opinion.

3. Making specific recommendation to clients in reports on engagements as to remedial measures shown essential or desirable by the outcome of the engagement.
4. Indicating to clients during the course of the engagements, any steps or procedures with respect to operations, internal control, accounting methods, et cetera, which will be demonstrably advantageous.

Reference should be made to Chapter 25 of the Handbook which covers in considerable detail the various services that can be performed.

Recommendations on Current Problems

The accountant should make it a practice to have, in addition to the specific information required for the performance of the services rendered, a general over-all knowledge of the business activities of his clients and their major problems. He also should make a practice of noting, recording and forwarding to clients as a matter of incidental service such general knowledge as he may have acquired which would be useful to the client. He should:

1. Inform the client as to pertinent changes in tax law.
2. Report on relevant tax rulings.
3. Forward magazine or newspaper clippings on matters of particular interest to the client.
4. Supply to the client, or refer him to, publications of trade associations, Chambers of Commerce and similar organizations which relate to his particular industry or business.

Where such information is furnished to clients, in appropriate cases, definite suggestions or recommendations should be added as to its relevance and applicability to the client's problems.

Acting as Consultant

Acting as a consultant on specific problems is of appreciable value in the building of a practice. This value is definitely greater in the case of the individual practitioner, particularly in the smaller communities, because small businesses generally require far more advisory service than large businesses and must have recourse to the all-around professional knowledge of someone already rendering service to them instead of retaining high-priced specialists. The rendering of such service makes it imperative that the accountant be well versed in tax matters, financial management of small business, sources of capital, insurance and other problems which confront management.

Personal Relations with Clients

The cultivation of friendly and personal relations with clients is definitely helpful to any practice whether just beginning or of long standing, but the practitioner should recognize the inherent dangers in the culti-

vation of such relations. There is an obvious point beyond which such relations should not go. It is the point beyond which friendship would tend to interfere with or hamper the accountant in the maintenance of his requisite attitude of professional independence. In other words, the relation of client and accountant should never be subordinate to the ties of personal friendship. The initiative in the development of friendly relations may come either from the client or from the accountant, but preferably from the former. However, the circumstances in each individual case should be decisive.

Competent Workmanship

The final note in dealing with clients, and the most important of all, is a well-handled engagement. This means completing it promptly, giving the client the kind of information that is definitely useful, and advising the client as to methods of making the data useful. The accountant should carefully avoid becoming involved in so many matters that he can only touch the surface of each. Chapter 13, "Professional Standards," discusses the requirements of competent workmanship.

CONCLUSION

It has been the purpose of this chapter to point out some of those factors which have proved to be helpful to the successful establishment of many accounting practices. The establishment of a practice will carry with it some disappointments and heartaches but, to a far greater extent, will provide deep satisfaction in engagements well performed and clients well served. The young accountant can take heart from the fact that many practices which now are successful were started with the bare but potent assets of skill, integrity, fortitude and ambition.

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Appendix A

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CHAPTER 3

ACCOUNTANTS' PARTNERSHIP AGREEMENTS

PRELIMINARY CONSIDERATIONS

Scope of Chapter. Legal and Professional Status of Partnership. Written v. Oral Agreements. Income Tax Problems (Goodwill Payments; Benefit Payments Intended to be Tax Deductible; Noncompetition Provision; Purchase of Partnership Interest; and Liquidation of Capital Account). Limitations of Partners' Outside Activities. Standards to be Maintained.

OPERATIONS

Accounting Records and Reports. Capital Contributions. Profit Sharing and Compensation Arrangements (Prevailing Methods; Sharing of Losses; General Considerations; and Variations). Administration of Practice. Limitations on Partners' Powers. Absence on Military Service. Admission of New Partners. Junior Partners. Miscellaneous (Scope of Practice; Operating Area; Office Location; Branches; and Duration and Binding Effect of Agreement).

PROVISIONS COVERING DEATH, RETIREMENT, WITHDRAWAL, DISSOLUTION AND RELATED PROBLEMS

Death Provisions. Retirement for Age (Allowances). Notice of Intention to Retire or Withdraw. Limitations on Retirements. Voluntary Withdrawal. Sick Leave and Incapacity. Forced Withdrawal. Dissolution (Tangible and Intangible Capital Division and Related Problems; Division of Clientele; Division of Files and Working Papers; Staff Distribution; Continuity of Service to Clients; and Disposition of Lease and Other Contracts). Disposition of Firm Name. Effective Date of Withdrawal. Avoidance of Dissolution. Noncompetition Clause. Financial Statements to Fix Values for Retiring Partners and Estates. Work in Process Valuation. Goodwill and Valuation. Rights to Firm Name. Plans for Payment of Capital and Other Balances. Security for Capital and Other Payments. Life Insurance. Division of Interest of Withdrawing Partners Among Remaining Partners. Arbitration.

APPENDIXES

Specimen Form of Partnership Agreement. Checklist of Major Points for a Partnership Agreement.

CHAPTER 3

Accountants' Partnership Agreements

BY MAX BLOCK

PRELIMINARY CONSIDERATIONS

Scope of Chapter

THERE ARE MANY small and medium-sized accounting firms, and perhaps some large ones too, that have been functioning for years on the basis of an oral understanding or with a very limited and inadequate written partnership agreement. This condition prevails for understandable, human reasons, and many such cases have probably developed in the following manner:

1. Two young men, embarking on their first partnership venture, feel that the need for any agreement, and particularly an extensive written agreement, for their personal service enterprise appears to be remote. At least, the matter can be postponed.
2. As the firm functions satisfactorily for years with no agreement, or a very sketchy written agreement, the absence of a more comprehensive understanding is hardly noticed. True, there is an awareness of the need for a sound, written, partnership agreement, particularly since the members of the firm themselves so advise others, but the matter is postponed for later consideration.
3. Finally, when the partners hear of a firm that has dissolved or of a partner who died, or if they are thinking of having wills prepared, then the desire for a full-fledged agreement becomes strong. But how can a personal service professional practice be dealt with in an agreement? What should be done about a deceased partner? How can a partnership be disentangled? These questions can seem so overwhelming that the preparation of an agreement is delayed unreasonably in some cases, and perhaps never carried out in others.

It is the purpose of this chapter to disclose the common provisions that are to be found in the partnership agreements of a cross section of representative accounting firms, so that those who are desirous of entering into an agreement, or of improving an existing agreement, may be guided thereby. The material submitted herein is intended primarily for small and medium-sized firms, though many phases are applicable to every firm. Presentation of these data does not constitute a suggestion or recommendation that accountants prepare their own agreements. On the contrary, an attorney should be utilized, but the accountants might first determine the provisions they desire, then review

them with an attorney and have him prepare a formal agreement. In this connection, it is essential to bear in mind that only a lawyer can decide whether any contractual provision quoted or otherwise set forth herein actually possesses legal validity, that any such provision, though presumably valid in the jurisdiction where originally used, may not be so in another, and that the best judgment as to the use of any specific content or wording is that of the lawyer preparing the agreement.

The agreement must take into account the provisions of the state partnership laws as well as the laws governing the practice of certified public accountants within the state. Where it is contemplated to have an out-of-state branch, or otherwise practice in other states, consideration must be given to the laws of the foreign states.

One of the most forceful reasons for the preparation of an agreement at the earliest possible moment is that at the outset of a new venture the "will to agree" is at its greatest height. On the other hand, if a formula for dissolution must be developed when partners are separating and have perhaps become unfriendly, the consequences are apt to be unpleasant and costly.

Another aspect which is worthy of consideration is that a partnership agreement reflects the status of the members as of the time the agreement is formed. Men who are embarking on their first venture and are under the spell of their hopes and aspirations, who look upon their effort as a friendly as well as a business tie, and who feel that they are all "starting from scratch," will enter into an agreement that may vary considerably from that between two or more veteran individual practitioners who desire to join forces. However, the status of partners within a firm is bound to change in time. One partner may do substantially better than another in obtaining new clients, or one may develop outstanding capabilities which are more helpful to the firm's reputation. For this reason an agreement should not be considered an unchangeable instrument, but, like a will, one which should be intelligently revised as conditions warrant.

The subject of human relations is not included in this chapter though it may well be one of the most important aspects. One cannot write good human relations into an agreement except, in a limited sense, where provision is made for the arbitration of controversies. Every partner must realize that each one of the firm is a distinctive individual, possessing peculiar personality traits, strong points, and weaknesses. All partners cannot act alike and think alike. If these distinctions are frankly discussed in advance, there may be less disappointment and misunderstanding thereafter.

It is not possible to get into an agreement a provision to cover every conceivable contingency. First, all possibilities just cannot be visualized, and second, the drafting of such an instrument might never be completed. Some areas of agreement must be left for discussion and a meeting of the

minds when, as, and if, unanticipated developments arise. The commonplace subjects, such as those reviewed in this chapter, have a proper place in every agreement.

As an aid to using the material in this chapter, a checklist of major points is included as Appendix B.

Legal and Professional Status of Partnership

An accounting partnership must not only be organized within the framework of the state in which it will be domiciled, but it must also conform to the requirements of the state's professional laws, if any, governing the public practice of accountancy. The former requirements can be attended to by an attorney, the latter should be known to the accountants even prior to any affiliation. When the firm extends its operations outside the state new problems may arise.

The use of the title Certified Public Accountants is subject to statutory conditions in many states. Firms whose partners are members of the American Institute of Accountants and of the state CPA societies must conform to their rules as to representations of membership, et cetera.

Where the estates of deceased partners have an interest in the income or assets of an accounting firm, related legal and professional questions should be checked and reviewed. Similarly, where a wholly or partly inactive partner retains a profit-sharing interest, the firm's position in the light of such agreement should be ascertained.

When a staff member is given a profit-sharing interest, a question may develop as to whether or not he has become a partner, dependent on other aspects of his working arrangement. This subject should receive attention from a legal standpoint when the problem arises.

A final point to consider is whether the partnership is of a continuing type; that is, whether under the applicable state law the firm must liquidate and terminate upon the death of a partner, or if by agreement it may continue without interruption. This has tax and operating consequences discussed elsewhere in this chapter.

Written v. Oral Agreements

There are many oral contracts in existence. Quite a few small firms, and even some good-sized ones, have them. This is probably so because the agreements cover only a few basic conditions. All unspecified points are to be dealt with, when, as, and if they arise. It is this aspect, obviously, which can be troublesome when an understanding cannot be reached on a new issue. By the same token, it is not possible to anticipate every future contingency in a written agreement.

The simplicity of an oral agreement is the major reason for its use. Issues that appear to be improbable or lie in the distant future need not be dealt with. Besides, it is very easy to agree to draw up a comprehensive

written agreement as soon as time permits — if ever. It is hoped that this chapter will expedite the completion of some long-postponed contracts as well as help in the development of new ones.

Written agreements are obviously more difficult to prepare because greater care must be given to them. The very fact that they are written means that everything pertinent should be included, and that the language must be weighed and considered carefully. An oral understanding is based upon discussion, which is usually informal and friendly, and, so long as the intent is presumably clear, no problem of drafting and weighing of words is involved. But intent is not always established easily when proof is required, and the matters left for future agreement may not later be settled as easily as when discussed without the pressure of the event, and when the will to agree was at its best.

The written agreement has one psychological advantage, namely, that it forces action on subjects that might otherwise be ignored because the provision cannot be worked out easily. For example, the termination of a partnership is a matter that is not simple to work out and is often omitted even from written agreements. Yet that is one of the problems that can be most troublesome when a partnership is dissolved, for any reason, unless some reasonable procedure has been specified, definitely and clearly, in advance. Should ill will have been engendered among the partners, the dissolution might well lead to acrimonious incidents and litigation.

Income Tax Problems

Several income tax considerations will be encountered in the drafting of an agreement. It is essential that they be recognized in advance because their effect may well influence the final decisions particularly with respect to the methods of payment and amounts to be paid to partners or to their estates in the event of retirement, withdrawal, or death.

Liquidation payments may cover one or more of the following considerations:

1. Return of invested capital and loans.
2. Payment for interest in firm's goodwill.
3. Payment for noncompetition agreement.
4. Payment of retirement pension (past considerations).
5. Compensation for being available as a consultant and advisor.
6. Income share to date of termination of interest.
 - a. Balance in personal account.
 - b. Undistributed realized income.
 - c. Undistributed unrealized income (uncollected fees and work in process).

All of these items but the first have income tax implications. However, tax considerations should not be permitted to overrule all other sound elements in an understanding dealing with human relations.

It should be understood that this discussion is not intended to be a

complete survey, with answers, of all of the tax problems that may arise. The area here explored is covered with doubts and differences of opinion. Moreover, tax rules and prevailing attitudes change with time, and the position that appears tenable or reasonable, or to the contrary, at one time, may prove otherwise at a later date. As accountants are well able to solve their own tax problems, this section does not deal exhaustively with this subject, but rather serves to spotlight certain problems and pitfalls.

Many agreements provide that, under specified conditions, partners or their estates are to be paid certain amounts in the event of retirement, withdrawal, or death, in excess of the balances due them according to their capital, personal, and loan accounts. In some instances, it has been observed, the considerations for the payments are not specified. Are they for an interest in the firm's goodwill or do they represent consideration for past services, or retirement benefits? Does any portion apply to a noncompetition agreement, if one is in the contract? These questions will require an answer if raised by an income tax examiner. In some agreements the proposed payments are identified specifically or by implication.

Payments out of life insurance proceeds are subject to the same inquiry, namely, what are they for? In such cases, the purpose is more obvious because life insurance is generally used to acquire a partner's interest in a firm. The acquisition of an interest, from the viewpoint of the one obtaining it, is equivalent to the purchase of a capital asset.

The obvious tax question in the benefit provisions is the following: Will the payments be tax deductible by the remaining partners and fully taxable to the recipient, or will the payments be nondeductible, and constitute capital gains to the recipient?

In view of the very high income tax rates presently in effect, the remaining partners may find it difficult to pay out large sums for the interests of other partners, unless such disbursements are tax deductible. This may be an acute problem where the amount to be paid to a controlling senior partner is very substantial in relation to the annual net income. Agreements which provide definitely for the payment for goodwill should be reviewed as to the tax consequences. Those anticipating the use of this provision should also calculate the tax consequences carefully.

A word of caution as to form and substance is applicable to this subject as to so many others. It must be recognized that where goodwill exists, and the agreement virtually spells it out, payments otherwise labeled may not stand up under severe scrutiny. Where the nature of the payment is not specified in the agreement, it may be inferred from the actual intent, if ascertainable, from the other contract clauses, and possibly from the status of the firm. Where the considerations are earmarked, there is some element of definiteness; where not specified they

are subject to interpretation. The parties to the agreement must decide for themselves which course to follow.

Goodwill Payments

Payments for goodwill are, under present rules, not deductible for income tax purposes except in the event of worthlessness, or as a cost basis in the case of sale. The seller realizes a capital gain, ordinarily.

However, a goodwill payment may possibly include consideration for a noncompetition agreement or it may include even the distribution of a share of uncollected fees and work-in-process. These elements should be segregated because of possible differences in tax status.

It should be recognized that, for tax purposes, goodwill can, but does not necessarily, exist in a professional, personal service partnership. This is a relatively recent development. Theretofore the prevailing opinion was that goodwill could not exist in a professional partnership. Whether goodwill exists in an individual instance cannot be determined by any simple rule. It may not be present at one stage of a firm's existence and yet be deemed to exist at another because of changed conditions. This fact, plus the changing attitude of the courts regarding the existence of goodwill in professional partnerships, are cogent reasons for the review of old agreements maintaining a contrary position.

The cases dealing with goodwill in an accounting firm should be studied by all interested in the subject. Three significant cases are: *Coates v. Commissioner*, *Horton v. Commissioner*, and *Wylar v. Commissioner*.¹⁻³

Benefit Payments Intended to be Tax Deductible

The development of a plan whereby benefit payments will be deductible by the remaining partners is a most serious and difficult tax problem.

Retirement Benefits

Unfortunately, partnerships do not yet have the right, by law, to include their members in a retirement plan and deduct the payments to them for income tax purposes. However, it may be found practical not to retire partners completely but to reduce their activities to that of advisory or consultant partners. In that event, bona fide payments should be deductible.

The use of a straight retirement plan is one that still deserves attention, tax considerations notwithstanding. Those who desire to adopt a retirement plan, exclusive of, or supplementing the advisory partner arrangement, should study all of the possibilities and techniques for achieving the desired tax result.

Where a partner retires, leaving behind all that he has contributed to the firm: clients, enhancement of the firm's position, and other intangible

¹⁻³ See references at end of this chapter.

values, — he is well deserving of some retirement benefits. However the benefits may only be partly in payment for these intangibles (commonly referred to as goodwill). He also may be deserving of some additional allowance for past services to the firm, just as corporate stockholder-officers are rewarded upon retirement. This aspect has a special significance for firms that customarily pay salaries to partners. There the payments may be considered, in effect, adjustments of or increases of prior salary allowances.

On the other hand there may be some partners who have not contributed materially to the firm's goodwill and clientele. Some may be "working" partners, men who were promoted from the staff in recognition of years of service and competence. If they are awarded retirement pay, there is not nearly the same element of consideration for intangibles as in the preceding instance. The element of goodwill in such payments is very remote, yet will such payments be considered tax deductible?

In some agreements there are clauses which permit a partner to resign from a firm and withdraw the clients he has contributed. In such instances retention of the contributed clients by the firm would support the assumption that payments to a partner or an estate included compensation for his clients. This represents the purchase of an intangible asset. If such clients are ever lost by the firm, the cost would then be deductible, if determinable.

Death Benefits

Death benefit payments create concern because of their easy confusion with consideration for goodwill. Yet, the accountant taxpayer in the case of *Coates v. Commissioner*¹ succeeded in having death benefits distinguished from payments for goodwill, and the payments were considered deductible from the survivors' income. The relevant partnership agreement provisions are cited in the court's decision and have since been employed by other accountants who desired to achieve the same end.

It appears to be important that the death benefit plan be based on future earnings, a share of which would be payable to the estate, rather than amounts fixed by past earnings. Moreover, it may be helpful to have the estate continue to receive its share of the earnings. An interesting tax article on how to adopt the Coates technique will be found in a paper by Milton S. Schiller entitled "The Lawyer's Dilemma."⁴ This should be read in conjunction with the helpful discussion by Charles F. Coates in his article "Tax Aspects of The Partnership Agreement," in *New Responsibilities of The Accounting Profession*.⁵

However, in the Coates Case, and in others decided at about the same time (see *John G. Madden, et al, v. Commissioner*, July 2, 1946),⁶ the court was inclined to the view that goodwill normally did not exist in a personal service partnership and even if there were valuable good-

will but it was agreed by the partners to be nonexistent, then such view should prevail for tax purposes.

Should the courts depart from the view that goodwill normally does not exist in a personal service partnership, the Coates decision might then be jeopardized.

Two decisions of the Tax Court since the Coates Case are deserving of attention. They are *Horton v. Commissioner*,² and *Wylar v. Commissioner*.³ These cases involve the sale of a clientele and are therefore distinguishable. Nevertheless, because they acknowledge the element of goodwill in an accounting practice and the possibility of its transfer under certain conditions, they should be studied as to their possible effect on the Coates decision. Here again there is available an informative article by one of the accountants involved. This is "Tax Court Says Goodwill Attaches to Accounting Practice and May Be Sold" by Richard S. Wylar in *The Journal of Accountancy*.⁷

Other methods to achieve a tax deduction for death benefits are known to exist. The variety of these measures and their success are not known. Two such plans which have come to the author's attention, whose sponsors feel that they have reasonable grounds for a tax deduction, are the following: The first plan provides that death benefits are to be paid where a partner has not availed himself of lifetime retirement benefits. In the second instance, death benefits are paid in lieu of a deceased partner's interest in work in process. This benefit is fixed at a declining percentage of fees from clients attributable to the deceased partner, during the benefit period.

As a precautionary measure, consideration might be given to a provision which would hold that if a benefit plan based on the assumption that payments were deductible was not tax effective, there should be a reduction in the total to be paid. This would, in effect, require a dual schedule of benefit payments. The arrangement may be justified on the ground that benefits which are fully tax deductible should be more generous than those which are not. In the latter instance the recipient would receive smaller amounts but might pay a smaller capital gains tax. Some may think that the inclusion of this provision would be indiscreet, taxwise. However it may well be the lesser of two evils.

Where the payments are not deductible, an enlargement of the benefits period may be employed to reduce the financial burden. This arrangement would permit the original amount to remain unchanged but would provide more time in which to make the payments.

Some consideration might be given to a plan whereby a royalty is paid for the use of a man's name in a firm name or a royalty for clients "leased." Tax effects may vary as between retired and deceased partners.

Noncompetition Provision

Payments for noncompetition agreements in some cases, are considered deductible over the years covered. However, where the non-

competition clause is considered indistinguishable from goodwill the payments may be held to be capital expenditures. Noncompetition allowances may be indistinguishable if, first, they are not specified as to amount, and, second, if deemed merely an inseparable mechanism for the effective transmission of the goodwill.

However, where the element of goodwill is not significant, or is non-existent, a noncompetition clause with a specified consideration may be tax advantageous. Some accounting partnership agreements contain goodwill provisions and noncompetition agreements. It was noted, however, that no separate consideration was placed on the noncompetition agreements.

Purchase of Partnership Interest

The tax possibilities of a purchase of a retiring partner's interest in an accounting firm should be explored. Of particular interest is the prospect of including uncollected fees in the "package" deal. This situation is surrounded by doubts but in time the tax status may improve.

Liquidation of Capital Account

The liquidation of a partner's capital or personal account balance may result in a pyramiding of income in one year. This could develop where the firm is on a cash basis and the liquidation payment includes a share of uncollected fees and work in process on which income tax had not previously been paid. Where this occurrence might be costly, the payment should be spread over a period of more than one year, with adequate safeguards, if needed. It may not be necessary to provide for an extended payment period in an agreement for this reason alone, because it is likely that an arrangement can be worked out readily when liquidation occurs.

In the event that an estate is involved it should be borne in mind that the Uniform Partnership Law holds that, in the absence of a specific provision, and until the decedent's interest is paid out, the executor is entitled to demand the profits arising from the use of his share of the assets. This condition militates against any undue extension of the capital payment period unless protective steps are taken.

A further question to be contemplated is that pertaining to the firm's tax position with respect to payments made to a retired or deceased partner on account of uncollected fees and work in process, where the firm is on a cash basis, and the collections are made in a subsequent fiscal year. Some agreements provide that payments against uncollected items will be made only after collection.

Limitations of Partners' Outside Activities

As a rule, partners in any business or profession are expected to devote all of their time and best efforts in their firm's behalf. This is the

situation in the accounting field, too. There are some exceptions, but in such instances the departures are specified or require the consent of the partnership. The compensation plans may make some allowance for the reduction in time devoted to the firm's business, but not in all cases.

Illustrative of the complete ban against outside activities are the following provisions:

"At all times during the continuance of these articles each partner shall give his full time and attention, and use his best endeavor, and to the utmost of his skill and power exert himself for the joint interest and profit of all."

"Each partner shall devote his entire working time and energy to the business of the partnership. No partner shall engage in any other business or become an officer or director of a corporation organized for profit without the consent of his partners."

Certain types of outside activities are permissible in some agreements. Exclusions cover public writing, speeches, lectures, acting as director, officer, fiduciary, and various other efforts. The earnings from these sources are in some instances retained by the partners and in others are turned over to the firm. Instances of such provisions are the following:

"Each of the partners shall at all times devote his entire time and attention to the business of the partnership, except that this provision shall not be deemed to prohibit the writing of books, pamphlets and other printed articles, regardless of how distributed; the delivering of lectures, speeches, and other addresses. . . . The fees, earnings and other emoluments therefrom shall . . . belong exclusively to the partner or partners so engaged. . . . It is understood and agreed, however, that in the event that the services of any of the partnership employees are used in the preparation for profit of such books, pamphlets . . . , the partner using the same shall reimburse and pay . . . the actual costs of the services so used."

"Any earnings of the individual partners from work which others might wish done by the partner as an individual and not as a firm — such as acting as temporary treasurer or comptroller, and so forth — shall be accounted for to the firm and be considered as earnings of the partnership, and not as earnings of the individual."

"It is understood and agreed that each partner shall devote his whole time to the business of this partnership, and shall during its continuance engage in no other business, nor accept any office or trust that may interfere with his attendance at its place of business; except that it is hereby expressly agreed that this does not preclude (partner) from continuing as a partner of (firm) and devoting such of his time as may be required of him as such partner. . . ."

Some partnership agreements contain limitations or restrictions on outside investments by the partners. One such agreement provides that no partner may acquire any investments in a business or property when the opportunity arises from a client contact or association, without offering to all partners the right to participate in proportion to their interests in the partnership. A restriction on outside investments, either jointly with clients or arising out of client connections, may be included

in agreements because of the possible effect of such investments on the accountant's independence.

Other types of limitations on partners' activities, and obligations assumed, are indicated in the following clauses:

"Each of the partners shall at all times . . . pay and satisfy his own personal debts."

". . . each of the junior partners hereby agrees that he shall not engage directly or indirectly in any form of business or professional activity of any nature without the written approval of the senior partner first had and obtained." (Note: — No reference is made as to senior partner's activities)

"None of the junior partners shall engage in any dealings or transactions with, or represent, act for or serve any person, partnership, firm, association or corporation without the consent of the senior partner, or whom or which any of the partners shall previously, in writing have requested him not to trust, deal with, transact business with or serve."

"Each of the partners who shall own or operate an automobile shall, at all times, maintain policies of insurance against liability for damages to property and against liability for personal injuries, the latter policy to be in the amount of at least \$_____ for injuries to one person, and \$_____ to more than one person, resulting from the ownership or operation of such automobile."

"Each partner agrees that if he prepares for publication articles pertaining to professional work such as that done by the firm, the periodicals to which they are to be submitted and the general tenor and character of the articles are to be approved by the firm. Among other things it shall be at the discretion of the firm whether the firm name appears in any way in connection with the articles, and the firm is to have the privilege, if it so desires, of copyrighting and reprinting any such articles.

Partners must notify each other of outside activities. Each may not . . . buy stocks or bonds on margin."

"Without the consent of his co-partners no partner shall engage directly or indirectly in any business whatsoever in competition with or incompatible with the business of the partnership."

"Each partner shall devote his entire working time and energy to the business of the partnership. No partner shall engage in any other business or become an officer or director of a corporation organized for profit without the consent of his partners. No partner shall, during the continuance of the partnership, sell, assign, transfer, pledge or otherwise dispose of his interest in the partnership business or assets, except with the written consent of all of the other partners.

No partner shall sign or endorse a note or any obligation as an accommodation to anyone other than a partner or the partnership, or become surety on any bond or undertaking, or make any guarantee of payment or performance without the consent of his partners."

One agreement is so worded as to provide in effect that younger partners must devote full time to business, and partners over sixty five years of age only such time and effort as they find convenient.

Some agreements provide that a specified partner serve the firm only as called upon. This situation covers partners who render only consultation and advisory services. In other cases a partner agrees to devote only as much time as he reasonably can. These situations usually involve a partner who controls the firm, or is valuable to the firm because of his prestige or client contacts. Partners who are close to retirement may also operate on this basis. The following is an example of such clauses:

"That the first party and the second party shall devote all of their time and attention to the business of the partnership, and shall not, during the term of the partnership, either directly or indirectly, engage in any other business.

That the party of the third part shall devote as much of his time and attention to the business of the partnership as may reasonably be requested for consultations with the other partners."

Some agreements contain a specific provision limiting the amount of expenses that may be incurred by any partner for nonrecoverable expenses charged to the firm — such as for entertainment, local traveling, and similar items. A clause of this kind sometimes avoids disagreements among partners as to the extent to which such activities should be undertaken.

Standards to be Maintained

Some agreements contain clauses requiring certain standards to be observed:

"Each partner obligates himself to maintain a high standard of professional work and conduct. . . .

Each partner shall make every effort to build up the business as a firm and not for the individual members thereof."

"Each of the partners agrees to conduct himself in manner befitting a professional man and in strict accordance with the ethics of the accounting profession and the rules and regulations of the State Society of Certified Public Accountants and they shall become members of said society and retain such membership during the period of this partnership agreement."

"Each partner must be a state-licensed certified public accountant. Each partner must be a member of the American Institute of Accountants and a state society of certified public accountants."

One agreement states in substance that any partner who commits an act involving moral turpitude may be required to withdraw.

OPERATIONS

In this section and in the following section entitled *Provisions Covering Death, Retirement, Withdrawal, Dissolution and Related Problems*, the provisions of accounting partnership agreements which have a broad,

general interest are reviewed and illustrated. The data are based on an analysis of many partnership agreements, sections of agreements, or summaries thereof, submitted by members of the American Institute of Accountants. In addition, data were obtained from a survey made in the form of a questionnaire concerning common partnership provisions, to which numerous replies were received from Institute members. Use was also made of partnership agreements, excerpts, and summaries collected by a committee of the New York State Society of Certified Public Accountants on which a report was prepared for the benefit of the Society's members. To the foregoing the author has added some personal observations based upon his own experiences, as a partner, in participation in the survey made by the New York State Society, and in other activities concerned with the organization and administration of accounting practices.

The information reviewed was representative of a wide cross-section of accounting firms, both in respect to size and as to geographic location. However, the material in this chapter is intended primarily for the large body of small and medium-sized organizations, though many aspects have universal application.

Agreements vary widely with respect to the number of provisions, and their complexity, in accordance with the origin and size of the firm, and the intimacy of the relationship. An organization created by a merger of two accounting firms will undoubtedly have a comprehensive, carefully drafted contract. On the other hand, one created by two friends making their first start as independent practitioners will generally be governed by an oral, extremely simple and limited agreement.

The fundamental relationships among partners, which provide the major basis for the agreement, vary widely. At one end of the scale is the type of firm that is very closely knit; the members collaborate fully; clients belong to the firm and not to an individual; income is shared according to a predetermined, fixed plan; and, within reason, it constitutes an "all for the firm" combination.

At the other end is the loose confederation of individual practitioners. In this instance the firm provides essentially a means for the sharing of office facilities plus the advantage each partner may derive from the representation that he is a member of a firm. Clients belong to the individual members; staff members belong to specific partners; the co-operation of partners is limited to matters of office administration mainly, with some friendly discussion of accounting and tax problems; income is shared in accordance with fees attributable to each participant less a proportionate share of office expense. This type of firm constitutes an "each for himself" arrangement in which the members are associates rather than partners.

Each of these forms serves the members in the manner they prefer. It is impractical to indulge in an analysis of which form is preferable.

Each has its advantages and disadvantages. Undoubtedly, the personalities of the participants dictate the type used.

In between the two extremes cited is a large variety of partnership patterns. Some lean in one direction with features of the other, and vice versa. Some patterns change as altered conditions necessitate. Each agreement, presumably, should reflect the mutually agreeable conditions for association and dissociation.

Many understandings are initiated orally. But as partnership interests acquire substantial value, or as members begin to think of retirement and death problems, the need for a comprehensive, written agreement becomes apparent. Often the prospective admission of a new partner is the cause for the preparation of a written agreement. Some of the agreements reviewed state, at the very outset, that they succeed oral understandings.

Accounting Records and Reports

Accountants' partnership agreements commonly make some reference to the records to be kept, the accounting basis, and reports to be submitted to partners. The records are not detailed but the basis, cash or accrual, is frequently stipulated. However, the provision as to reports is interesting because of the terms as to their conclusiveness.

Since this topic needs little amplification for accountants, a few agreement abstracts are submitted merely for illustrative purposes.

"The fiscal year of the partnership shall be May 1 to April 30. Proper books of account shall be kept wherefrom the 'realized gross income' and 'net income' as herein defined, may be ascertained at any time. Such accounts when properly completed for any fiscal year, after giving effect to the provisions of this agreement (as evidenced by the filing of tax returns based thereon) shall be considered to be conclusive and binding upon the parties to this agreement."

"A general account shall be taken of the affairs of the partnership at the close of business on the 30th day of June and the 31st day of December of each year. Such account shall be signed by all the partners, and after such signing, shall be binding on all and not reopened save for a manifest error discovered within ninety days thereafter."

"Said books of account shall be maintained on the basis of a fiscal year ending _____ and on the cash receipts and disbursements method of accounting."

The books . . . shall at all times be kept . . . in the principal place of business of the partnership and each partner shall at all times have access to said records or any of them."

"Accurate books of account of all the business transactions and affairs of said partnership shall be kept, and said books shall be audited by an independent auditor at least once a year. . . ."

"Full and complete accounts shall be kept of the partnership business, and the profits or losses determined annually on the accrual basis. . . ."

"The goodwill partners and the employees holding non-goodwill shares shall have the right at any reasonable time to examine the books of the partnership but such right shall be exercised by them personally and not by any agent or attorney. . . ."

One agreement provides in substance that so-called junior partners, as a practical fact, are not permitted to examine the firm's books except in the event of a disagreement requiring the application of the arbitration provision included in the agreement.

There are special provisions for reports to retired partners and to the estates of deceased partners where they are receiving profit-share payments from the firm or are creditors. This subject is discussed in another section.

Capital Contributions

The need for capital is a relatively minor matter in a small accounting partnership, as is the case with other personal service organizations. Capital is needed at the outset to equip an office. Funds are required to finance payrolls and office expenses. In time, earnings retained in the firm replace the original capital investment. For this reason some firms do not have capital accounts on their records. Instead, they use titles such as: personal accounts, profit distribution account, et cetera. Where payrolls are very large, as in the case of audits of large national corporations, and a number of engagements are under way at one time, substantial capital is required. Bank loans are sometimes resorted to in such instances to relieve the financial strain.

Capital is not always paid in with cash. There are firms whose initial capital consisted partially of contributions of office equipment and books. Clients turned over to a firm have, in cases, also been valued and considered as capital investment.

Some very large firms, and perhaps a few small ones, use shares or units to represent partners' capital interests. These shares or units are transferable under prescribed conditions. Apart from representing capital they usually carry rights to shares of profit and participation in management. The rank of partners is determined by the number of shares owned. Its advantage is in the ease of transfer of interests, but consideration must be given to the danger of the partnership being held to be an association taxable as a corporation.

The large majority of agreements provide that capital be invested and retained in the firm in an amount proportionate to the profit-share arrangement. There are agreements which call for the payment of interest on capital investments, others which also call for the collection of interest on capital deficiencies. Many agreements make no reference to interest on capital or deficiencies.

Under the subheading of "Admission of New Partners" in this section

there is a discussion of the prevalent capital contribution plans for new partners.

The following are excerpts from actual agreements illustrative of the types of understandings that are in effect:

"The capital of the partnership shall be \$_____, and shall be contributed in the following proportions. . . . Any depletion of capital shall be made good through assessments against all the partners in the above proportions. The partners shall contribute in the same proportion any additional capital which they may consider necessary or desirable in the operation of the partnership business."

"The parties agree that the firm shall commence business with a cash capital of \$_____ which shall be separate from their investments in the form of furniture and equipment, and for that purpose the parties agree to make cash deposits in the firm bank account upon the signing of this agreement as follows: (names and amounts)."

"No interest shall be allowed or paid on partners' capital accounts."

"*Capital:* A and B agree to and hereby contribute to the capital of said partnership \$_____ each in cash; all of the office equipment, furniture, books, supplies, papers, and other equipment valued at \$_____ which are used by them in their current practice of public accounting; purchased goodwill in the amount of \$_____, and \$_____ in cash for the office cash fund of said partnership.

C agrees to and hereby contributes to the capital of said partnership \$_____ in cash.

The partners further agree that the capital of said partnership shall also consist of such sum, or sums of money, as from time to time shall be required, and shall be contributed in such portions as shall from time to time be agreed upon between them.

For the purpose of this agreement the partners shall be considered as having made equal contributions to the capital of said partnership."

"The amount of the aggregate capital to be contributed in the above proportions shall be determined from time to time and shall approximate the amount required to furnish such office furniture, fixtures and equipment as may be necessary or desirable for the efficient operation of the business, plus the minimum amount of accounts receivable (consisting principally of uncollected fees) at the end of any month in the preceding year."

"For the purpose of providing funds to finance the business of the copartnership the profits of the several copartners which have not been drawn out by them and appearing to their credit on the books of the copartnership are treated for the purpose of this agreement as the capital of the copartnership. Each copartner shall be credited on the books of the firm with the profits thus left in the business by him from time to time. This paragraph shall not apply to the estate of a deceased partner."

"It is understood and agreed that each partner will be paid interest at the rate of ____% per annum on his average monthly investment in the partnership capital, this interest to be considered as an expense in determining the partnership profits."

"The following accounts shall be provided for each of the capital partners:

1. Capital account, in which shall be exhibited the amount of his original capital contribution, and the adjustments which have resulted from additional investment or contribution of capital, or of permanent drawings or retirements of capital. This account will also be adjusted to reflect the fluctuation in the valuation of the goodwill of the partnership. . . .
2. Personal account, in which shall be recorded the respective share of the profits and losses allocable to each capital partner and his current drawings. . . . This account will also be credited with an amount equal to 6% per annum upon the amount of capital standing to the credit of the particular capital partner at the beginning of each fiscal year."

In addition, the following three summaries of actual provisions may be of interest:

1. The respective investment of each partner is the same proportion of the total investment as his profit-share proportion, and is represented by his capital account on the books of the copartnership, plus his proportionate interest in any surplus or undivided earnings.

Capital fixed at \$_____ and contributed and maintained by A,B,C, and D in following percentages —, —, —, —. Any deficiency bears interest at 6% per annum payable to other partners according to their percentage participations, but this interest provision may be waived as to any partner if all consent. Interest is paid at 6% per annum on average balance of each partner's capital account, but, unless A determines otherwise, no such interest shall be paid on any amount in excess of a partner's required capital contribution. Such interest payments shall be charged as a firm expense and paid whether or not there are sufficient net earnings.

2. Capital contributions are required to be made in cash with the added provision that the required amount may be provided by the application of 60% of the withdrawable net income of the partnership.

3. The amounts contributed by each partner are based upon the percentages of profits or losses of each partner. Interest shall be credited to partners on their capital accounts and charged or credited as the case may be on June 30 and December 31 of each year on the monthly balances in the current accounts provided, however, that no interest shall be charged for money drawn by way of salary, but in so far as salary drawings may have been deferred and credited to current accounts of the partners, interest shall be credited.

Non-Capital Partners

Not all partners are required to make an investment in the firm. This applies to junior partners in certain instances, and to "working" partners. The prevalence of such exceptions is not known. Opportunities may nevertheless be provided for such partners to acquire "capital" interests in the firm as their status in the firm advances. The ownership of a financial interest is advantageous as an evidence of good faith and a more binding tie to the firm. It may be facilitated by providing that

a percentage of the partner's profit share be retained in the firm until his capital account has been built up to an agreed amount.

New Partners

The admission of a new partner into a firm, other than non-capital partners previously referred to, is accompanied by an investment of capital. If a partner is admitted (rarely) because of his extensive client contacts, no capital may be required. In such cases, the development of a financial interest out of profit shares is desirable. Otherwise an investment is usually made upon or after admission. The investment may take the form of cash, property (equipment, books, clients, and so forth) or a combination of both.

Profit Sharing and Compensation Arrangements

The division of income is accomplished by various methods. Each plan presumably represents the best efforts of the parties to develop that formula which in the particular case will most fairly and judiciously compensate them for ordinary and extraordinary contributions to the firm's income and growth.

Personal abilities cannot readily be evaluated. Moreover, accomplishments in business often depend on personality as much as on ability. Some achievement in public accounting is not due to any extraordinary efforts of accountants but may well result from the growth of small clients into large ones, or from good family and other associations. These factors complicate the problem of determining what is a fair method of division. Finally, the effectiveness of partners and their income-producing abilities do not remain in the same relationship indefinitely. This presents the most disturbing problem of all. In other words an arrangement that is deemed satisfactory at an early stage of a firm's existence may be inadequate at a later stage, unless some flexibility or a provision for modification is introduced into the plan to deal with this situation.

A plan that is not eminently fair at its inception, or becomes unfair thereafter, will create discontent and friction. Failure to correct this may well result in the resignation of a partner or other dissolution of the firm. This possibility can be avoided either by providing the mechanics for flexible division of income in the agreement, or by arranging for periodic reviews (not too often) of compensation and profit-share plans to eliminate inequities, if any. Too frequent reviews of the profit division basis are not desirable, for in the process some frictions may be engendered which will have a disrupting influence.

As in all matters of human relationships, the character and personality traits of the partners will have an important bearing on an agreement. In one instance two persons may enter into an accounting partnership almost as into a marriage — an enduring tie — to be united through thick and thin. On the other hand two rugged individualists may unite with

the forthright representation that compensation and profit shares will be constantly measured by recorded contributions of time and fees. Each of these methods has its good and bad points and is entirely satisfactory to the parties, within reasonable bounds, because of their attitudes.

The determination of a partner's contributions to a firm's profitability is not a simple matter except where each partner operates virtually as an individual practitioner and keeps records of his individual income and expenses. Where there is any degree of co-operation, small or large, then the accomplishments of any one partner are influenced to some extent by his associates. It would be odd for the unusual talents of a partner not to be utilized by his copartners. Similarly the inspirational value of a partner's personality may have a direct bearing on the activities and performance of his associates. The prestige of one member of a firm may be of considerable help to the others in securing new clients. All of these possible interrelationships cannot be recorded, accounted for, or evaluated easily.

In any event, the plan that is adopted should not be too complicated nor involve too much analysis of effort and accomplishment. Too intricate a plan has in it the seeds of constant discord and strife. Moreover, it is not necessarily a more accurate or fair method than a simpler plan because no basis for calculations can be perfect.

Writers on this particular subject stress the many and highly variable factors that may have to be considered. An interesting illustration of this is given by Paul E. Bacas in his recent book entitled "The Successful Practice of Accountancy."⁸

Prevailing Methods of Compensation and Profit Division

Based upon survey disclosures, the most prevalent plans are:

1. Salary-plus-profit share.
2. Straight profit share.

Other plans are based on the recorded contribution of fees by a partner, or time devoted to the firm's business, or a combination of both. Some firms add an incentive element to a profit-share or salary-plus-profit share plan. The incentive is in the form of a percentage of the gross fee, for a stated period, of new clients secured by a partner.

Salary-Plus-Profit Share Method

This method provides that partners get an annual salary and that such salaries be treated as expenses. It is intended that the salary reflect the time devoted to the firm, variations in productivity, and differences in the services performed. As to the sharing of the income remaining after such salary payments, that is based on capital proportions as a rule, or merely on an established schedule of percentages. Thus, as some partners increase their activities or as others decrease their activities,

salary adjustments can be made. The profit share is looked upon virtually as a property right.

This plan is of a type that perhaps should not be used by a newly formed firm of young members. It is likely that their talents have not been definitely established or become fully known to each other. Moreover, there will probably be no variations in time devoted to the business. In the absence of these factors the salary provision may be premature.

Straight Profit Share Method

This is the simplest method to establish and to administer. Yet, it is not necessarily the most equitable plan. It is suitable for a new firm of young partners and for any firm that prefers a simple formula for the division of income.

Drawings against profits are usually allowed on a weekly, semimonthly, or monthly schedule. The drawings are usually less than the anticipated annual income thereby permitting the "splitting of a melon" once or twice a year, perhaps leaving a little to be added to the "rainy-day" reserve.

Income Division Based on Fees Produced and/or Time Worked

Some firms divide income according to each partner's proportion of the gross fees by which it is produced. In relatively few cases, time worked is added to the formula. The latter method appears to be relatively uncommon and the former is not as popular as either of the foregoing profit-share plans.

The fees-produced method is one which is sometimes used where two individuals merge their practice and cannot find a simple profit-share basis on which they can agree. This is a more materialistic approach and one which is not conducive to the fullest measure of co-operation. Gross fees do not necessarily yield proportionate net income results. Some jobs are more profitable than others. Therefore, the fees-produced method more equitably should be a net fees (fees less related expense) method.

Time devoted to the business is not truly a measure of a partner's contribution to the firm's welfare. One may contribute much in the way of clients and service in little time, and another contribute less in more time.

Incentives for new clients may at first thought appear a practical, business-like arrangement. This, however, loses some of its force upon careful consideration. The obtaining of new clients may so often be due to the contributions of more than one partner that the attempt to make an allocation may be disruptive. Some partners are in the nature of a "catalytic agent", they are not expected to produce business themselves but their very membership in the firm is capitalized on by others.

In this connection the comments of Ira N. Frisbee on the subject

of accountants' partnership agreements are cited because of their pointedness:

"Some agreements provide for extra shares of a portion of the profits to partners obtaining new clients and charge them similarly for the loss of clients. Some specify the number of hours for a base share of profits, with an additional share for excess hours. These and similar charges and credits would appear to be unjustified in the usual partnership. The obtaining of clients and the number of hours of chargeable or of total time do not necessarily indicate the value of a partner. To make special provisions for profit sharings on such bases is likely to increase jealousies and misunderstandings when more important contributions or services by other partners are not recognized."⁹

There are a few agreements which provide that the distribution of profits is to be determined by the partners at periodic intervals. In some instances the senior partners have that exclusive privilege. This arrangement, while intended to distribute earnings equitably in accordance with production, nevertheless creates the problem of frequent review of income production, time devoted to the firm, and consideration of unusual achievements. As pointed out previously, the criteria can be so vague and the accomplishments so indefinable that the harmonious relations of the partners may be disrupted if disagreements are numerous and sharp. Other than in unusual cases, as in the case of an exceptional "windfall," a review should not be made more frequently than every five years.

Some firms use share or unit devices to establish capital interests and profit sharing ratios. In such cases there is no unusual problem in division because the income is divided among the total shares or units according to the contract terms and the amount allocable to each partner is thereby determined. This arrangement is utilized mainly by large firms.

Sharing of Losses

With respect to the sharing of losses it is observed that they are shared commonly in the same proportions as profits. This rule is applicable where no specific reference is made to losses. However, there are cases where by arrangement, some partner or partners assume all losses. This situation prevails mainly where there are junior partners. The motivation for such exemptions is that the junior partner may not be able to absorb a loss, or that it might not be good for morale. To protect the exempt partners against loss, in the event of suit or other contingency, an indemnity provision is included in the agreement.

It also is observed that some contracts provide that a loss due to wilful neglect or conduct of a partner is chargeable in full to him.

General Considerations

In the fixing of partners' salaries or of profit shares the problem is more one of relationships than the amount allotted to any one partner.

In other words, it does not matter (within financial bounds) what partner A's salary is fixed at so long as, by comparison, that of partner B is fair and reasonable. The same applies to profit-share percentages. Obviously the aggregate salaries should be within the firm's predictable income limits. By the same token profit-share advances should be less than realized earnings.

A technical feature of the profit-share provision that is worthy of note is that it may be expedient to place the profit-share percentages, salaries, and also the capital interests on a schedule which is annexed to the agreement and initialled by all or a specified majority of partners. This facilitates the revision of the schedule in the event of a change in partners or any of the subject points without requiring a rewriting of the agreement itself, if the agreement provides for such a separate schedule and its periodic revision.

Examples of Variation

Profit-share arrangements present more diversity than any other provision in partnership agreements. Evidence of this situation is found in the following excerpts from agreements comprising common situations as well as some oddities.

"The partners shall equally share in all profits and losses."

"It is further understood and agreed that the partners will share in the earnings and profits of the partnership as follows, to wit:

The parties of the first part (three persons) shall each receive as salaries \$_____ per week. The parties of the second part (three persons) shall each receive as salaries \$_____ per week. The partnership profits, after the deduction of the aforesaid interest and partners' salaries, shall then be divided as follows, to wit: Parties of the first part —%, (divided among names and respective percentages varying), and parties of the second part —%, (divided equally amongst named persons)."

"... the salaries of the members of the firm shall be as follows: (names and varying amounts). However, the foregoing is subject to adjustment by the mutual consent of the partners, but shall continue as aforesaid if the partners are unable to agree on any other adjustment, and the salaries as herein stipulated shall continue until the partners mutually agree on a change."

"Profits and losses shall be borne ratably in proportion to the respective interests of all partners in the net income. The distributive share of profit or loss of each partner shall be determined by dividing the total shares of interests in income of both capital and non-capital partners, into the amount of net profit or loss after the deduction of interest on capital . . . , and by multiplying the amount so obtained by the number of such interests in income held by each partner."

"When, as a result of withdrawal, retirement, death, or other cause, the percentage participation of a partner or his estate in partnership net profits is terminated, such percentage shall be absorbed by increasing the percentage participations of the remaining partners in the net profits of the partnership

in the proportions that their respective required shares of partnership capital bear to the total required shares of all the remaining partners."

"The profits of the partnership shall be divided annually on such basis as shall be mutually agreed to by the partners.

Profits will be computed no less frequently than once a year. Partners' drawings and distributions of profits will be effected as agreed upon by the partners from time to time."

"Salaries of partners shall be computed at the end of each month, and each partner's account credited with his salary, to be computed on the following basis:

1. ____% of the net fees credited to the fees account of each partner, plus . . .
2. \$_____ for each hour devoted to office, gratis, or other nonproductive business time.

The following amounts shall be minimum yearly salaries, and if the respective salaries as computed under paragraphs (above) amount to less than the following minimums, there shall be credited at the close of each fiscal year to the respective salary accounts such amounts as are necessary to make up such minimum salaries: (names and amounts).

Interest shall be computed on monthly balances in salary or drawing accounts of partners at the rate of ____% per annum, interest to be charged or credited at the close of each year and added or deducted in determining net earnings or losses available for division.

Net profits or losses resulting after deducting . . . partners' salaries, and plus or minus interest on partners' drawing accounts (monthly balances at ____% per annum) shall be divided among the partners, in the proportions specified . . . , except that if a partner fails to earn in any year the minimum salary provided in Paragraph ____ then for the purpose only of computing the division of profits for such year, the fractions specified in Paragraph ____ as representing such partners' interest, shall be reduced by a percentage equal to one-half that obtained by dividing such deficiency by the minimum salary provided.

The factors so reduced shall be combined with the remaining factors and a substitute ratio ascertained by which profits for the year will be divided."

"For the purpose of this agreement all determinations of net income or loss shall be on the accrual basis of accounting, notwithstanding the partnership reports on a cash basis for income tax purposes.

In lieu of salaries the partners shall be entitled to monthly drawing accounts based upon the following annual rates (names and amounts).

Net income sufficient to pay such drawing accounts must be earned first, and thereafter any remaining net income shall be distributed upon the following basis:

1. Fifteen per cent shall be set aside for employee bonuses: One-third of such amount to be distributed to the individual employees on a merit basis, and the remaining two-thirds according to the following formula: three units for each full year of service; one unit for each dollar of monthly salary. Employees with less than one year of service shall not participate in the formula distribution.

2. Eighty-five per cent as additional distribution to partners divided in the following manner (names and percentages).

Should the net income be insufficient to pay drawing accounts in full such deficiency shall be charged to the accounts of the partners according to the percentages just listed.

Any partner shall have the right to withdraw the full amount of his distributable share of net income immediately upon final determination following the close of each fiscal year. Monthly withdrawals against the distributable earnings of the current fiscal year in excess of drawing account allowances may be made by any partner, provided such withdrawals shall not exceed 50% of such excess. The provision with respect to withdrawals against current interim earnings may be modified as to any partner, with the consent of all other partners, when otherwise a hardship may result to a partner due to circumstances beyond his control."

"Whenever drawings in excess of the proper proportion of the annual salaries stated in Paragraph ____ shall be taken by any partner, the partners' accounts may be adjusted and disbursements made to the other partners from the funds of the partnership so that the undrawn earnings of no partner shall equal a greater proportion of the total undrawn earnings than that set forth in Paragraph ____ above."

"The senior partner shall be entitled to draw a salary of \$_____ per year, and each of the junior partners shall be entitled to draw salary as follows: (names and amounts).

All salaries paid to each of the partners as above provided shall be charged to the expense account of the partnership.

The senior partner shall determine, from time to time, the amount of the net profits of the partnership to be distributed and the junior partners shall be entitled to share only in the net profits accruing and/or distributed within the term of the partnership in accordance with such determination by the senior partner. The division of net profits shall be as follows:

1. To the senior partner ____% thereof.
2. To each of the junior partners ____% thereof.

Net losses, if any, sustained by the partnership shall be borne by the partners in the same proportion."

"The profits from said business shall be distributed in the following proportions:

1. The parties hereto shall be entitled to receive monthly drawing accounts as follows:

A \$_____ B _____ C _____

Such amounts received pursuant to such drawings shall be charged respectively against the share of profits of each of the partners, but the share of the profits including drawing accounts of the partner (name) shall be at least \$_____ over the full term of this agreement.

2. In the event that the said profits from said business shall be more than \$_____, then all such profits over \$_____ shall be distributed in the proportions of

A - 25%, B - 25%, C - 50%

The losses of said partnership shall be borne in the following proportions:

A - $1/3$, B - $1/3$, C - $1/3$ "

"Participation Schedule: Attached hereto and made a part hereof is a schedule designated 'Participation Schedule No. 1 - Effective _____,' in which are set forth the names of the several partners, the partners designated as administrative partners, the annual salary of each partner, the ratios and units of participation in the distributable profits and stated capital and the amount of the stated capital of each partner, all as of the time of the taking effect of this agreement."

"After the payment of all partnership expenses, the net profits shall be divided as follows:

(names and percentages)

Irrespective of the amounts produced by the foregoing percentages and irrespective of the amount of, or presence or absence of, net profits, the parties hereto do hereby jointly and severally guarantee to _____ the following minimum amounts free from any firm liabilities of any nature whatsoever:

(names and amounts)

Any deficiency required to be met pursuant to the aforesaid guarantee shall be paid to _____ in or prior to three months following the close of the fiscal period . . . (and) be met by the guaranteeing parties as among themselves in the same proportions as . . . firm losses.

The net losses shall be borne as follows:

(names and amounts)

Losses sustained by the partnership shall be made up by the partners enumerated . . . in cash at the end of the year and in the proportions set opposite their respective names.

For the purposes of determining profits and losses as well as for the purposes of the minimum guaranteed . . ., each fiscal year shall be considered separately and profits earned in one fiscal year shall not be offset against losses sustained in any prior or subsequent fiscal year.

The profits shall be distributed as and when convenient. . . . If any partner shall not withdraw the whole or any of his share in the net profits, he shall not be entitled to receive interest (thereon) nor shall he be entitled by reason thereof to an increase in his share of the profits of the partnership. The partners shall not receive salaries.

A partner shall be entitled to ____% of the first two years' fees received . . . from any new client . . . obtained by said partner. Said per cent shall be charged as an expense of the partnership. For the purpose of this subdivision, the first two years shall be deemed the period of two years from the date on which the new client retains the firm. _____'s decision as to whether any client is a new client and as to whether such client was obtained by a particular partner shall be final and binding on all the parties hereto."

"The partnership profits will be divided as follows: Jones (full time partner) will receive the first \$_____ profits for the year and the excess will be divided equally. In the event that the profits do not equal \$_____, Jones will be entitled to receive full amount thereof.

The division of the profits as set forth above, contemplates that each partner will contribute to the partnership, in business and value of services, substantially the same contribution as was made in (year). At the end of each year,

the partners will review their contributions in the light of this stipulation and if it appears that such contributions are materially different from those in (year) the partners will mutually agree upon a variation in share or the profits (over \$ _____) to which each shall be entitled for the preceding year."

"The first _____ thousand dollars of net income as hereinbefore defined is designated 'the first division of net income' and shall be divided equally among the three partners. The next amount divided designated as 'first excess of net income' over the above sum shall be divided _____% to (A) _____% to (B) and _____% to (C), and the 'second excess of net income' being the (balance) shall be divided equally. In the first fiscal year of the partnership under this agreement the 'first excess of net income' shall be \$ _____, and in each succeeding year it shall be reduced by \$ _____. The first excess amount shall not be cumulative if net income earned in any year should fall short of the amount designated."

"The losses of the business, if any there be, shall be borne as follows: The losses . . . up to a maximum of the total of the partners' salaries shall be borne by the partners in the same proportion as the salary of each partner bears to the total partners' salaries; losses, if any there be, in excess of the total partners' salaries in any fiscal year shall be borne in the same proportion as profits are shared."

"In addition to salaries as hereinbefore provided, each of the partners and all staff accountants employed by the partnership shall be entitled to participate in a bonus to be calculated at the end of each fiscal year of the partnership in the following manner:

Each net fee for partnership services shall be allocated proportionately among such of the partners and staff accountants as shall have performed services in or in connection with the particular work resulting in such fee. Said allocation shall be based both on the number of hours of service performed by such partner or staff accountant on the particular work and the rate per hour as fixed from time to time by the partners as the hourly rate chargeable to clients for such partner's or staff accountant's services. The amounts thus allocated to a partner or staff accountant shall be accumulated to the end of each fiscal year of the partnership and 50% of the total amount thus allocated shall be such partner's or staff accountant's total compensation for such fiscal year, and the amount by which such total compensation shall exceed the fixed salary previously drawn by said partner or staff accountant shall be paid or credited to him. If the amount of the fixed salary previously drawn by such partner or staff accountant shall be in excess of his total compensation computed as aforesaid, no bonus will be earned or paid."

Various agreements also contain relevant provisions which are summarized as follows:

1. On the determination of net income, salaries are determined by the Management Board and are treated as operating expenses. Also there is a provision that "as to any fiscal year when the net income . . . shall exceed \$ _____, an amount not exceeding one half of such excess may be apportioned by the Management Board to one or more partners . . . for the purpose of effecting additional compensation for individual service of special benefit to the partnership. . . ."

2. Partners are to be paid 50% of their earnings plus 10% of

the total fee from clients introduced by them plus a proportion of the net earnings after partners' compensation as above based on the ratio of the partners' individually introduced business to the total business of the firm.

3. The distribution of the profits of the partnership is on a unit basis, which unit basis is increased as additional partners are admitted and decreased as partners retire.

4. Profits are divided according to the percentage interests of the various partners in the firm. Losses are shared by the senior partners proportionately to their interests but junior partners bear no share of any loss.

Junior partners receive a stipulated salary plus a small percentage of interest in the business, and the total earnings are subject to a minimum quantity. However, in arriving at the percentage share of junior partners in the profits, nominal salary amounts for the senior partners are first deducted.

The amount of cash drawings which each partner may make during the year is stipulated.

Administration of the Practice

Partnership agreements, written and oral, may indicate which partners are charged with the responsibility for policies and other administrative measures, but do not describe or fix the program for managing the practice. This, of course, is a practical approach because administration should be left to the daily considerations of those in charge, who, as a rule, are the members who have a preponderant interest in the firm, and also the required experience and ability.

Management consists of two major functions. The first deals with policies — standards for audits, reports, staff, new engagements, fees, et cetera. The second deals with the supervision of the practice and observance that set standards are complied with. In some instances the functions are combined, in others they are segregated. However, a clear-cut distinction may not be possible with respect to all administrative matters. Generally administration is linked to control and it is dictated by a majority of the partners in interest except as to matters where unanimous or other specified agreement is required.

The selection of the person who is generally in charge of administration is dependent on the constitution of the firm. In an organization consisting of a senior and one or more junior partners, the senior partner may reserve for himself full authority. In large firms, commonly, the senior partners (sometimes referred to as capital, goodwill, or founder partners, or as members) constitute the administrative partners. Some of them designate one partner as the managing partner and in some instances he is compensated for such services. The administration of a small firm may be shared by the partners in an individualistic manner. As it grows, and administration becomes more important, one partner will somehow emerge as the executive and the partners as a group may deal only with policy questions. Particular phases of administration

are divided among partners, in many firms, but general policies are fixed by the partners as a whole.

Many agreements contain no references to administration. Where they do appear it is usually because the responsibility is definitely placed in the hands of a specified partner or group of partners. A few selected illustrations of such provisions are here submitted:

“The partners agree that the general conduct of the partnership business in respect to relations with clients, employees and others and the general control of the partnership funds shall be supervised by _____.”

“Each partner shall have power on behalf of the firm to sign checks, endorse checks for deposit and sign drafts in the regular course of the business; to incur the firm liability on notes for loans for the conduct of the regular business; to enter into contracts with clients to do accounting work, subject to the provisions of paragraph ____ (which paragraph permits the managing partner to reject any proposed work when in his opinion such work would not be to the best interest of the firm), and to engage upon such work; to engage assistants for cases and for the office; to render reports to clients; to render bills to clients; to purchase supplies or equipment; — in general, to enter into any obligations and exercise any functions which any partner would be called upon to enter into or exercise in the proper and legitimate carrying on of the business were he the sole proprietor instead of a partner, — except that the managing partner shall normally, when available, exercise the above functions unless one or more of such functions shall be by him specifically delegated to one of the junior partners.”

“The management and control of all business of the partnership shall be under the direction of the goodwill partners sitting as a managing board. . . . One of the goodwill partners shall be chosen by the board as a business manager who shall be . . . subject to the orders of the managing board.”

“The business and affairs of the partnership shall be managed and controlled by the administrative partners and all matters involving the general policy of the firm and its administration shall be decided by the administrative partners. Except as in this agreement otherwise specifically provided, in the event of any difference of opinion among the administrative partners any matter or question shall be decided by a majority in interest of the administrative partners.”

“The financial affairs and business of the firm shall be under the management of the senior partner who shall have sole control of its cash funds and final determination with respect to any and all matters pertaining to the conduct of the firm's practice. The junior partners agree to abide by the decision of the senior partner with respect to all of the activities of the partnership. . . .”

“Mr. _____ shall be the managing partner of the partnership, and, except to the extent otherwise provided in this agreement, his decision shall control with respect to the management and conduct of the partnership business. Where the provisions of this agreement provide for or require the consent or agreement of the partners with respect to any matter, a decision of a majority of the partners shall control unless otherwise provided.”

“All matters of policy, procedure, participations, and general administration shall be determined by agreement of the partners. In the event of inability

to agree upon any matter except those matters (dealing with withdrawal) requiring unanimous action by certain partners, the decision of the surviving active partners in the order that the signatures are affixed to this instrument shall be final and binding on all parties."

"The charge or charges for any and all services rendered by the partnership or any member thereof to any person, firm, association, or corporation, shall be fixed by the senior partner, or, in his absence, by the manager and administrative assistant."

The matter of voting rights is a subject which should get consideration and attention particularly when the partners are not all on an equal footing. The administrative matters which may require partners' approval or disapproval fall into two major categories. First is that group of subjects which involves the partners themselves and matters of similar importance. Included herein are matters such as admission of partners, fixing of profit shares and salaries, retirement and death benefits, et cetera. Second is the group of subjects which deals with operations, such as hiring of staff, staff salaries, operating policies, et cetera.

The first group of subjects is ordinarily the province of the senior partners; the second is open to all partners. Thus, the admission of a new partner might require 75% or 100% approval of senior partners whereas the question of bonuses to be granted the staff might require a majority vote of all partners.

Even where all partners are of equal rank, voting rules might be set up. Some matters may properly be settled by a majority vote: for example, hiring an extra senior. But the subject of complete dissolution of the firm and matters of similar importance should perhaps have more than a simple majority approval.

Usually each partner entitled to vote has one vote, but sometimes voting representation is given a different basis. This takes the form of giving each partner voting rights in relation to his share of capital interest. On this capital apportionment basis, a partner having a one-third capital interest would have one-third of the authorized voting power.

Limitations on Partners' Powers

In a preceding section reference was made to restrictive clauses governing the activities of partners outside of the firm's scope. Some contracts, in addition, contain provisions dealing with limitations on the activities of partners within the orbit of the practice. These restrictions pertain essentially to administrative matters. Illustrations of the latter provisions are here submitted:

"Each partner, with the exception of the managing partner, shall consult at least one other partner, obtaining his consent before doing any of the following: Engaging assistants with direct or implied promise of permanency; incurring special expense in travelling or otherwise for the purpose of securing

business; purchasing fixed equipment; engaging offices and signing leases; incurring firm obligations for loans; — and, generally, when new outlay, beyond the ordinary outlay for prosecuting the work in hand, is contemplated.

No partner may make reports to clients without placing copies of such reports in the firm files.

Whenever practicable, all reports prepared shall be submitted to the managing partner, or in his absence, to one of the other partners before being sent out, in order that uniformity of style and method may be adopted, and in order that the work may have the benefit of the consideration of more than one partner."

"No notes or any evidence of indebtedness shall be executed in the name of the partnership without the signatures or written consent of the majority of the partners who shall represent at least 75% of the partnership capital."

"No partner shall undertake any firm business, the desirability of which may be questionable under general firm policies without first submitting the engagement for approval by the management committee."

"Without the consent of his copartners no partner shall . . . hire or discharge any employee; compromise or release debts owing to the partnership; make any contract in the partnership name involving more than \$250; sign or endorse any negotiable paper so as to create a liability contingent or otherwise on the firm's part; use the partnership name, credit or property for other than partnership purposes. . . .

All differences as to policies shall be decided by a majority in interest of the partners, and no partner shall knowingly do any act in relation thereto contrary to the decision of the majority."

Also applicable is the rather unusual clause in one agreement that no partner shall perform work which can be done just as well by a staff member.

Absence on Military Service

Leave-of-absence provisions are not common in agreements, yet one type of leave — military service — can arise in almost any firm and involve young as well as older partners. Other leaves of absence may be taken for reasons such as the acceptance of a teaching or research assignment, or to write a book, or to take a position with a government agency, or for other meritorious purposes.

It is reasonable to assume that such contingencies can be dealt with satisfactorily as they arise. Nevertheless some forethought, and perhaps even a provision therefor, may avoid subsequent misunderstanding, acrimony, or even an impasse.

The following are illustrations of provisions that have been adopted:

"Vacations and voluntary leaves of absence, including voluntary enlistments as distinguished from enlistment when a draft call is anticipated, shall be taken as mutually agreed upon. Financial arrangements as to the sharing of profits and losses, salaries to the remaining partners used in determining said

profits and losses, capital investment, et cetera, shall be as mutually agreed upon at the time of such absences."

"In the event that a partner involuntarily, including enlistment when a draft call is anticipated, becomes a member of the military services . . . salaries to the remaining partners shall be credited at the rate of 150% of the highest current monthly basic salary paid to accountants employed by the firm, plus bonus (when such bonus is measured by salary), for the period of such absence, excluding the first thirty days. Consideration shall be given to vacations not taken previously or during the current year in determining the end of the waiting period." *

"In the event that either of the parties hereto shall be inducted into the armed services of the United States Government, and actually called for active service, or in the event of the illness of (specified partners) which may prevent either from personally attending to the business of the partnership and in the opinion of the remaining partners it becomes necessary to retain the services of an outside accountant then and in those events the salary paid to such employee up to the sum of one-half of the monthly drawings shall be a charge against the drawing account of either who may be absent on account of such induction or of such illness, but whatever sum is paid to such employee over and above one-half of the monthly drawings shall be considered a partnership expense and charged to the partnership business, during the term of the partnership."

Admission of New Partners

It is not necessary to deal with this subject extensively in an agreement. One cannot anticipate the firm's status at the time of a prospective admission nor the standing of the candidate. For this reason many agreements are silent on the subject, but some deal with it very briefly, touching on one or more of the following aspects:

1. The minimum percentage or number of partners' votes required for affirmative action.
2. Class of partners which may vote on admissions.
3. Whether or not a capital investment is required.
4. Whether or not a payment is to be made for goodwill.
5. Effect of admission on participation percentages of retired partners and interests of estates.

Questions such as the profit share, salary, if any, and other pertinent conditions for the new partner can be considered only when the occasion arises.

In the sections of this chapter dealing with goodwill and with capital contributions there will be found certain references to new partners. Examples of how admissions are dealt with in agreements reviewed are contained in the following excerpts:

"Additional partners may be admitted on such terms and conditions as are agreeable to all active partners, but the admission of additional partner or

* Author's note: It is presumed that the partner on leave continues to draw his usual allowance during all of his absence from the firm.

partners shall be on such a basis that it will not reduce the share of a withdrawing partner or the estate of a deceased partner."

"Eighty per cent in interest of the partners shall have the right to admit additional general partners."

"In the event that the number of administrative partners shall at any time be reduced to less than five by the death, retirement, or withdrawal of an administrative partner or otherwise, then within six months thereafter a new administrative partner or partners shall be chosen by a majority in interest of the remaining administrative partners, it being the intention that the number of administrative partners shall never be less than five for any period of longer than six months."

"The withdrawal or death of one or more partners, or the admission of one or more new partners, shall not terminate this agreement. . . . Any additional partners admitted shall be required to become parties to this agreement as a condition to admission to the firm and shall sign the original of this agreement as evidence thereof at that time."

Junior Partners

References to junior partners appear in various sections of this chapter. However, the subject is well deserving of discussion in a centralized manner due to its importance and great interest.

The creation of junior partners becomes increasingly important as a firm grows, and as partners become overburdened, or reach an advanced age. Another factor of considerable influence is the desirability of retaining, permanently if practical, staff men of unusual talent and capacity. It appears that the purported complexities of the junior partner problem are probably overrated. Anxieties as to the difficulties that may develop from the addition of a junior partner to the firm are often found to be unwarranted in actual experience.

If a firm is to be perpetuated, new partners must be added. As senior partners disappear from the picture, junior partners should be able to step into their places. Likewise, the ranks of the junior partners can be filled from the staff, which is one of the opportunities that can be held out to the rank and file.

Small firms are not necessarily barred from having a junior partner, or even two. It is reasonable to expect that a junior partner will contribute more to a firm than a staff man. The pride of position and a new sense of responsibility will inevitably reflect themselves in a greater interest in client relations, profitableness of the operations, and in the securing of new clients. Moreover, the increased compensation, if any, may soon be offset by the benefits that will accrue from the increased enthusiasm and effort.

The duties of many junior partners vary little from their duties as senior accountants, supervisors, or office managers. They do, however, participate in partners' meetings but they are not privileged to vote

on every issue. Certain issues, as reviewed elsewhere, and representing matters such as admission of a partner, adjustment of partners' salaries and profit shares, retirements, et cetera, are reserved for senior partners. In time, they may be assigned, or assume with implied approval, new or more important functions. This is a matter of natural development. Junior partners should be trained to assume greater responsibilities as conditions warrant.

Eventually, in the course of years, the junior partner or partners assume increasing responsibilities and the senior partner or partners reduce their activities. In this process the distinction between junior and senior partners gradually diminishes. The stage is then reached where the only difference between them may be in capital shares, profit shares or salaries, and finally, many junior partners become senior partners.

Relations Between Junior and Senior Partners

The common provisions governing the relations between senior and junior partners are here reviewed in somewhat condensed form because they also appear elsewhere in the topical sections. Illustrative of the most frequent type of arrangements are the following excerpts from two agreements:

"A majority in interest of the partners shall have the right to introduce as non-capital partners such members of the staff or other individuals as they may see fit under separate agreement as to salary and other remuneration, with or without interest in profits, and with an agreement to indemnify them against liability for losses or debts of the firm; no such agreement, however, shall entitle such persons to a voice in the management or to any additional (death, involuntary retirement . . .) benefits but any interest in profits so granted to such non-capital partners shall be treated as an expense and be deducted before determining the (earnings . . .) of the partnership."

"The senior partner shall have the right to require the withdrawal and resignation from the partnership of any junior partner by reason of conduct deemed by the senior partner to be injurious or detrimental to the partnership. In the event that such right be exercised, or in the event of the voluntary withdrawal or resignation of a junior partner, . . . there shall be paid to the withdrawing partner in full for all of his right, title, and interest in and to the partnership, a sum equivalent to the amount payable to him as salary for a period of — months together with the amount of his credit balance upon the books of account of the partnership. There shall also be paid to him, within — days subsequent to his withdrawal or resignation, a sum equivalent to his share of the net profits of the partnership accrued to the close of the second month after which such withdrawal or resignation shall occur.

Such retiring or withdrawing partner shall, upon request, make, execute or deliver such instruments and perform such acts as the continuing partners may require in order to more effectually vest in them all of his right, title, and interest in the partnership.

Such retiring partner shall not at any time solicit or perform the work of any clients of the partnership and shall not at any time disclose to any person,

firm or corporation the name of any client or clients of the partnership, or any of its transactions, and such retiring partner shall not at any time use the firm name, nor, either in conjunction with his own name or otherwise, use the words 'formerly of' or 'late of' or any other combination of words containing the firm name."

Financial Arrangements

With respect to the subject of financial arrangements, there is considerable latitude, and accordingly marked variations are found to prevail. The dominant pattern is a salary plus percentage of profits, yet some junior partners do not receive a profit share. Instead they get bonuses. The bonus plan, while not as definite as a profit-share plan obviates the need for opening the firm's records to the junior partner and of making explanations of abnormal items. Moreover, in many instances the profit-share plan is not such in reality because junior partners are not required to share loss and are even assured a minimum annual remuneration. Any fair and reasonable financial arrangement will usually be found satisfactory to the prospective junior partner, particularly where there is no doubt as to the integrity of the other parties. There is no doubt that the title "partner" has a tremendous appeal and a reasonable arrangement can readily be worked out in this atmosphere.

The course followed in each instance reflects to an important extent the character traits of the individuals. Men who are trusting, generous, and of an understanding nature will make arrangements that are more liberal than those made by men who are not similarly constituted. In addition, firms that have a highly profitable practice can afford to be more liberal.

Likewise, the personality of the junior partner, as reflected in evidences of his loyalty, appreciation, trust, and understanding, will influence the partners in the formulation of the arrangements. The staff man who creates the impression that he is interested mainly in monetary rewards, or that he is of an overly suspicious nature, will be dealt with in a more controlled and rigid manner than one otherwise constituted.

In the consideration of the salary to be paid there is no need for any immediate material adjustment as a result of the admission to partnership. The gain can come from the profit share, enlarged expense allowances, life insurance protection paid for by the firm, and other incidental benefits. Thus the fixed overhead need not necessarily be increased. Profit-share percentages start at rates varying from 1% to 5% commonly, dependent on the amount of the senior partners' salaries and whether they are treated as expenses for profit-share purposes.

Some firms provide that junior partners share in earnings over an annual minimum. This minimum may be the average earnings of the past five years. In such instances the salary should be as adequate as possible and the profit share higher than would otherwise be allowed. It must always be borne in mind that the junior partner should be able

to maintain a standard of living consistent with his position. Moreover, care must be taken not to create a situation whereby a new partner is disillusioned by failure to earn any profit share because of an abnormal minimum.

The advancement of a junior partner should be more frequently by salary adjustment than of percentage of profit. Changes in profit shares are a more delicate subject than changes in salaries. In the latter respect, and as will be noted in other respects too, the problem of junior partners is not entirely dissimilar from that of senior partners.

There are firms that do make their books and financial statements available to junior partners from the outset. Others do not start on this basis but change to it in time, whereas still others never do, though a profit-share arrangement exists. If there is complete trust, a serious question may never arise but in the event of a withdrawal full disclosure may then be demanded. Mention should again be made at this point that some agreements contain limitation periods after which no claim may be raised by a partner for an accounting.

As to limitations on the activities of junior partners within, and outside of, the firm, they are subject, of course, to all of the limitations placed on all partners by the terms of the agreement. In addition they are also subject to certain subordination to the senior partners with respect to administrative and policy matters, and the initiation of new engagements.

Capital contributions are not usually expected from junior partners. However, in time they may be encouraged to permit part of their profit shares to accumulate in the firm and to earn interest if interest is paid to other partners. Some firms may make a capital contribution a condition for admittance and there are instances where an interest in the firm is actually purchased from the partners. These are unusual, however, and are apt to involve men who have not been taken in from the ranks.

Separation or Withdrawal from Firm

The provisions dealing with the broad subject of separation from the firm require careful attention for junior partners as well as for senior partners. Retirement benefits may be available to a junior partner (usually a remote situation) after a specified number of years of service, in amounts proportionate to the senior partners' benefits. This presumes that such benefits are available to senior partners. Death benefits are more frequently available to junior partners, through life insurance or by payments from the firm to the estate. The benefit payments by the firm should be based on years of service, annual earnings, and finally, should be in reasonable proportion to the payments to senior partners. In the two foregoing respects the consideration should be similar, at least, to that which would be accorded an old, faithful executive. Social security benefits may, of course, be taken into account, if any will be received.

Where withdrawal is involved, by voluntary action of the junior partner or by a demand for his resignation, certain protective provisions should be considered. These provisions may be in the partnership agreement or in a separate agreement with the junior partner. They provide, as a rule, that the junior partner upon separation from the firm will not communicate this fact to clients, will not solicit them, will not advertise his former association, or in any other way take advantage of his former connection. There are some agreements which provide some security against violations by this method: a part of the junior partners' earnings are retained by the firm; only part is paid to him upon his withdrawal and the balance is paid to him in two or three years if he has lived up to the conditions of his contract.

Whatever amounts are due a junior partner on account of balances in his capital or personal account are paid out on the same terms as, or shorter terms than similar distributions to senior partners.

Matters of illness and incapacity of junior partners are dealt with, in the few instances observed, on a scale considerably below that affecting senior partners. It is likely that, despite the absence of such a provision in an agreement, upon the occurrence of serious illness or incapacity the firm will take some steps to provide aid.

With respect to military service, little specific reference thereto appears to exist. In a few instances the agreement provides that a junior partner is to be restored to his position on his return and some minimum benefits paid to him during his absence. Nevertheless, though many agreements are silent on this point, it may in any event be the intention, and the practice of some of the firms to act similarly.

Compensation for New Clients

Some provision should be made for clients obtained by junior partners. Whether there should be extra compensation therefor, and how much, are not questions that can easily be settled satisfactorily. Unfortunately, like many other situations, it depends upon the circumstances in each case. Good support can be found for either side of the issue. It may be argued as follows: Where the profit share and salary, if any, are generous, and the junior partner is closely integrated with the senior partners, and his continued progress is reasonably assured, then obtaining clients for the firm may call for no extra reward unless such payments are, as a matter of policy, made to all partners.

Where, on the other hand, the junior partner's annual earnings are not on a very satisfactory basis, then some reward, in the form of an annual percentage of gross fees, will serve to raise his earnings and provide incentive for trying to develop more new clients. Others may argue that, regardless of compensation status, all partners have the obligation to do everything in their power to advance the firm's interests, and developing new clients is just one phase of the fulfillment of this obligation.

Some junior partners may be satisfied to receive no extra remuneration in the belief that they may thereby assure or expedite their further advancement in the firm.

It is of interest to note that other titles than that of junior partner are in use, to wit: non-goodwill partner, non-capital partner, nonadministrative partner, and the term associate. However, the last term is also used for semi-independent staff men who have some clients of their own and yet continue to serve the firm, their names appearing on the firm's letterhead. Some firms avoid classifying partners. Since their profit-sharing arrangements are such as to call for divisions of income according to value to the firm, and salaries are fixed according to capacity and experience, and administration of the firm's affairs is naturally centered in experienced hands, they find it unnecessary to make any formal distinctions.

Miscellaneous Provisions

The following subjects are elementary provisions in partnership agreements and, because of their obvious nature, require no discussion. They are nevertheless set forth because of their place in the list of provisions to be considered.

Scope of Practice

This is usually a reference to accounting and tax services though instances were noted where cost systems and other services were specified.

Operating Area — Location of Office

Some agreements define the area in which the firm may operate, others impose no such limitations. Most, however, disclose the location of the main, or only, office.

Branch Offices

The only references observed as to branch offices are those which provide that offices can be opened in any cities decided upon by the partners. As to the conduct of branch offices, that is an administrative problem and is rarely included in agreements.

Firms having branch offices sometimes create the classification of resident partner to designate a person who participates only in the profits of the office in which he is active. Sometimes branch offices are managed by a person designated as resident manager, with or without a profit-sharing interest.

Resident partnerships and resident managerships are usually created under separate agreements, apart from the firm's general partnership agreement. All of the usual provisions dealing with capital investment, shares in profits, salaries or earnings, retirement, withdrawal, death, non-

competition, and so on, require the same degree of consideration in a resident agreement as in the general agreement.

Duration of Agreement

There is a considerable degree of variation in the agreements reviewed with respect to the period of duration. Some terms are of a definite nature, ranging from one to ten years, usually with provisions for automatic renewal unless notice is given, within one to six months prior to the expiration date, of an intention not to renew or to seek amendment.

A considerable number of agreements specify no term. This arrangement does not preclude revisions or retirements, and is probably more realistic than the limited term agreement. The short term contract may appear to be advantageous to some in that it permits easier revision and termination.

Binding Effect of Agreement

The well-drafted agreements usually carry the provision that the agreement is binding on heirs, assigns, executors and administrators.

PROVISIONS COVERING DEATH, RETIREMENT, WITHDRAWAL, DISSOLUTION AND RELATED PROBLEMS

It has frequently been stated that it is easier to get into a partnership than out of it. (This is borne out, to some degree, by the fact that the major portion of many agreements is devoted to withdrawal, death, retirement, and related provisions.) This is particularly so in the case of smaller firms where initial agreement is likely to be restricted to only immediate needs, and broad and detailed revision is left for later.

The subjects of retirement, withdrawal and death of a partner alone warrant a written agreement. In these instances, more than any other, advance understandings are desirable. This is so for several reasons.

Because no two people can be expected to reach identical conclusions years later, as to how to deal with one of the subject problems, there is a great likelihood of disappointments and misconceptions. Regardless of how well-intentioned the parties may be, the valuation yardstick used by each of them will vary and consequently there are bound to be differences. It does not follow, patently, that differences cannot be compromised and all concerned be satisfied. But it does not always work out that way. Moreover, changing conditions may even affect the personalities and attitudes of some persons. The addition of new partners, also, might create difficulties at a later date.

In a recent case, two members of a firm were forced to seek outside advice in reaching an agreement on what should be done for one of them who desired to retire because of age. In this instance, the two had been pleasantly associated for many years and had previously given no thought to retirement. Despite the best intentions and sincerity, the

valuation yardsticks used by each varied considerably. It was obvious that the differences, though reconcilable, must have been disturbing and that some disappointment had thereby been engendered. There is no doubt that the wind-up of years of association could have been far more wholesome and gratifying had there been no need to work out a retirement agreement at that late date.

An advance accord, modified as necessary to reflect changed conditions, is essential for those who recognize the need for estate or other long-term planning. It is in order for young people to engage in long-term planning more so perhaps than older ones. At present, it takes much longer to build up a retirement fund and income than ever before.

The ease of mind created by an agreement covering at least the essentials, unconsciously if not realizingly, will prove to be an important factor in the cohesiveness of the partners.

This section deals essentially with the separation of partners from their firms. Such separations occur in the case of death, retirement, withdrawal, dissolution, and leave of absence.

In the case of retirement, it may be:

1. After reaching a specified age, or having completed a stated number of years of service.
2. Because of a permanent disability.

Withdrawal from a firm may be for any of the following reasons:

1. To go into business, practice alone, or with another firm (or to some other field).
2. Expulsion from the firm.

Leave of absence from the firm may be due to military service, other temporary engagements, or illness.

Each of these separations has varying considerations and problems and is therefore treated individually herein. All of the major attendant problems of each separation, such as goodwill, liquidation of capital and personal accounts, noncompetition provisions, et cetera, also are discussed.

Death Provisions

The need for a plan for liquidating the interest of a deceased partner is one of the most impelling motives for a partnership agreement. It is a "progressive" provision requiring change as the firm grows to insure that the terms are realistic and consistent with the changed position. After a certain stage has been reached revision may be required only at long intervals, if at all.

Certain of the death provisions are of an invariable nature. These provide for paying out a partner's capital and other credits due him. But, as a firm grows in age and affluence it may add new elements such as payments of death benefits to the widow or to the estate, and payments

for goodwill, where such is recognized. Moreover, it may increase such benefits as improvement in its position warrants.

As to the liquidation of the capital and other credits due a partner, this procedure is described in a later section of this chapter.

Varying partnership organizations call for correspondingly different methods of acquiring a deceased partner's interest. To illustrate, a firm consisting of one senior partner and several junior partners has a different problem from one having two equal partners. A firm having many partners generally has less difficulty financially than one with few partners. But where the partners are all approximately of the same age, several deaths may occur within the course of only a few years. This possibility should not be disregarded.

The date of terminating the interest of the deceased is important. It can, and should be fixed as of the close of the partnership fiscal year unless there are compelling reasons for some other termination date. Whether or not the partner's estate is to receive a share of the income between the date of death and the end of the year is a matter for agreement. Frequently, the partner's profit share is continued to the end of the year.

As to the form of the disposition of the interest, relatively few agreements refer to it as a purchase of the deceased partner's share in the firm, most contracts referring to it as the liquidation of his interest or the reversion of the interest to the surviving partners or to the firm. Each of these methods may have different tax connotations and tax benefits to the estate and the surviving partners may well exercise the decisive influence in the choice of a plan.

It has been observed that in some instances estates or widows are continued as if partners in that they share in the profits (not losses, in some cases) for a specified period of years. The validity of such arrangements for a professional firm must be carefully checked with state statutes and with the rules of ethics or professional conduct of the national and state accounting societies.

In one instance the following provision was made for a partner's widow:

"Beginning with the first day of the following fiscal year the widow of the deceased partner shall share in the partnership profits so long as she remains unmarried or is charged with the support of minor children of the deceased, or for a period of ten years from the first day following the close of the current fiscal year in which the said partner shall have died, whichever is longer; with the share to such widow computed as follows . . ."

The agreement goes beyond the widow, providing in addition as follows:

"If wife does not survive partner having minor children, or minor children survive wife after death of partner, profit sharing above shall be made instead to the legal guardian of the child or children for use in their support until the youngest becomes of age, at which time profit sharing ceases."

These plans may involve interesting tax considerations.

An instance of the continuance of the estate as a member of the firm is illustrated in this clause:

"The estate of a deceased partner shall continue as a member of the partnership for a period of three years as hereinafter provided, and shall participate in the net earnings but not the net losses of the partnership, but such estate shall have no voice in the administration of the affairs of the partnership."

The Rules of Professional Conduct of the American Institute of Accountants do not preclude the inactive affiliations of a retired partner or of an estate of a deceased partner for the sole purpose of a sharing of income for a specified period. However, it would not be proper to make an executor a partner, with all of the rights and privileges of one, unless that person was a certified public accountant and not otherwise unqualified. This point is touched on by John L. Carey in "Professional Ethics of Public Accounting" (pages 70-71) and the following is an excerpt therefrom:

"It would be improper for a firm practicing as certified public accountants to include as a partner any person who is not a practicing certified public accountant and whose qualifications do not justify the designation or description of the firm as used. An arrangement could be made whereby the widow of the deceased partner would receive a share of earnings, based on her husband's goodwill value in the firm, without making her a member of it."

The participation by an estate in a firm's profits for a period of years is held to be proper within Rule 3 of the Rules of Professional Conduct of the American Institute of Accountants in this statement by Mr. Carey:

"... the deceased partner's estate shall be entitled to share in the profits of the firm for five years. The attorneys question whether this would be in violation of Rule 3. There appears to be nothing objectionable from the point of view of the Rules of Professional Conduct of the Institute in the proposed provisions of the partnership articles submitted."

The purchase of a deceased partner's share is illustrated in the following excerpts:

"In the case of the death, incapacity or retirement of a partner the remaining senior partners have the right to buy such partner's interest in accordance with their relative interests in the business prior to such purchase."

"No partner shall have any right, title or interest in any of the specific assets of the partnership, such as files, records, papers, equipment, and so forth, but his proportionate interest therein shall be expressed only in the dollar amount of his capital account as set forth above. In the event of the death of any partner (or voluntary withdrawal, as specified in another clause) each for himself binds his heirs, executors, administrators and representatives to accept the amount of his capital account in full settlement of all his interest in the partnership assets; and the surviving and continuing partners agree to purchase, on that basis, the net interest of any decedent (or retiring partner) in the assets of the partnership and assume and agree to pay all partnership liabilities."

Other known death benefit plans are summarized very briefly to disclose further the variety of patterns:

1. A comprehensive agreement covering senior and junior partners, provides the following payments in addition to capital, loans, et cetera:

Estate of deceased senior partner receives:

- a. A specified dollar amount for relinquishing its right or interest in the firm name — payable over a 5-year period.
- b. A stated percentage of net profit, before partners' salaries, for five years, but not to exceed a stated maximum.

Estate of junior partner receives only the benefits in item (b) above but in a lower percentage and lower maximum.

The partners covenant, each with each, that in the event of the death or retirement of a partner: (1) The sum of his capital account and of his personal account (including all credits which would be due him . . . were he an active member up to the end of the month of his death or retirement) shall be paid in cash, without interest, in four semiannual installments. . . (2) Each partner conveys to the surviving or remaining partners all his interest in the goodwill and the partnership name and a majority of the surviving or remaining partners, if they so elect, may continue to use the partnership name.

2. A suggestion appearing in *The Journal of Accountancy*, November 1951, page 607, provides the following:

"The beneficiary of a deceased eligible but unretired partner shall be paid one-half his then salary for a normal week during a period of four years after death; the period for a deceased partner who was ineligible for retirement shall be fixed by majority vote."

Typical of many agreements reviewed are the following clauses:

"Upon the death of any partner, the firm shall not be dissolved thereby but shall continue on the same basis of profit sharing agreed to for the current year until the close of the then current fiscal year."

"Upon the death, retirement, or withdrawal of any of the partners during the term of the partnership the interest of the deceased, retiring or withdrawing partner in the firm assets and business shall be and become vested in and transferred to the surviving or continuing partners in proportion of their participations in the stated capital and distributable profits . . ."

"The legal representatives of the deceased partner shall be deemed to have assigned, transferred and set over to the continuing partners all of the deceased partner's right, title and interest in and to the assets of the partnership, without any further act on the part of said legal representatives and said legal representatives of the deceased partner shall, upon request, execute, acknowledge and deliver such instruments and perform such acts as the continuing partners may require in order more effectively to vest in them all of the deceased partner's right, title, and interest in and to the said assets."

The following is a condensation of certain interesting requirements of a comprehensive agreement:

1. The estate of a deceased partner is to receive for five years a stated percentage of the net profit of the firm. These percentages, however, are lower than the percentages effective when the partner

was alive. The reduction in the percentage is justified on the ground that estates do not share losses.

2. A bank trustee is appointed to determine (a) that the agreement is faithfully performed insofar as an estate is involved and (b) that the interest of a deceased partner's estate is not impaired. The bank is given the right to move for a dissolution of the firm to protect the interest of an estate or estates. In the event of dissolution, balances due estates are given a priority over payments of capital to surviving partners.

Agreements generally make it a point to exclude estates and widows from any voice in management. In the above case a similar provision exists but the bank is injected as soon as a death occurs to receive copies of monthly balance sheets and income statements so as to be able to observe the financial soundness of the firm and to act to prevent loss to the estate.

Protection of an estate is accomplished by other means in other agreements. One agreement provides that the partners are jointly and severally liable for the indebtedness to an estate.

In another instance provision is made as follows for the eventuality of an inadequacy of a firm's income to make fixed goodwill payments to an estate, possibly due to a dissolution of the firm. Payment of goodwill is required to be made from the gross income of the firm or, interestingly, from fees.

"For any public accounting work engaged in by the surviving or remaining partners, or any of them, including sums received from and employment by any corporation, partnership, or individual engaged in the public accounting business — provided that no surviving or remaining partner shall be liable hereunder for any part of the collections made by any other party to this agreement who does not remain in partnership with him."

Another plan provides that fixed amounts are payable, for five years after death, from net profit if earned. Net profits of the partnership for the purpose of this paragraph are to be computed without deduction of partners salaries as an expense and the payments to the deceased partner's estate are deemed an expense payable prior to any compensation to partners by way of salary, profit share, or otherwise.

One unusually far-sighted provision covers the simultaneous death of two or more partners, or a mass retirement in this manner:

"In the event that all the senior partners with the exception of one shall simultaneously die, become incapacitated or decide to retire, payments to them or their estates shall be subordinated to a fixed salary allowance to the sole surviving partner."

Retirement for Age

A retirement compensation plan is one of the long range provisions in a partnership agreement. Young accountants may be inclined to ignore it because the prospect is distant. This may not be an entirely impractical

view except for certain psychological benefits that might otherwise be obtained. However, on the grounds that an agreement should be reached when the will to agree is greatest, and when the disturbing effect of the event is not imminent, this provision should perhaps be considered by young men. It could have a perpetuating effect on a partnership and increase the incentive for the development of a firm that will be able to pension its partners. Federal and state social security benefits, where, or when applicable to partners may never be a substitute for a partners' retirement plan, since at best they will probably merely supplement it.

A retirement plan is of advantage to the firm as well as to the partner who desires to retire. Should there be no such arrangement, a partner who is not financially independent might resist retirement for as long as possible, even beyond a proper limit, to the detriment of the firm. Moreover a partner whose capacity for accomplishment has been materially reduced by age or disability should make place for a more vigorous partner.

On the other hand, it might be harsh to turn out a partner who has devoted many years of his life to helping build up and maintain a firm's practice, with only his capital account balance to carry on. Capital account balances often are relatively small sums. The consequences of such action might well be that the retired partner would have to supplement his independent income by engaging in a competitive practice.

The retirement benefits contemplated herein do not include any element of goodwill, but deal with consideration for years of service to the firm, and advisory or other services to be rendered after retirement. If it is desired to give recognition to goodwill in lieu of retirement benefits, a clear-cut distinction should be made. The grounds for each type of benefit must be soundly established and the tax aspects determined as conclusively as possible. An unfavorable change in the income tax status may materially reduce the benefits to the beneficiary or increase the cost to the firm.

For the very reason that it is a long range plan, requiring some visualization of the future both as to general economic conditions and as to what the firm's position may be when the retirements become operative, this subject requires careful consideration. In those instances where all the partners are of about the same age a dilemma might well develop in the event of mass retirements or other incidents. The simple solution, however, and one that is practical for other reasons, is to bring "new blood" into a firm at reasonable intervals so as to permit older partners to reduce their activity and eventually retire.

Where a retiring partner has earned unusually large special fees for the firm, and it does not appear likely that the remaining partners will be able to continue such earnings, it may be necessary to adjust the retirement allowance so as to avoid undue hardship on the firm. This would not be an injustice if that partner has been compensated adequately for his unusual contributions to the firm.

Some large firms effect retirement on a two step basis; First the

partners become advisory partners and are considered to be available for consultation when needed. This, in effect, is nothing more than their continuance as part time partners. No reference is necessarily made as to the time that must be expended in the firm's behalf. It is sufficient that they be available for consultation on problems of clients they had supervised in the past or as to matters on which they are specialists. The second and final step is total retirement.

Smaller firms may find this procedure useful inasmuch as it will permit a gradual transition of a partner, in stages, from active to partly active to inactive. An arrangement of this nature should be helpful to the firm in the retention of clients supervised by the retiring partner. Even an inactive partner may desire some mild form of activity, unless he is physically unable to render any service. Provision for post-retirement services need not be made in the agreement but can be dealt with as an administrative matter.

The use of a limited partnership has developed in instances where it was desired to continue a partly or fully retired partner in the firm either for advisory services, for the use of his name, or for profit sharing in accordance with the retirement plan. These arrangements are not necessarily of the legal limited partnership type where the public is informed by advertising that certain partners have only limited liabilities, which arrangements some accountants hold to be unprofessional. Where the limitation is from within, and the active partners agree to hold the limited partners free from loss, there seems to be no ground for objection.

The major problems of retirement provisions are the following:

1. The amount of the annual payments.
2. Period of years in which payments will be made.
3. When retirement becomes effective.

Of the firms interrogated in the AIA questionnaire survey, those who operate with oral agreements reported no benefit provisions for retirement for age and disability. That does not necessarily mean that such payments will not be made. What may be intended is that the problem will be dealt with when it arises, according to the means of the firm and the consciences of the partners.

Only a minority of the firms with written agreements provided for retirement benefits for age or disability. The remainder probably also intend to deal with the problem when it arises.

In addition to the retirement compensation, the partner obviously is entitled to receive payment of his capital, loans to the firm, if any, and his participation in uncollected fees and work-in-progress if such are not included in the capital account.

Retirement Allowances

The retirement allowance provisions of two agreements are here described in the belief that the details submitted may adequately disclose

the major factors that must be contemplated in a retirement plan. Accountants should be able to use these data in the formulation or revision of their own plans, making such adaptations and innovations as they may require. The retirement for age may be mandatory at a stated age, or optional with the subject partner, or at the will of a majority of the partners.

Plan 1

This is applicable to partners of a large accounting firm reaching the age of sixty-five. It provides substantially the following benefits:

Apart from the repayment of his capital and other credits, the retiring partner is paid six annual retirement benefits. These payments start at the end of one year after the retirement (not necessarily the firm's fiscal year-end date) and are made annually. Other payment arrangements are possible if approved by the stated partners.

The total allowance is determined as follows, and is payable out of distributable profits:

1. An amount determined by a decision of the majority in interest of the administrative partners, but in no event less than the smaller of the following:
 - a. An amount equal to three times the annual average of the total salary and profit share earned by the retiring partner within the ten years next preceding the year of retirement, or
 - b. An amount equal to the sum of the total salary and profit share which he would have earned within the succeeding three years, including the year of retirement as the first (and with his ratio of participation in profits unaltered). In the calculation of profits, salaries paid to new partners and interest on their capital are treated as expenses.

The effect of clause 1 (b) is to provide a margin of safety if earnings decline in the years following the retirement.

The firm retains the right, by decision of a majority of the administrative partners within one year from the date of retirement, to fix the retirement allowance at an amount not below that computed under clause 1 (a) and to pay it in full immediately. This decision is binding on the retiring and surviving partners.

It is further provided that, if annual installments are paid, the first three are to be of an amount no less than equivalent to 50% of the annual salary of the retired partner as of the date of retirement, or no less than a specified amount.

The mechanics of the payments involve the calculation first of a tentative amount, as soon as practicable after the retirement, on the basis of prior earnings, or a larger amount if fixed by the partners. However, should the safety clause (1 (b)) become operative, then it is provided that future payments be reduced by the excess paid unless otherwise decided by the administrative partners. In no event are payments made prior to the redetermination recoverable from the partner out of payments still due.

Plan 2

Under this plan a partner may retire after either (a) twenty-five years of service as a partner; or (b) he has reached the age of sixty-five, whichever occurs earlier. The retirement allowance is paid for life, out of firm profits, in accordance with a "years of service" scale which starts at 15% for twenty-five years of services and graduates upward at $1\frac{1}{2}\%$ annually until a maximum of 30% is reached for thirty-five or more years of service.

The percentage is applied against the lower of two amounts, to determine the annual benefit. These amounts are the following:

1. The annual income, profit share plus salary, to which he would have been entitled had he not retired.
2. An amount of income equal to his average annual earnings, profit share plus salary, during either the 5-year period, or 2-year period immediately preceding the year in which the retirement becomes effective, whichever lower.

The agreement provides further that a partner desiring to retire may nevertheless be required to serve on a half-time basis for a period of from three to six years, dependent on the will of the remaining partners. The intent is to cushion the effect of the withdrawal of an important partner. In such event the partner would be paid one-half or other proportion, dependent on time actually devoted to the firm, of his active scale of salary and profit share. Such time is included in determining the applicable "years served" percentage.

Protection of retirement allowances is provided for by a provision that the active partners agree not to dissolve, divide, sell, or in any other way dispose of the practice without the approval of the retired partners. If this rule is violated, the obligations become personal liabilities to the active partners.

A retired partner is encouraged to obtain business for the firm by the allowance of an annual share of $12\frac{1}{2}\%$ of fees therefrom. However, a distinction is made between fully and partially retired partners, the former getting the allowance on all new business, the latter only on clients not stemming from prior clients of the firm.

A noncompetition clause exists which calls for a cancellation of the retirement benefits in the event of violation.

Other Plans

Another simple method of compensation contemplates the payment to a retired partner over a period of five years of an annual amount equivalent to 15% of his annual billings. Detail is lacking as to how the annual billings are determined in this particular instance, but it is likely that it represents either the partner's billings in the year preceding that of retirement or the average of the two or three preceding years.

The November 1951 *Journal of Accountancy*, page 607, published the following suggestion as to a retirement plan:

"A partner who has reached the age of sixty and has had at least ten years of service is eligible for retirement. If he retires (but need not), he is entitled to receive one-half his current salary for a normal week during a period of four years after retirement."

Other points that may be covered in retirement plans are the following:

1. The interest of the retired partner may be divided among the continuing partners in proportion to their capital or profit-share interest. To carry out his withdrawal properly, the retiring partner agrees to do whatever is necessary to vest effectually in the remaining partners all of his right, title, and interest in the partnership.
2. There are instances where the retiring partners or estates of deceased partners are given the right to make an examination of the firm's books until their retirement payments (or death benefits) are completed. In one reported instance retired partners are entitled to receive copies of the firm's annual statements.
3. Retirement provisions involving fixed amount payments should be reviewed at least every five years to insure that the plan is representative of the firm's position and ability to pay. A plan which uses a percentage of profits as a basis or a "ceiling" will avoid the difficulties of the fixed payment plan. In any event, changes in benefits should not be made except when a drastic change, and one of apparently indefinite duration, has occurred in a firm's position.

Notice of Intention to Retire or Withdraw

Few agreements include a specific provision for the period of notice of intention to retire or withdraw or for the method of communicating such notice. This is a surprising situation because it is of little consequence as a drafting problem yet a great advantage in the preparation for the event.

The clauses reviewed indicated that notice periods range from thirty days to one year. Notice of intention to retire is required by registered mail, as a rule, addressed to one of the following: a) all of the partners, b) administrative partner or partners, c) the firm. The office, or main office address, is specified as the location to which the notice is to be mailed. Several agreements were reported to contain specific dollar penalty provisions for failure to give the required notice, such penalty, however, being subject to modification by the other partners. This is an indication of the seriousness attached to the requirement of notice.

Limitations on Retirements

Where there are a number of partners of similar age in a firm it is conceivable that a mass retirement could occur. To avoid such an incident one agreement provides that, except for reasons of disability, only one retirement may take place in a 2-year period.

Voluntary Withdrawal

The term withdrawal applies to any of a number of reasons for resignation from membership in the firm.

Common grounds for a voluntary separation are the following:

1. Disagreement or other discontent with partners.
2. Desire to practice alone.
3. Desire to join another accounting firm.
4. Desire to go into private accounting work.
5. Desire to enter another field or the teaching profession.
6. Other personal motivations, such as moving to another section of the country.

The first three causes may involve an unpleasant situation whereas the last three situations need not necessarily engender any ill-will. In any event, a withdrawal for any reason creates a serious problem for the firm, and may possibly require a physical dissolution, change in firm name, division of clientele and staff, or other difficult arrangements. Hence a withdrawal should not be an impetuous action and the provisions relating thereto are, usually and deservedly, not as liberal as for retirement for age or in the event of death.

Where the withdrawal, by agreement or by law, will bring about a dissolution of the firm, then the references thereto may be confined to notice and the mechanics of the dissolution, but where there shall not be a dissolution, then specific terms for the withdrawal are necessary.

All oral agreements, actually or by implication, intend that when a partner desires to withdraw from the firm, he will negotiate the terms of his withdrawal. Some written agreements, perhaps in the realization of the difficulty of advance understanding on this issue, merely provide for negotiation without a definite formula or with a reference to the pattern to be followed. The following clause illustrates the latter viewpoint:

"Should any partner wish to voluntarily withdraw from the firm to retire or to engage in any other activity not in conflict with the business of the firm, such partner may negotiate a settlement with the continuing partners relative to any intangible values in excess of balances in capital and drawing accounts, determined in accordance with the provisions of Paragraph — (pertains to participation in profits after death.)"

In one summary of a partnership agreement appears this significant illustration of the distinction between retirement and withdrawal terms:

1. If he retires, he gets both his interest in tangible and intangible capital; if he withdraws he receives only his interest in the tangible capital.

The provisions covering withdrawal of a partner vary widely but nevertheless they generally reflect the nature of the association itself. For example, where a partnership in effect has been little more than an association of two individual practitioners who operated independently to a large extent, the resignation is carried out relatively easily because there is not much to untangle. In such a case there is a dissolution of the firm.

However, where partnerships have developed in size and form over a period of years, and some partners have come in from the ranks of the staff, and the method of operation has been on a "firm" basis rather than

on the "individual partner" basis, a resignation is not a simple matter and it may involve some sacrifices by the withdrawing partner. In such cases a partnership dissolution does not necessarily accompany a withdrawal.

Most partnership agreements, oral and written, make provision for conditions such as these in providing for withdrawal: Notice of intention is required for periods suitable in the individual case and differing in extent from one month up to six months. In such instances the effective date is not necessarily the fiscal year end date as is sometimes the case in other forms of withdrawal. Reference also is made to whether or not such action requires a dissolution, in which event all of the dissolution provisions (if any) become effective. The right to the use of the established firm name, or the retention of the name of the withdrawing partner, are other conditions which are dealt with.

Important in all resignations is the question of withdrawal of clients and competition with the continuing partners. Some partnership agreements are drastic in this respect, and include provisions to the effect that upon withdrawal a partner agrees not to solicit, directly or indirectly, or not even to handle, clients of the firm. Moreover, he may be barred from using the firm name, and in at least one known instance from even exploiting his former association. One large firm agreement contains a stated penalty for the violation of the noncompetition clause. Forms of noncompetition clauses in use appear in a later section of this chapter.

Some agreements provide that a resigning partner is not entitled to any consideration for goodwill, where it may be otherwise considered; nor may he "withdraw" the clients contributed or supervised by him, nor may he receive any profit-share distribution beyond the date of his inactivity though such privilege is available under other circumstances.

An illustration of a provision calling for a division of clients is the following:

"In the event that the withdrawing partner shall elect to take a share of the business of the partnership in lieu of cash as herein provided, the partners shall divide the business of the partnership, insofar as it is possible, so that the withdrawing partner shall retain the clients with whom, and with whose work he is most familiar, . . . shall continue to be served by him."

Where a withdrawing partner is entitled to a share in the firm's goodwill there is usually a companion noncompetition clause. This view is exemplified in the following clause:

"It is agreed, however, that any partner who voluntarily withdraws from the partnership may elect not to accept payment for his interest in the goodwill of the partnership, in which event the prohibitions against engaging in public accounting work as set out in Paragraph . . . shall not be effective."

But there also are noncompetition clauses in contracts where the existence of goodwill values is disavowed.

On the other hand, some agreements do provide, and properly so, for the "withdrawal" of specified clients and even the acceptance of engagements from clients of the former partnership if offered. The following is an illustration of a compromise provision:

"Should the withdrawing partner intend to engage in the practice of public accounting immediately upon withdrawal, he shall not be entitled to take any partnership business with him, but shall not be prevented from accepting an engagement from a client of the former partnership."

The severity or liberality of the withdrawal conditions, as previously indicated, depends largely on the nature of the association, its origin, and its development. No general rule therefor can be evolved that will be universally acceptable. But this much is definite, that the withdrawal of a partner can most equitably be negotiated when the imminence of the matter, and the accompanying emotional reactions, are not aggravating conditions.

Some agreements contain a reference to withdrawal by junior partners. In such cases the provisions are slightly more stringent as to competition, since most such partners are selected from the staff. The junior partner is usually entitled to his accumulated capital, profit share to date of withdrawal, and any similar credits due him.

Where a partner withdraws to enter a noncompetitive field he may expect better consideration than otherwise. This may not represent a considerable advantage but it permits negotiation on a friendly basis, where there is no withdrawal provision or this is inadequate.

Several additional illustrations of withdrawal provisions are submitted herewith:

"After a voluntary dissolution of said partnership, if the withdrawing partner elects to take cash for his interest in said partnership, as herein provided, he agrees not to perform any accounting service for any client served by the partnership within a period of twelve months immediately preceding the date of dissolution for a period of two years immediately following the date of dissolution of said partnership." (The partnership interest in this case includes goodwill).

"A partner may withdraw from the partnership at the end of any month by giving not less than sixty days prior written notice thereof to the other partners. The withdrawal of a partner shall have no effect upon the continuance of the partnership business. . . ."

"Voluntary retirement may take place by mutual consent, or by the giving of two months' notice in writing to the others by the one wishing to retire. In the event of voluntary retirement of any partner, the purchase of goodwill must necessarily be upon such terms as shall be mutually agreed upon. It is however, agreed that in the event of voluntary retirement or dissolution by expiration of the partnership, and lacking any other agreement, there shall be made such a division of the business and goodwill as shall appear equitable, taking into consideration the source of the business, namely, the business of a partner prior to his entry into the partnership, or business secured through such former clients, or a partner's personal connections. Such a division

having been made, each partner shall refrain from soliciting in any way, directly or indirectly, the business allocated to the others."

"In the event that one partner gives notice to the other partners of his desire to retire from the partnership or to dissolve the same, . . . the partnership shall be dissolved and the business of the partnership shall be terminated in the manner provided for termination of the partnership by death or 'permanent incapacity' . . . *except* that after the partnership has been in existence for a period of one year, that the withdrawing partner may elect to take in lieu of the cash payment, as provided in Paragraph . . . a share of the business of said partnership, said share to be determined as follows:

- a. The partners shall determine the total gross business done by the firm, including that done by an accountant, or accountants, employed by the partnership for a period of twelve months immediately preceding the date of termination, excluding any amounts billed as 'expense' as distinguished from 'service.' Provided, however, that the last fiscal year of the partnership shall be used, if date of termination is not more than three months after the close of said fiscal year.
- b. The profits of the partnership shall next be determined for said 12-month period to which shall be added the total compensation paid or payable to any full time accountant or accountants employed by the partnership, (either as salary, wages, or bonus) during said period. This total shall be designated for the purpose of this agreement as 'the total net accounting fees' of the partnership.
- c. The share of the retiring partner, (including his 'base salary' and percentage paid, or payable) in 'the total net accounting fees' shall next be computed.
- d. The share of the business which the retiring partner may take in lieu of cash, shall be equal to the proportion of the total gross business of the firm for said 12-month period represented by the ratio which his share of the total net accounting fees bears to the total net accounting fees for said period. In determining said share, the total billing to each client chosen for services during the preceding fiscal year, or the twelve months preceding the date of termination, whichever period is used to determine total gross business, shall be the measure of said business. The physical assets of the partnership, (furniture, fixtures, office equipment, books, supplies, and so forth) together with any lease of premises, shall belong to the remaining partners and shall not enter into the share of the business to be taken by the retiring partner.
- e. In the event that the withdrawing partner shall elect to take a share of the business of the partnership in lieu of cash as herein provided, the partners shall divide the business of the partnership, insofar as it is possible, so that the withdrawing partner shall retain the clients with whom, and with whose problems he is most familiar, and that the clients served by any accountant, hired by the partnership, shall continue to be served by him."

The final aspect of a withdrawal is the payment of the partner's capital, his share of undistributed profits, and all other liabilities to him. In some instances it is specified that a partner may withdraw items contributed by him such as furniture, files, books, and other property.

In the section dealing with dissolution, and in other sections, will be found specific illustrations of provisions dealing with withdrawals, payment of capital, and other pertinent subjects.

Sick Leave and Incapacity

These are relatively common provisions in written and oral agreements. It is quickly recognized that sickness and disability may be progressive developments and that there is no clear cut line of demarcation. For that reason the understandings usually contain arbitrary criteria.

Sickness in itself is not a serious problem when of short duration. Only when it becomes extensive or indefinite, and becomes indicative of a permanent disability, does a difficult question develop.

The provisions reflect, for obvious reasons, the personal relationships of the partners. Where two brothers are involved, or a father and son, or even two friends with great attachment for each other, sickness or disability payments may have no limitation other than ability to pay. However, in the average business association, provisions such as those which follow are the rule.

"The involuntary retirement of a partner may take place by the continued illness or disability of a partner preventing his regular attention to business for a period of twelve consecutive months in the case of a junior partner, and twenty-four consecutive months in the case of the managing partner, — at the end of which time the other partners are hereby empowered to retire him from the firm, and his goodwill, if the retiring partner consents thereto and so desires, shall become subject to purchase under the conditions enumerated below. The remaining partners severally and collectively obligate themselves to purchase the goodwill in such case if the retiring partner is willing to sell. If the retiring partner is unwilling to sell his goodwill the remaining partners will give consideration to accommodation management of business for his connections (clients). After the expiration of the first six consecutive months of disability in the case of a junior partner the 'first division of net income' to which he is entitled . . . shall be reduced by 50% for the remainder of all or any part of the succeeding six months' period of disability; after the expiration of the first twelve consecutive months of disability in the case of the managing partner the 'first division of net income' to which he is entitled . . . shall be reduced by 50% for the remainder of all or any part of the succeeding twelve months' period of disability." (Author's note: This agreement provides elsewhere for the dissolution of the firm due to such involuntary retirement and the liquidation of the partners' interests.)

"Should a partner become incapacitated his interest in the business may be acquired by the remaining senior partners and paid for as indicated under the withdrawal section. Incapacity is deemed to mean the inability of a partner to attend to the partnership business for a period of at least one year."

"For purpose of this agreement 'permanent incapacity' shall be defined either as: a) loss of certified public accountant's certificate for a period of longer than one year by action of the State Board of Accounting of (State), or any court of competent jurisdiction or b) inability to actively participate in the business of the partnership on account of the physical or mental condition of said partner for a period longer than forty two consecutive weeks, exclusive of the provisions made herein for vacations and sick leave."

"Should sickness or accident temporarily incapacitate any partner, his drawing account allowance shall continue in full for a period of six months com-

mening with the month following that in which such sickness or accident occurred. For the next succeeding six months the drawing account allowance shall be reduced to 50%, and for the next succeeding twelve months it shall be reduced to 25%. Any partner so affected shall continue to participate to the full extent in any net income or loss distribution, as hereinbefore defined, for the period during which drawing accounts continue, or in other words, for two full years commencing with the month following that in which sickness or accident occurred."

"In the event that any partner becomes incapacitated, the active partners shall determine upon a fair and reasonable course for the mutual protection of the firm and the incapacitated partner; the unanimous conclusion of the active partners, communicated in writing, shall be accepted as binding on all parties, and their personal representatives."

One firm sums up its special arrangement as follows:

Incapacity means any total disability which prevents a partner from practicing or engaging in the profession during a continuous six months period upon the expiration of which the remaining partners may claim incapacity and if such incapacity does not cease or the incapacitated partner does not return and resume practice within thirty days, incapacity shall be deemed complete and settlement will be made with the partner in the same way as if he had died.

Options to rejoin the firm are not common, presumably because this is a difficult situation, fraught with possible unpleasantness, and one that might have too many "ifs" for advance understanding.

One agreement, in summary, provides merely the following, apparently leaving some aspects to the consideration of the remaining partners when the issue must be met:

1. The senior partner may elect to rejoin the firm within two years after retirement for incapacity. If the option is not exercised within the 2-year period he must dispose of his interest in the firm. A junior partner has one year in which to act.

The physical or mental ability of a partner to rejoin should not be settled on a unilateral basis, as there must be an accord between both sides.

Sick leave, apart from disability, is referred to in a few agreements. In one instance a 6-week vacation period is fixed, together with a 4-week sick leave period, with pay. After a total absence of ten weeks from active practice the subject partner goes off the payroll but receives his full share of the profits for the calendar year. If the illness continues for a year incapacity is deemed to have developed. This is the type of provision that may be left for disposition as the situation arises.

The provision of one agreement as to incapacity gives the following details:

"Any goodwill partner shall be entitled to withdraw from the partnership on the ground of incapacity, which is defined to include only the following causes, to-wit: insanity, either judicially determined or found by the Managing Board of partners to exist, a condition of health that shall preclude

active participation in all business affairs, or after five years active participation in the affairs of the partnership as a goodwill partner, including the business heretofore conducted by _____, such condition of health as shall reasonably require an abandonment of active practice as necessary to prolong life. The incapacity of any goodwill partner having been brought to the attention of the Managing Board, the interest of such goodwill partner in the capital, profits, and goodwill of the partnership shall be ascertained upon request made by the interested party or his guardian, which interest shall be determined and made payable in the same amounts and in the same manner as hereinbefore provided for in the event of the death of a goodwill partner. The Managing Board shall be entitled, in the first instance, to determine whether the condition of health of such goodwill partner be such as to warrant or require his retirement on the ground of incapacity but a certificate of a reputable physician shall be a prima facie evidence of the condition of health of the partner desiring to retire."

Forced Withdrawal (Expulsion)

Provisions for the forced retirement of a partner for cause are found in the agreements of some firms. In a firm having two partners a dissolution is readily possible if the conduct of one partner has become intolerable to the other. The same procedure can be followed in a larger firm but the complaining partners may sometimes organize a new firm and thereby continue their association. However, in a very large firm dissolution is not a matter that is lightly contemplated; therefore in such cases there are provisions for the forced retirement of partners, for cause, generally upon the unanimous action of the administrative partners or as otherwise agreed.

In cases where a firm consists of one senior partner and the other partners are junior partners it is usually found that the senior partner reserves the right to remove a junior partner from the firm for cause.

The penalty, apart from any stigma resulting from the forced dissociation, and the necessity to seek a new association, is usually the loss of benefits payable to a partner retiring voluntarily. Such benefits, as indicated in other sections of this chapter may be a share of goodwill, compensation for noncompetition agreement, or an actual pension allowance. Capital, and undistributed profit shares are, however, payable in full.

Cause is defined to include various actions, and the following are specified in the data reviewed: Encumbrance or assignment of partnership interest for debt, bankruptcy, loss of CPA certificate, willful misconduct, bad faith, misconduct resulting in loss of money or prestige to the firm, moral turpitude, continued inattention to business (except in case of illness), or merely the best interests of the firm.

The following excerpts from agreements indicate how the matter is dealt with in some instances:

"In the event that any partner's association or affiliation with this firm shall become detrimental or harmful to its best interest, and this fact shall be determined unanimously by the other partners after fair consideration, a partner

may be asked to withdraw. In this case, however, no limitations are imposed by this agreement as to competitive practice."

"The senior partner shall have the right to require the withdrawal and resignation from the partnership of any junior partner by reason of conduct deemed by the senior partner to be injurious or detrimental to the partnership. In the event that such right be exercised, or in the event of the voluntary withdrawal or resignation of a junior partner, . . ., there shall be paid to the withdrawing partner in full for all of his right, title, and interest in and to the partnership, a sum equivalent to the amount payable to him as salary for a period of . . . months together with the amount of his credit balance upon the books of account of the partnership. There shall also be paid to him, within _____ days subsequent to the date of his withdrawal or resignation, a sum equivalent to his share of the net profits of the partnership accrued to the close of the second month (following the month) during which such withdrawal or resignation shall occur.

Upon the withdrawal of any junior partner the partnership shall be continued by the remaining partners and the share of the withdrawing partner, after the payments above set forth have been made to him, shall be divided among the remaining partners in proportion to their respective interests in the net profits of the partnership.

Such retiring or withdrawing partner shall, upon request, make, execute or deliver such instruments and perform such acts as the continuing partners may require in order more effectually to vest in them all of his right, title, and interest in the partnership.

Such retiring partner shall not at any time solicit or perform the work of any clients of the partnership and shall not at any time disclose to any person, firm or corporation the name of any client or clients of the partnership, or any of its transactions, and such retiring partner shall not at any time use the firm name, nor, either in conjunction with his own name or otherwise, use the words 'formerly' or 'late of' or any other combination of words containing the firm name."

"If any partner, not voluntarily withdrawing, shall be deprived of his interest by the vote of the other partners under the provisions of the agreement, he shall accept in full payment and satisfaction of his interest one-fifth of the amount his estate would have received (for goodwill) in the case of his death, plus his proportionate share of the undistributed net earnings, if any, which have accumulated to the date of his withdrawal and which stand to his credit on the books."

Dissolution

In some agreements it is provided that a dissolution is mandatory in the event of any of the following occurrences:

1. Death of a partner.
2. Withdrawal by a partner.
3. Bankruptcy of a partner.
4. Expiration of the contract term, without a renewal.
5. General agreement.
6. Decision of the sole senior partner or of the senior partners.

Other agreements, generally of larger firms, specifically provide for dis-

solution only upon agreement of a majority of all or certain stipulated partners. Other events call for only a change in the membership but not for dissolution.

Both of the foregoing positions may be warranted and necessary in individual cases.

To illustrate: if one partner of a two-man firm dies or withdraws there is no alternative but to dissolve. However, there are two possibilities — first, that one member may acquire the interest of the other; second, that the assets, tangible and intangible, must be divided. Thus, in one instance there is a legal but not a physical dissolution, in the second both phases must be dealt with.

A well-established firm consisting of three or more partners may, for very good reasons, resist physical liquidation except by general agreement of the partners. This position is understandable when the difficulties and the costs of the division of a large firm are comprehended. So long as a partner may be detached without a break-up of the continuity of a firm this procedure is most desirable.

This section is concerned only with the actual dissolution, and the mechanics of it. Other sections deal with the acquisition of the interest of a retired or deceased partner.

The subjects requiring consideration in any dissolution are, generally, the following:

Tangible Capital Division and Related Problems

1. Division of net assets among partners.
2. Disposition of equipment and library.
3. Completion of work in progress.
4. Collection of outstanding accounts.
5. Settlements with retired partners and estates to whom there are liabilities.

Intangible Capital Division and Related Problems

1. Division of clients and files.
2. Distribution of staff.
3. Disposition of firm name.
4. Continuity of service to clients.
5. Disposition of office lease and other contracts.

Upon recognition of the complexity of the problems involved there is little wonder why, in many agreements which make some reference to dissolution, the mechanics are left to be determined when the need has arisen. This is undoubtedly the understanding where oral agreements are in effect. This may, in some cases, work out satisfactorily. But there surely are instances where, because of a strained atmosphere prevailing at the time of the dissolution, the problems are aggravated by the lack of advance agreement, and litigation is required to settle disagreements.

The seriousness of the problem of dissolution has a direct relation to the cohesiveness and position of the partnership. Where a firm is, in

reality, a loose association of independent practitioners, each dealing exclusively with his clients, and the firm as such has been largely one in name only, a dissolution should not be too difficult because the disposition of the intangible assets should not be troublesome. To the contrary, if a firm has developed a reputation, is well integrated, has taken in partners from the ranks, has obtained clients because of its standing, and there has been a measure of collaboration among the partners, the problems of dissolution are obviously such as to make it complex and costly. It is worthy of reiteration that problems of dissolution should not all be left for a time when the heat of aroused emotions will render the solution extra difficult. The best time to lay down fundamental rules is when the prospect is remote and when the will to reach a reasonable understanding about an unpleasant situation is most favorable.

The so-called "tangible" capital division presents no challenge because it is largely a simple accounting problem. Some difficulty may be encountered in the disposition of work in progress, but the other aspects are elementary. However, in the illustrative provisions which appear at the end of this section will be found instances of the mechanics in use.

To the extent possible, all work in progress at date of dissolution should be completed by the firm. If this is not possible, each engagement should be completed by the partner to whom the client will be allocated in the dissolution. The value of the work completed should be treated as a firm asset for capital determination and charged to the partner to whom distributed. It is conceivable that some matters, because of their contingent nature, cannot be evaluated. These matters can only be left in suspense until completed and an agreement reached as to the allocation of the fees between the firm and the one who will complete them. This too is a business arrangement which accountants are well qualified to determine. It is the intangibles that provide the difficult problems. In this sphere, particularly, is advance agreement desirable.

Division of Clientele

How should clients be divided? One answer to the question is that clients should be allocated first according to partners who brought them into the firm; second, to partners supervising them. Where clients originated with one partner and have been supervised for a long period by another, then the one engaged in the supervision should, except in unusual circumstances, take over the clients on the ground that he is most likely to retain them.

However, the foregoing suggestion is an oversimplification of the problem. If a client is considered to be an asset of the firm, though intangible, why should it not be valued, added to the firm's capital, and be taken into account in the distribution of capital? This second method is actually specified in a few instances. Should it develop, in this event, that a partner has received, in clients, more than his capital interest, he

should reimburse the firm for the excess realized. For this purpose, all clients might be valued for instance, at one year's average gross fees, based on the last five years or less.

Nevertheless, even the second method may be inequitable insofar as it affects clients who were brought into the firm at its initiation or by the partner upon his admission. Such clients should properly be excluded from being treated as firm assets unless the partner received some credit for them. This type of arrangement also is in effect.

In one instance there is an understanding that clients that cannot be allocated because of disagreement are to be sold and the proceeds added to the tangible capital.

After the allocation is provided for, some agreements add a "non-competition" clause to insure the definiteness of the arrangement. Nothing, patently, will make a client continue with one partner when he prefers another. Thus, such allocations should be on as realistic a basis as possible and it may even be desirable to cautiously obtain an advance reaction from clients.

The question may be raised as to whether clients should be consulted about the distribution of their accounts prior to any allocation. It should not be answered hastily because of the possible risk that some clients might use this opportunity to make an entirely new arrangement. Obviously, clients should be transferred intelligently, and with the prospect of continuation. The matter of consultation, however, should be settled by consideration of the status of the individual clients, the nature and strength of their ties to any individual partner, their satisfaction with the firm as a whole, the ability of the senior in charge to help the transition, and any other considerations relevant in each case.

Division of Files and Working Papers

Such material should follow the client. Assurances may be requested, if expedient, to insure that papers pertaining to prior years will be available in the event of need for reference in a matter involving the firm.

Distribution of Staff

To the extent that it is practical and expedient, staff men should be requested to affiliate themselves with those partners to whose clients they can give most continuity of service. The outcome is not predictable for obvious reasons. To avoid undue hardships, some arrangement should be made as soon as a dissolution is decided upon to assure continuity of service to clients and in that connection a friendly agreement should be reached on the desired allocation of staff.

Continuity of Service to Clients

Nothing should be permitted to interrupt service to clients. The old structure should be dismantled with such intelligence that the occupants

are transferred with no undue annoyance or harmful effects. This type of co-operation needs more than a written provision; it requires an understanding on the part of all concerned that it is to their individual welfares, and for the good of their profession, that everything necessary to carry on and assure an orderly and equitable dissolution be done in the right spirit.

It is questionable whether such mechanics need be written out in advance. But when the dissolution is decided upon, the mechanics should be planned carefully and the procedures and agreements reached might well be written up as a supplementary contract.

Disposition of Office Lease and Other Contracts

All contractual obligations must be listed and their liquidation, or assumption by certain partners, should be fixed in the supplementary agreement covering the dissolution. Apart from the lease, there may be tax service subscriptions, insurance, and other minor contracts which must be disposed of. In times of office space shortages and rent controls the office lease may have considerable value. It might be fair to turn it over to the majority of the partners who continue their association.

Disposition of Firm Name

Only where the firm name has acquired considerable value is there any problem as to its disposition. In the large majority of cases each new segment of a former firm will use a title indicative of its actual members. But there are cases where the firm name is worthy of perpetuation and then questions arise. Who should be entitled to use it? May the name of a noncontinuing partner be retained in the title? These questions are not easily answered.

It appears that the preponderance of custom, where a firm name is to be perpetuated, is that the name be used by any group that constitutes a majority of the former partners. However, it seems that specific agreement is essential to make such use legally effective.

It will be observed, from the later discussion and illustrative provisions dealing with firm names in another section, that there is a variety of specific conditions. Some agreements provide that a noncontinuing partner's name shall not be used, others contain definite conditions for the transfer of the name. Consideration should be given to state laws and professional society rules of ethics regarding the relation between firm names and the names of the constituent members.

Various provisions on dissolution are here submitted:

"Upon any dissolution of the partnership, all working papers, correspondence, audit reports, tax returns, and so forth, contributed by the respective partners . . . , together with all subsequent working papers, correspondence, audit reports, tax returns, and so forth, added to the partnership plant shall be divided between the parties in such manner that each partner receives all

such working papers, correspondence, audit reports, tax returns, . . . , as relate to the respective clients which heretofore have been or hereafter may be secured directly or indirectly by each such respective party."

"The partnership may be terminated by —% in interest of partners giving notice to other partners at least thirty days prior to effective date."

"It is, however, agreed that in the event of voluntary retirement or dissolution by expiration of the partnership, and lacking any other agreement, there shall be made such a division of the business and goodwill as shall appear equitable; taking into consideration the source of the business, namely, the business of a partner prior to his entry into the partnership, or business secured through such former clients, or a partner's personal connections. Such a division having been made, each partner shall refrain from soliciting in any way, directly or indirectly, the business allocated to the others."

"It is hereby understood and agreed that the accounts of the business as of date (of agreement), and all new business or accounts arising from such accounts and all new business or accounts brought into the business through the efforts of 'A' shall be known as 'A accounts,' and all new business or accounts brought in to the business by 'B' shall be known as 'B accounts,' and upon the discontinuance of the partnership business or in the case of its dissolution by agreement or death of one of the partners, said 'A accounts' and working papers and tax files shall be distributed to 'A' and such 'B accounts' and working papers and tax files shall be distributed to 'B.'"

"Upon the termination of the partnership by reason of its expiration or for any other cause, an account shall be taken and rendered of its affairs and business and, after the payment of its obligations, division of such of its assets as are not the exclusive property of the senior partner, as hereinabove provided, shall be made to all of the partners in the proportions herein agreed upon with respect to the division of the net profits. In taking such account, however, the goodwill and firm name shall not be valued as a partnership asset, but shall belong to the senior partner exclusively, except as hereinabove provided in case of the death of the senior partner."

"In the event of dissolution of the said firm, either by withdrawal or death of one of the parties, 'A' or his heirs, executors, administrators or legal representatives shall be entitled to retain all clients or accounts of said partnership, except those clients or accounts as have heretofore been designated in writing by the said 'A' to belong to either 'B' or 'C'; all net profits up to time of said dissolution shall be shared, and losses if any, up to the time of said dissolution shall be borne between them upon the terms hereinabove set forth, but neither 'B' nor 'C' shall be entitled to share in any of the present capital investment of said partnership, nor in any goodwill, nor in any furniture, furnishings or equipment of the partnership offices."

"That if any disagreement shall arise between the parties, in respect of . . . its dissolution, . . . the same shall be decided and determined by arbitrators; and each of the parties shall select one of such arbitrators, and the decision of two of such arbitrators, when made in writing, shall be conclusive upon the parties hereto."

"Upon the termination of this agreement either voluntarily by either party, or by the death of either party, the clients whose names now appear on the attached initialed list or whose names may later be added thereto . . . shall be

regarded as clients of Richard Roe, while all other clients shall be regarded as clients of John Smith and both parties to this agreement hereby agree to refrain for a period of three years from the rendering of any accounting service to the client of the other except as hereinafter provided."

"Upon dissolution of the firm (excepting dissolution by the death of any partner) the first parties and the second party shall each withdraw the furniture and equipment contributed by them, at the appraised value as hereinabove provided, less depreciation of 20% per annum, the said valuation to be charged to their respective capital accounts. Thereafter distribution in liquidation shall be made as the interests of the parties may appear."

"Upon dissolution of the firm an accounting shall be prepared showing work in progress. The fees to be received from such work after the dissolution shall be divided among the parties on a basis to be agreed upon at dissolution, the intent being that the proportion of interest in the partnership be maintained in such division."

Effective Date of Withdrawal

Regardless of whether or not a partnership is to be dissolved because of the death or withdrawal of a partner, the effective date may have a tax consequence. If the agreement provides that a partner's interest is to continue until the year-end, a pyramiding of two distributive shares into one taxable year will be avoided. If dissolution is desired, it can be arranged as of the fiscal year-end date. The tax aspects must be checked when the subject is under consideration because of possible changes in the law and in its interpretation.

The foregoing policy is followed in many written agreements except where the withdrawal is for the following reasons:

1. Withdrawing partner to practice independently or competitively.
2. Withdrawal is forced by the partners.

Under these circumstances the partner's interest usually terminates as of the date fixed.

Illustrations of provisions pertaining to this subject appear in the sections dealing with the various forms of withdrawal of partners and the dissolution of a firm.

Where the effective date (year-end) of a withdrawal is beyond the actual date of termination of services it is customary for the subject partner to receive all of his profit share up to the effective date. It does not always follow, however, that he also receives his salary. This arrangement is one that is set by the partners in accordance with the tone or liberality of the entire agreement.

Avoidance of Dissolution

In preceding sections of this chapter dealing with the withdrawal of a partner, for whatever reason, there are various references to the termination of the partnership. Though state laws may hold that the with-

drawal of a partner automatically dissolves the firm it does not follow that a liquidation is always necessary. In this respect, particularly, the advice of counsel will be helpful.

Some firms, particularly large ones, provide specifically that the withdrawal of a partner does not require a dissolution of the firm. This position is wise because there is no reason why the practice cannot be continued without interruption despite the withdrawal of a partner. Some arrangements will obviously be necessary to fill the vacuum but these matters can be dealt with without business interruption. A legal dissolution could be a costly, time-consuming and annoying matter and, if practical, it should be avoided.

It is with these thoughts in mind that some partnership agreements contain provisions such as the following:

"The death, retirement or withdrawal of any partner shall not dissolve the partnership between the other partners."

"In case of retirement by any partner, said partner agrees that he shall not insist upon a complete liquidation but shall withdraw upon receiving his share of capital."

"If any of the partners shall die during the existence of the partnership neither the partnership nor the interest therein of the deceased partner shall terminate but shall continue subject to the terms and conditions hereinafter set forth . . ."

There are cases, nevertheless, where a formal dissolution is unavoidable, as in the case of a withdrawal from a two-man firm or where the partners decide to dissolve the partnership.

The termination of a partnership as of the date of a withdrawal of a member may cause a pyramiding of the income of more than one partnership taxable year into one taxable year of the retiring or deceased partners. In periods of high tax rates this occurrence could be very costly.

As a practical matter, the possible tax consequences alone make it important to give this subject adequate consideration in advance.

Noncompetition Clause

A restriction against competition by a retiring or withdrawing partner is a prevalent practice. The periods involved vary and so do area limitations. An illustration of one such provision is the following:

"The withdrawn partner shall not engage directly or indirectly in the practice of accounting in or within five miles of the cities of _____ and _____, for a period of five years from the date of his withdrawal, and if, at the time of his withdrawal, his name is used in the firm name of the partnership, the partners of the continuing or successor firm shall have the right (but shall not be required) to continue such use during said 5-year period."

Other noncompetition provisions that prevail are the following:

1. Not to contact, directly or indirectly, for the purpose of securing business, any of the known clients of the firm.
2. Not to accept, without the firm's written consent, any business from any of the firm's clients.
3. Not to disclose any information as to the firm's clients or the affairs of said clients.
4. Not to refer to himself for business purposes as "formerly of" or "lately of" the firm.

One firm imposes a penalty on a partner who violates a noncompetition clause, willfully or unintentionally (at request of client), of an amount equal to 125% of one year's gross fee. Where a penalty is not fixed by mutual agreement, which is the common situation, the damages, if any, must be settled by legal action or arbitration.

Where a partner retires without receiving any retirement benefits but nevertheless is subjected to a restrictive clause, some agreements provide that he is to receive either a payment for goodwill interest or for the noncompetition agreement. Taxwise, remuneration for agreeing not to compete may be more desirable to the party making the payment than a payment for goodwill if there is a reasonable prospect that the two factors will not be held to be one and the same. This aspect is discussed at greater length in the section on income tax problems.

A noncompetition clause must not be too severe or it will run the risk of being invalid because it is against public policy. This violation was found to exist in an agreement and it resulted in a much publicized law suit. See the Appellate Division decision in *Lynch v. Bailey* which is set forth in full in *The Journal of Accountancy* in May 1950.¹⁰

Financial Statements to Fix Values for Retiring Partners and Estates

Agreements should contain provision for the preparation of financial statements to determine the value of the interest of a partner. The thought aroused in the drafting of this provision will cause more adequate consideration of all of the balance-sheet items, some of which might otherwise be viewed with indifference or ignored and yet later turn out to be important.

The provision should state the basis on which the balance sheet is to be prepared — either cash or accrual. If the records are on a cash basis but the statement is to be on an accrual basis, careful references must be made as to how some accruals are to be computed, particularly work in process, bad debt reserves, and valuations of equipment and library. Intangibles, if any, should be dealt with definitely, either to be included or excluded, and if included then the valuation basis should be fixed.

It would be helpful to provide that the statement on which a valuation

will be based be submitted to a partner who desires to retire, or to the estate of a deceased partner, and that if no objections are raised within a specified period of time it become fixed and final and free from later contention. Some agreements permit an examination of the records in this connection. Differences of opinion must be given recognition and a plan for their settlement established. One agreement covers this contingency in the following manner:

"If withdrawing partner does not accept and approve the statement within thirty days after it is furnished, the remaining partners may employ a CPA to audit the books and report on the interests of the retiring partner. His decision shall be binding and the partners agree not to institute proceedings against the remaining partners for any other accounting, except in the event of failure to pay the sum certified."

Somewhat similar provisions appear in other agreements.

In one instance it is provided that the signatures of the remaining partners on the statement make the financial statement final and beyond appeal, except as to subsequent review by the partners if a question of fact is raised. Other agreements have general arbitration clauses which would cover disputes as to financial statements.

During the period in which payments are being made to retired partners or to estates, financial statements are furnished to payees, as specified in some agreements. The right to check such statements would require agreement of the partners, if desired. It may suffice, for all practical purposes, to have the opinion as to the statements include a reference to the fact that the distributive shares for the year, paid or to be paid, are calculated in accordance with the agreement.⁴

Valuation of Work in Process

Work in process is an item which may materially affect the valuation of an interest in an accounting partnership. Inasmuch as there may be sincere differences of opinion as to the method to be employed, advance agreement on this subject is desirable.

Two principles of valuation exist—one using cost and the second using billable amounts. The cost method is probably most prevalent. The other policy prevails where there is an intent to be liberal in the valuation.

Where an accrual basis accounting system is used, and costs are charged to job cost accounts, the records will disclose the work in process and the costs accrued. In some firms, though on a cash basis, client time and cost records are nevertheless employed. Here too there may be no difficulty. Where no running record of job costs exists, then it becomes necessary that a list of unfinished matters, and the costs incurred, be drawn up. Here there may be questions as to cost determination.

Care must be taken to include matters which have been completed but which, for some reason, have not been billed.

Even the term "cost" may require some definition. Shall it include only staff salaries or shall administrative salaries be included? Shall office overhead be allocated to each job? Most agreements shed no light on these questions.

Some constructive views on the valuation of work in process appear in accounting literature. Questions and answers, on this topic, dealt with in a committee meeting reported in the *New York Certified Public Accountant*, February 1946,¹¹ are reproduced herewith to shed some further light on this subject. Other discussions will be found in the February and March 1940, issues of *The Journal of Accountancy*.^{12, 13}

"Question: In case of death of a partner, how should work-in-process be valued in case of: (a) regularly recurring audits; (b) single engagements, undertaken on a flat fee basis or at per diem rates; and (c) retainers on tax cases?

Answer: There should be provision in the partnership agreement calling for valuation of the work-in-process in the event of the death of a partner. It might provide that all work-in-process should be handled by the surviving partners, and charged upon the basis of the cost of the actual time expended in the completion of the work. . . .

A Member: I should like to relate my own experiences and, perhaps, answer this very important question — the question of valuation of work-in-process. I recently terminated a partnership and although our agreement was a good one, we were left to decide what should be done with the work-in-process. We decided, after much discussion, that the following should be done: In each case the work would be completed by the partner who would take over the service of the client; the fees would be held in trust, as a partnership asset; at the time that the work was completed, an accounting would be had. Only the actual costs would be charged to the expenses of a particular job, that is, the labor costs of the senior or junior; the excess of the amount of the fee over these costs would be divided among the partners in their profit-sharing ratio, irrespective of whether it was a per diem engagement, a tax engagement, or any other type of engagement. In other words, we 'let it ride' as long as we possibly could, until we could determine the actual net cash value of that particular job. . . .

Another Committee Member: I feel that the question of valuation of work-in-process might have been handled a bit differently, because there are accounting firms which keep their records on an accrual basis. They have cost records for individual engagements and post current costs to these cost records. It should not be too much of a problem, therefore, at the close of any period, to make some valuation of work-in-process based upon accumulated costs. Of course, as with any inventory of work-in-process, you might go beyond the recorded accumulated costs and perhaps given consideration to other factors. There are partnership agreements that provide specifically for some basis of valuing work-in-process . . ."

In the paper by Ira N. Frisbee, previously mentioned,⁹ appears the following viewpoint on the valuation of work in process:

"As to work-in-process, there are differences of opinion as to the proper basis for valuation. It may be provided that, following the death of a partner, the estate will receive the partner's share of the entire profit realized upon com-

pletion of each job in process. A more equitable arrangement, however, will provide that the estate shall receive a proportion of the final profit on each job which is to be determined by finding the ratio of the standard billing price for the work-in-process at death to the entire standard billing price of the completed job."

Where routine audit engagements are involved, the problem of valuation may be simple, as time and billing rates can be applied easily to work performed. However, where special matters are in process, the fees for which may have little relation to time and where the final date of completion is not determinable, a problem exists. Such matters may be disposed of in this manner, which is not a "cost" basis:

1. List the special matters in process.
2. Have the supervising partners indicate the stage of completion.
3. Provide that the portion of the fee earned as of the settlement date is to be fixed by the partner supervising the engagement, when it is completed.
4. Agree that the retired or deceased partner's share is to be paid upon collection of the fee.

In one agreement there appears this instance of a valuation formula not on a cost basis:

"The value of the then work-in-process shall be increased to an amount which shall be twice the cost thereof as then stated on the copartnership ledger."

It is conceivable that work-in-process costs may not be collected in full or in part. A similar risk attaches to uncollected accounts. This contingency may be met by making an allowance for doubtful items or by paying the pro-rata share to a partner when collected.

Goodwill and Valuation

There are many accountants and attorneys who contend that goodwill — that which can be evaluated and transferred — cannot exist in a personal service partnership. This view is well expressed as follows:

"Professional goodwill clings to its creator, can be dissociated from him only to a limited extent and at best is a fragile thing in other hands. There is a vast difference between furnishing an opportunity and delivering goodwill."

Those who share that feeling back it up by definite statements in their partnership agreements to the effect that goodwill is to be considered nonexistent or that no value is to be placed thereon. The latter position does not necessarily constitute a denial of its existence, and may be only a mutual understanding that it is not to be valued. In many partnership agreements no reference to goodwill appears. This may mean one of the following four possibilities: (1) that goodwill had not yet been recognized at the date of the agreement; (2) that the matter was just overlooked; (3) that goodwill was not considered to have any value or; (4) that it was intended that no value be placed on it in any event.

It has been said as to goodwill in an accounting partnership that the

elements that produce true partnership results are too intangible and too indefinable to be measured even approximately.

There are however many contrary viewpoints, as evidenced by the fact that a goodly number of partnership agreements do specifically acknowledge the existence of goodwill and provide for its valuation and purchase from the estate of a deceased partner or from a retiring partner. There probably are instances where, because of a material improvement in the status of a firm, a former denial or disregard of goodwill value has been replaced by an acknowledgement. The mere fact that individual clients and clientele have been sold demonstrates that tangible value can be placed upon such intangibles and the clientele may therefore be considered to have a goodwill value. See *Horton v. Commissioner*² and *Wyler v. Commissioner*.³

Inasmuch as agreements do not set forth the reasons for the expressed views as to goodwill — pro or con — or their reasons for making no reference to goodwill, the grounds can be surmised only by a process of rationalization.

Where it is contended that goodwill does not exist, that position may have been taken for any of these reasons:

1. The firm is relatively new or small and the existence of goodwill as a firm asset just is not visualized.
2. Clients of a deceased or retired partner may not be retained very long after the separation date.
3. The valuation of goodwill presents such complexities as to warrant its total disregard.
4. The firm represents a loose aggregation of individual practitioners and changes in membership are easily possible.
5. The firm does not have an outstanding reputation in its community and does not receive recommendations of new matters from banks, credit grantors, attorneys, and so forth.
6. The death or withdrawal of the one partner responsible for the company's growth and position will surely result in a diminution of its practice and prestige.

At this point the views of an accountant who strongly dissents from the position that goodwill exists in an accounting firm deserve consideration as supplementing the foregoing points.

"... I am one of those who believe that goodwill in the commercial sense cannot exist in a professional personal service partnership. I recognize that there are some who do accept goodwill as such but I am convinced that what they attempt to value as goodwill is in reality a combination of intangibles inherent in a going concern consisting of a cohesive group of professional persons who combine their talents to serve their clients. I believe in a retirement plan, but by the time that partial retirement is completed, the partner should have effectively transferred his clients' responsibilities and control to his associates so that there remains no goodwill to be purchased from him. I consider a payment or series of payments to a deceased partner to be in lieu of retirement rather than a purchase of his clients under the name of 'goodwill.'

Perhaps the two-partner type of firm has a different and more difficult problem of evaluating the amount to be paid by the survivor to the deceased partner's estate. But, in my opinion, such a payment is merely a fair recognition of the future earnings which he helped create and which are realized after his death, and not a purchase of goodwill."

As to those who do make provision for goodwill they may have done so for any of these reasons:

1. The firm enjoys an outstanding reputation and receives recommendations of new matters from banks and other sources because of its record of good work and service, and the firm's status does not depend on any one partner.
2. The firm's policy is such as to have more than one partner acquainted with each client and the loss of one partner would not likely result in the loss of clients on a large scale.
3. The relations between the firm and many of its clients have extended over a long term, have been satisfactory, and have resulted in an accumulation of such intimate knowledge of clients' affairs, that, barring any deterioration in future services, the relations should continue indefinitely, regardless of changes in one principal or executive on either side. The loss of a few clients due to the withdrawal of a partner may not necessarily be serious and does not negate the possibility of the existence of goodwill.
4. Other accountants would gladly pay some amount, small or large, for goodwill to become a partner in, or to acquire the clientele of, certain accounting firms.

The following illustrations of goodwill clauses will be helpful as guides:

"It is agreed between the parties hereto that the goodwill of the partnership has at any date a value equal to 25% of the collectible charges (fees) whether billed, accrued or work in process, for services rendered (the gross value of such services) during the two years immediately succeeding such date . . ."

"This account (partner's capital account) will also be adjusted to reflect the fluctuation in the valuation of the goodwill of the partnership, which shall be determined as of the last day of each fiscal year of the partnership as follows: By computing the average of the annual profits of the partnership and including if necessary those of the preceding partnership or partnerships, which have accrued to the capital interests during the three years next preceding the end of such fiscal year, and multiplying the amount of such average profits by one and two-thirds."

". . . goodwill arises only in the event of the death of an active partner in which case a 10% commission on business classified as his is paid to his survivors for a period of three years."

"Policies of term insurance are to be taken out . . . for the term of the aforementioned partnership . . . and upon the death of either (partner) the amount paid thereunder shall represent the deceased person's interest in the accounts and goodwill of the partnership. . . ."

"Upon the dissolution of the firm by the death of a party there shall be added to the regular assets of the firm a sum for the value of the firm's goodwill, which shall be credited among the partners (surviving and deceased) according to the profit-share ratio as above provided. The sum to be added to the assets as goodwill shall be equal to one-third of the total of the gross yearly charges of the firm for services for the fiscal year then last past. If the period

be less than one year the amount charged in such period shall be increased as the proportion of the period covered bears to a full year."

Another provision worth noting is one which, in effect, provides that on the death of a partner, the surviving senior partners shall acquire his interest by paying a stipulated sum over a period of five years.

Illustrations of the disavowal or nominal value of goodwill are the following:

"There shall be no increase in the book value of furniture, equipment, library or tax services; nor shall any value be placed on goodwill, the evanescent nature of which is recognized."

"Because of the personal nature of the business of accounting, the parties hereto realize that the value of the goodwill of the partnership, if any, is nominal. No partner, withdrawn or retired partner, or estate of a deceased partner shall have any individual or separate interest in the goodwill of the partnership, if any,"

"There shall be no value placed on the goodwill of the partnership name at any time in computing the capital invested either for original investment or for the liquidation of the partnership."

"All rights which any partner may have enjoyed in the firm name, established business, and so forth shall pass immediately upon death to the surviving partners, in consideration of the terms and conditions set forth in this Paragraph" (*Author's Note:* The consideration referred to is the participation by the estate in the firm's earnings for a limited period).

"Amounts to be paid to the estate of a deceased partner or to an involuntarily retiring partner for its or his interest in the business shall include no sum of money for goodwill in the partnership, which shall be deemed to have no value, but there shall be paid to the estate of a deceased partner or to an involuntarily retiring partner in accordance with the terms hereof, additional sums" (*Author's Note:* The additional sums vary amongst partners and, briefly, constitute a year's salary plus an excess over the amount of such salary determined from a computation of the partners' average earnings).

"Upon dissolution the right to use firm name and goodwill shall pass to any firm designated by ___% in interest of the partners, but not otherwise, it being expressly understood that each partner and associate waives all claims for compensation for goodwill or use of firm name in event of withdrawal, or death, or dissolution, and use of name by firm in which he is not included."

To insure a mutual understanding of the term goodwill, the following definition and pertinent comments will be found helpful:

The term goodwill is used in this discussion as encompassing certain intangibles which may acquire value by virtue of their apparent permanence or because they may be salable. Included therein are factors such as (1) firm prestige, (2) profitableness of the practice, (3) better-than-average organization of partners and staff, (4) the ability to retain clients

despite changes in principals in the accountant's or client's organization, (5) the possibility of transferring clients for a consideration.

Intangibles, for the most part, develop and grow at a moderate pace. For that reason, and because of their very nature, the creation of these values may just not be given any unusual consideration.

Nothing can deteriorate so quickly as confidence and goodwill. This is one of the major reasons for the long-held views that goodwill does not have a tangible value in a personal service, professional organization. Nevertheless, despite that hazard, there are quite a few old and illustrious firm names in the accounting field and many small firms that are soundly entrenched in their communities.

Here are several additional factors which should be considered before one reaches a decision to adopt a goodwill basis or a retirement basis and death benefit basis. Each of these methods has different tax implications.

1. A fair retirement plan is more suitable, in the case of medium and large firms, than compensation for an interest in a firm's goodwill. A pension is gratifying and honorable reward for past services by a partner, no different than for a stockholder-officer of a corporation. For small firms a retirement plan may not be feasible. If a partner dies before retirement, payments may be made to his estate in partial payment for retirement allowances he might otherwise eventually have received. However, the tax effect of retirement payments to a partner, or to his estate, may not necessarily give the payor an ordinary tax deduction. But in the absence of a retirement plan, some other recognition should be given to the intangible values inherent in the firm.
2. The presence of a goodwill value in a practice may be disregarded even where, in fact, it may actually exist. This is a voluntary arrangement and undoubtedly binding upon the partners. However, this position should not be taken merely because of the complexity of the valuation, as is sometimes the case, unless the amount involved is not material. Where, however, goodwill is disavowed and yet payments are provided for, which are not clearly distinguishable, the substance may overcome the form.
3. Regardless of the possibility that goodwill may exist, and even if no consideration therefor is fixed (which is the privilege of the contracting parties), payments may be made to an estate of a deceased partner for past services of the partner and any assistance that the estate may furnish in retaining the clients supervised by the deceased partner. Payments may be made annually to retired partners for being available for advisory or consultation services, for services in helping retain the clients whom they used to contact, and for agreeing to refrain from entering into any competitive practice. Such payments should not be considered alternatives of goodwill for, in fact, some of them might well be made in addition to goodwill payments, if so desired.
4. Since the specific payment of goodwill is not tax deductible, it would be well to consider the use of life insurance to help finance the burden and assure partners of compliance with such provision.
5. Where there is no insurance cushion, goodwill payments might be made over a period up to three years, perhaps providing some security for the payment of this obligation. Elsewhere in the chapter, reference has been made to security provisions for retirement plans, which provisions are applicable as well to goodwill payments.

The valuation of goodwill, where recognized may be based on one of the three common methods in use.

These are:

1. Capitalization of earnings.
2. Capitalization of fees.
3. Fixed amount, settled by insurance proceeds or otherwise.

Though these valuation methods may in some respects resemble those used in calculating retirement allowances, the similarity in itself should not result in a conclusion that a retirement plan necessarily encompasses goodwill.

As to the earnings method, at least one year's earnings averaged over the past three to five years is a fair minimum. If more than one year's earnings are to be used as a base, then the average should be spread over at least the past five to ten years. Five years' earnings is probably the maximum goodwill valuation base, as a practical matter, and a factor of two to three times average earnings may be adequate in a majority of cases.

The goodwill valuation may be made for the partnership as a whole, and the subject partner's capital percentage share thereof determined, or the subject partner's individual earnings used as the base. It is not possible to determine in advance which of these two methods is preferable but the former one appears to be more common.

Another factor requiring consideration is the definition of earnings — is it the amount before or after partners' salaries, if any? Where such salaries are to be consolidated with earnings, the "times earnings" factor obviously cannot be as large as where such salaries are excluded from earnings.

With respect to the "fees" basis for valuation, 30% of a year's billings appears to be the lowest valuation base used, insofar as could be established.

Other reported methods use equivalents of 33⅓% and 50%. The amounts used are the billings of the past one or two years. These percentages appear somewhat inconsistent with the fact that the price placed on a clientele where a sale is involved ranges from two-thirds to one year's gross billings, and is seemingly low in relation to the net profit bases, assuming that partners' salaries (if any) are not treated as an expense.

In an article entitled "Valuation of Goodwill in an Accounting Practice"¹⁴ in the *New York Certified Public Accountant*, June 1946, there are several references to valuation placed on clienteles. Some of these references relate to the following quotations which are noteworthy because valuation of clientele may, for all practical purposes, be synonymous with valuation of goodwill:

"An arrangement which has been found satisfactory is to give the seller pay-

ment for tangibles and agree to give him, say 100% of the earnings for each of the two years following the date of the sale and 50% of the earnings of the third and fourth years."¹⁵

"The better plan for a purchaser would, I think, be to establish some relationship under which he would give a commission to the vendor based on the actual fees received out of a certain designated list of clients, such commission being restricted to, say, from 15% to 20% of gross fees, at the outside, and for a limited period only, say three years."¹⁵

"I am inclined to suggest that the fairest method, both to the buyer and the seller, would be for the buyer to undertake to pay to the seller a percentage upon each gross fee for each of a period of years. . . . The percentage might range anywhere from 10% to 20% upon each fee, and the period of time over which these payments would be payable might range from five to ten years. Naturally, if the percentage agreed upon should approach the higher limit just mentioned, the period of years would tend to be reduced."¹⁶

"A method which is growing in favor . . . is . . . that business should be transferred from one practitioner to another . . . on one year's purchase of the gross fees, payment being spread over three years on the understanding that no payment will be made in respect of work which is not renewed to the purchaser. In respect of any appointments which are not renewed in the second or third year the purchaser is entitled to reduce the payment due for goodwill in that year by a proportionate amount."¹⁷

There also is a plan suggested by Mr. Frisbee in his article⁹ on partnership agreements. This calls for payment for goodwill in declining percentages of gross fees, annually, on this scale: 8%, 7%, 6%, 5%, 4%, 3%, 2%, 1%, and then no more.

Where recognized, one year's billings from accounts secured or supervised actively by the partner, is a fair basis for goodwill valuation in a well-knit, homogeneous firm, where the likelihood of retention of clients is considered to be good. This is in line, it is felt, with the previous suggestion that on an earnings basis goodwill may in many cases be valued at two or three times earnings.

As to the use of a predetermined, fixed amount for the goodwill valuation, its sole merit is simplicity — no formula to be fixed and no calculations to be made thereafter. However, arriving at the amount is no simple matter in itself and it may well be based on one of the formulas here reviewed. But, as the firm's position changes, an inequity may develop unless the amount is revised.

The views of other writers on the subject of goodwill in an accounting practice are worthy of presentation herein. This excerpt from the paper by Ira N. Frisbee⁹ is enlightening:

"Under the condition of a gradual retirement of a living partner for whom a salary is provided after retirement, the need for goodwill valuation is not acute. In such a situation, during the period of the partial retirement, a successor partner or partners are to be developed to carry on the business and to increase the goodwill. But for a retirement that is to occur entirely at a definite date, a valuation formula should be set forth in the partnership agreement, particularly if the retiring partner is a founder of the business.

A common basis is to take as the goodwill value from one to two years' profits, computed by finding the average annual net income for the past three or more years. Such an amount may be varied according to the number of years the partner has been in the firm, or for other reasons, and often it includes his share of the entire income, including so-called partners' salaries and interest on investment, rather than the excess of profits over salary and interest.

A rather interesting and seemingly fair method of paying for goodwill is on the basis of a reducing percentage of the gross fees in subsequent period. Thus, as high as 8% of the entire gross income might be paid the first year after retirement or death and 1% less in each succeeding year, such as 7% the second, and 6% the third, until eight years have elapsed when no more payments are to be made. Although the payments are based upon gross income they do not qualify as an expense of the continuing partnership but are to be treated as a purchase of goodwill. From the standpoint of the retiring partner or his estate the plan may have considerable appeal because a larger total payment will be expected under such an extended plan than would be received if settlement were in a lump sum. The burden of payment by the remaining partners should be lighter because of the deferral over several years and also because the amount depends upon the volume of work obtained.

The lump sum settlement, based upon a valuation formula that depends upon past profits, appears to be quite common and it has the advantage that there is a definite determinable goodwill value for estate tax purposes. Leniency in the provision for payment can be provided by permitting several semiannual, or even annual, payments."

An interesting observation is made by George Rea in *The Journal of Accountancy*, October 1948.¹⁸ Discussing how to figure the purchase price of the practice of a single proprietorship, or of a partnership all of whose members will withdraw, he remarks parenthetically, "The continuance of one or more partners creates a condition in which a higher proportionate value should be placed on the retiring partner's interest." In effect, he stresses the fact that there is an appreciable difference in value dependent upon the "going-concern" or "sell-out" aspects of the transfer.

Rights to Firm Name

In the case of well-established firms, the firm name may be the most important intangible asset. Partners of all firms are concerned to keep it free from blemish and to enhance its standing within the profession and in business circles. So valuable is the firm name that its ownership and use are jealously guarded. In many instances the firm name and goodwill are closely linked.

Agreements usually fix the firm name. Title to the name in the event of death or retirement of a partner, or a dissolution of the firm, is fixed in many agreements. In some, the firm name belongs to one partner (usually a "one senior partner" firm), in some it belongs to all partners. There are agreements which prohibit the use of a retired or deceased partner's name whereas others, to the contrary, specifically permit it.

Illustrations of provisions dealing with "one-man" title to a firm name are the following:

"No partner, other than _____, shall use the firm name either alone or in conjunction with his own name or use any other combination of words containing the firm name."

"It is hereby understood and agreed that the firm name 'X & Company' is the exclusive property of the managing partner, and that upon dissolution of the partnership by expiration; upon voluntary retirement of any of the partners; . . . upon dissolution by death . . . ; or any other change or dissolution, the firm name 'X & Company' shall be the exclusive property of . . . 'X' and shall be subject to transfer with his goodwill only in the event of his death or in the event of his voluntary sale thereof."

"In case of the dissolution or termination of the partnership 'A' shall have the sole and exclusive right to partnership name and to the use thereof, and 'B' shall not either directly or indirectly use the same."

The following provisions pertain to situations arising from the death or retirement of a partner:

"Each partner agrees, however, that the firm may continue to use his name in its business after his death without compensation, if the surviving partners shall so elect."

"The firm name _____ shall belong to and may be used by the partnership and shall not be sold or disposed of so long as the partnership shall continue in existence.

Upon the dissolution of the partnership or the termination thereof as provided in Article ____ hereof, the firm name shall become the property of the then surviving administrative partners and may be disposed of in such manner and upon such terms as a majority in interest of the administrative partners shall determine.

In the event of the death, retirement, or withdrawal of any of the partners during the term of the partnership, the deceased, retiring, or withdrawing partner shall have no interest in the firm name and shall have no right to receive any payment therefor."

"The continuing partners and their successors, if any, shall have the right to use the name of the retired partner in the style or title of the firm name."

"Therefore, mutually understood and agreed that upon the death of any or all of the partners of the first part, the surviving partners will pay to the estate of the deceased partner \$_____ for the relinquishment of any rights he or his estate may have in the firm name of _____, this payment to be made in five equal instalments, beginning within one year from date of death."

"If, at the time of death or retirement of a partner, his name is used in the firm name of the partnership, the partners of the continuing or successor firm shall have the right, but shall not be required, to continue such use."

"The Managing Board may at any time, by unanimous consent of the good-will partners, change the partnership name, otherwise the name shall not be changed on account of the decease or retirement of any partner whose name

appears as part of the firm name. If, however, the partnership shall at any time become insolvent, which shall be held to include not only an excess of liability over assets but also inability to pay or extend partnership obligations, then any partner who shall have retired from the firm shall have the right to require his name to be dropped from the firm name."

Plans for Payment of Capital and Other Balances

The plan for the liquidation of a partner's interest should be carefully considered and drawn up. It should provide for full or installment payments; fix the dates thereof; state whether or not interest is payable; cover defaults; fix security, if any is to be furnished; and such other clauses as the parties deem advisable. Here, as in other instances, there is variety in the plans in use.

Where the amount to be paid out is relatively small, the payment may be in full within thirty days after determination of the total due. Should the amount involved be substantial, the payments might extend over a period of several years.

If payments are to be made over an extended term, security provisions might be considered. A few agreements contain such clauses, illustrated in the following section.

The methods in use, as ascertained from the agreements and other data analyzed, are disclosed by the following representative arrangements:

"In the absence of any agreement to the contrary the total amount due a withdrawing partner because of balances in capital and drawing accounts shall be paid in cash within a period of ninety days from the effective date of this withdrawal."

"However, if such purchase settlement exceeds \$5,000, the surviving and continuing partners may, if they elect, limit their payments to \$5,000 per year by giving notes bearing 5% interest evidencing the unpaid balance."

"Balance due the estate to be paid within twenty-four months."

". . . the capital interest of a deceased partner shall be determined and settled as soon as possible but in not more than five years from date of death payable in equal quarterly installments without interest. . . ."

Representative Clauses

Each of the following represents a summarization of provisions appearing in partnership agreements:

1. The partner's stated capital shall be paid in six equal semiannual installments, commencing six months after separation.
2. The share of the distributable profits, to date of separation, shall be paid in the ensuing fiscal year as the majority of the administrative partners may determine.
3. Other indebtednesses to the partner, if any, are payable at the separation date.
4. Remaining partners agree to reduce their participation in profits by 10% until all payments to estate of senior partner are completed. Also, to take out

enough life insurance in favor of estate to guarantee their pro-rata share of payments.

1. *Tangible Capital*: Estimated one-half within six months, and the balance within one year from date of death or retirement, or within one month after realization (of assets constituting capital) if not realized within 1-year period.
2. *Intangible Capital (Goodwill)*: First payment — eighteen months after retirement or death, and balance semiannually until balance is paid.

1. A stipulated sum for the goodwill share payable over a period of five years.
2. The balance in his capital account payable within six months after death.
3. The deceased partner's share of the net profits on an accrual basis to the last day of the month immediately preceding the date of the death and payable within sixty days after death.

His capital shall be paid in quarterly installments during the fiscal year following the date of termination of the partnership.

1. Undrawn earnings (capital and profit share on a cash basis) — payable within thirty days after end of fiscal year in which death occurs.
2. Share of uncollected fees — included as part of profit share payable to estate from income of next three years.
3. Fees unpaid after three years — estimated amount realizable to be paid with profit share for third year.

1. Cash basis capital — due immediately.
2. Pro-rata share of collections of accounts receivable — payable on 10th day after month of collection.

1. *Rights in Firm Name*: Payable in five equal installments beginning within one year from date of death.
2. *Tangible Capital*: Payable in three annual installments beginning within one year from date of death.

1. *Tangible Capital*: As soon as practical, but in any event within sixty days after withdrawal or death.
2. *Goodwill*: Monthly payments until paid off out of collections from fees in accordance with formula therefor.

These above provisions as to tangible capital and goodwill are modified for new partners, as follows:

"It is further agreed that the provisions . . . in respect to death or voluntary withdrawal . . . shall not apply to the 'new partners' if death or withdrawal . . . occur within a period of four years from the date of this agreement. In such event (they) shall be paid . . . the amount of cash that he or they paid for the interest acquired . . ., and this amount shall be the purchase price of his or their interest in the partnership instead of the amounts set forth in Paragraphs _____. It is further agreed that in such event the prohibitions set forth in Paragraph _____ on engaging in public practice shall not apply."

The payment of capital and profit-share to a partner forced to retire from a firm is specified in one agreement as follows:

"His interest in the capital shall be paid to him by the remaining partners, without any interest thereon, in four equal quarterly installments commencing

three months after the date of his expulsion, and the balance of his share of the profits shall be paid to him when ascertained after the end of the fiscal year. . . .”

In another agreement, provisions for payment of tangible capital are set up somewhat as follows:

Tangible Capital:

1. Twenty-five per cent of the estimated amount payable at the end of three months after retirement or death.
2. Fifteen per cent of the estimated amount at the end of the next four 3-month periods.
3. The balance, which will then have been determined, is payable at expiration of eighteen months.
4. Unpaid balances bear interest at 5%.

Goodwill:

Payable in forty-eight consecutive monthly installments.

Other Agreements

Some agreements vary the terms of payment dependent on the reasons for the separation. One agreement provides that capital be paid out in equal quarterly installments, without interest, over a period of one year in the event of retirement. In the event of death, however, the payments are extended over a 3-year period.

Another agreement calls for payments of capital balances to an estate in twelve equal monthly installments, but in ninety days to a retiring partner.

Withdrawing partners apparently are paid in shorter periods than estates, presumably on the ground that they may desire to use the funds as soon as obtainable.

The question of what is to be done about payments in the event a partner dies while receiving retirement pay is not referred to except in very few agreements. One contract states that unpaid balances are to be paid to the partner's estate. Where the agreement is silent can it be assumed that the balance will be paid to the estate? Because of such a possibility, it is important that, where it is so desired, payments to a retired or withdrawn partner definitely constitute a liability.

A final problem under this topic heading has an income tax aspect. It pertains to the taxability of capital to the recipient where it represents a share of uncollected fees not previously taxed and the pyramiding of such income in one taxable year. The continuing partners also have a problem as to the status of payments made by a cash-basis partnership of amounts representing uncollected fees not yet subject to tax. This situation is discussed in the section devoted to tax problems of an accounting partnership.

The tax considerations may influence the provisions and the term of years over which payments are to be made.

Security for Capital and Other Payments

The question of securing the payment of retirement (or death) benefits, though apparently rarely considered, nevertheless is deserving of some thought prior to a decision to provide for it or disregard it.

There are several methods of providing for security, each having its own peculiar appeal:

1. An agreement that retirement allowances are to be treated as an expense prior to partners' salaries and profit shares. This provision can be varied as to the amount or percentage of preference.
2. An agreement to invest a percentage of the firm's annual profits in a fund to guarantee the payment of the benefits. The fund could be started before any benefits are payable, to help build it up to a specified maximum as quickly as possible. A suggestion as to a satisfactory level is the following: An amount sufficient to pay the largest potential benefit claim (retirement or death) of an active partner with additions for the unpaid claims of retired and deceased partners. Obviously the funds should be invested to earn an increment and provision must therefore be made for the form of investment, custody, and accounting. The contributions to the fund made by retired or deceased partners during their active periods are to be refunded because they are equivalent to capital account investments.
3. A one premium annuity contract purchased at the date of retirement, to transfer the responsibility for payments from the firm to an insurance company.
4. The acceptance of the retirement payment by the remaining partners as personal liabilities in the event of subsequent disposal of part or all of the firm, merger, dissolution, and other changes.
5. A provision that a default in the plan calls for a liquidation of the firm unless remedied within a short stated period.

In one agreement there is a provision that in the event a firm should split up after the senior partner's death and before payment is completed in full for the assets and practice, the estate should decide whether (1) to accept from each remaining partner a sum representing his share of the total due the estate or (2) to sell the assets and the practice on the open market to the highest bidder. It continues:

"In the event this option (No. 2) is elected by the estate, the remaining partners agree hereby (not) to induce any of the accounts of the firm to accept them as their accountant, in place of the firm. In the event a client of the firm, of his own volition, should elect to retain one of the partners, said partner agrees, in order to maintain the corpus of the senior partner's estate and to avoid any legal action, to pay the estate a sum equal to 125% of the fees received from said client over the twelve months preceding separation or death of senior partner, such sum to be paid quarterly in equal payments over a period of two years."

In one agreement the estate of a deceased partner leases to the survivor its interest in "goodwill, files, correspondence, and clientele owned by (deceased partner)." The monthly rental is 20% of all amounts earned by the survivor while using the firm name (which he is required to

do for five years) for a period of five years. In addition, the survivor has an option to buy the leased items, at the end of the term, for \$100.

In another agreement, in the event of default in the terms or failure to exercise the option "the representative of said estate shall have the right to sell the goodwill herein mentioned to others, retaining as liquidated damages any and all amounts that may have been paid under this paragraph by the party of the second part."

Another security provision worthy of note requires that, during the period during which there is a liability to a retired partner or to the estate of a deceased partner, all remaining partners are to reduce their profit shares by 10% to preserve cash and assure the payments, and to take out enough life insurance in favor of the estate to guarantee their pro-rata share of payments.

Life Insurance

The use of life insurance as a means of assuring the availability of funds for the liquidation of the interest of a deceased partner is fairly widespread. However, certain accounting factors must be considered in agreeing on the settlements, to avoid unforeseen inequities. These factors involve the accounting treatment of the premiums paid, and their offset against the insurance proceeds.

There are instances where the life insurance proceeds constitute full payment for the deceased partner's interest in the firm and, in some cases, in the goodwill. This may be a dangerous situation if there is laxity in revising the insurance in conformity with changes in the firm's position. It would be more reasonable to apply the proceeds as a minimum payment on account of the value placed on the partner's share.

In some instances the insurance is paid to the firm, in others directly to the surviving partners. Legal security probably should be the guiding consideration in selecting the beneficiary.

The treatment of the payment of the premiums and proceeds varies, as indicated in the following illustrations:

"... the cost for the premiums of said policies shall be considered a business expense and charged to the partnership business."

"Whereas, the annual premiums on said policies are paid out of the profits and proceeds of the partnership business; ... it is agreed; ... the proceeds of insurance on his death paid to the surviving partners shall be used to pay the estate of the deceased partner the amount of (his) undrawn earnings (capital) in the partnership. In the event that the proceeds of life insurance exceed the undrawn earnings the excess shall be paid into the partnership funds.

... the surviving partners shall participate in the proceeds of life insurance in the ratio of the division of partnership earnings ..."

"Whereas the partnership has taken out a policy of group life insurance, which includes insurance on the lives of the partners, which insurance is pay-

able, as to the partners, to beneficiaries named by them, and not to the partnership, it is agreed that insurance payments made to such beneficiaries shall be construed in effect to belong to the partnership as it was constituted prior to the decease of the partner involved to the extent hereinafter set forth, and the current account of such partner shall be charged with the amount of such payment up to the amount of his current account balance, and any remaining part to his capital or other accounts, with the same force and effect as if the partnership had paid such sum to or for the account of the partner involved, except as hereinafter next provided. If the sum paid by the insurance company shall exceed the aggregate of all sums found to be due by the partnership to the estate of the deceased partner (after his current account has been credited with his share of the amount of the insurance money), such excess shall not be required to be repaid to the partnership."

Insurance premiums expense, in one case, is charged to partners other than the insured except that the amount in excess of the term rate is charged to the account of the insured.

Obviously, the insurability of partners is a condition precedent to an insurance plan. Where only one of several partners is not insurable, it may nevertheless be desirable to utilize insurance to the extent possible.

Summaries of provisions in two agreements state:

1. Insurance premiums are paid by the firm but charged to the beneficiaries of the policies.
2. In ultimate effect, insurance premiums are paid by all of the partners other than the partner upon whose life the insurance is carried. The premiums are paid by the partnership for account of such partners. That part of the premium which represents the (increase in the) cash surrender value of policies is carried continuously as an account receivable against the interested partners. . . .

Division of Interest of Withdrawn Partners Among Remaining Partners

In the event of the death of a partner, or withdrawal for any reason, it is generally provided that his interest is to be apportioned among the continuing partners in accordance with their respective profit-sharing interests.

A companion provision calls for compliance by the estate or retired partner, in making legally and otherwise effective the transfer of the interest to the remaining partners. The following are representative provisions:

"The retiring partner, upon receipt of the payments mentioned in subdivision ____ of this paragraph ____, shall be deemed to have assigned, transferred, and set over to the continuing partners, all of his right, title, and interest in and to the assets of the partnership, without any further act on the part of such retiring partner. Such retiring partner shall, upon request, execute, acknowledge and deliver such instruments and perform such acts as the continuing partners may require in order to more effectively vest in them all the retiring partner's said right, title, and interest in and to said assets."

"The percentage of profits to which any retiring partner is entitled shall, following his retirement, be added to the percentages of the remaining partners in the proportion that the percentage of each remaining partner as set forth in subdivision ____ of Paragraph ____ bears to the total percentage of all the remaining partners as set forth in said subdivision _____. Similar adjustment shall be made with respect to percentage of losses, the percentages in subdivision ____ of Paragraph ____ being used for such purpose."

Some agreements refer to the acquisition of an interest in the form of a "buy-sell" provision whereby the firm acquires the partner's share for a stated consideration. This is usually done where goodwill is valued in determining capital, but it also may be applicable where rights to a firm name and other intangibles are involved. The word "buy," however, may raise tax implications that perhaps were not intended.

As a matter of caution, one agreement holds that the transfer of the interest takes place only after the stipulated payments have been made in full.

Arbitration

A significant number of agreements provide that disagreements which cannot be settled by the partners are to be submitted for arbitration. In some instances the American Arbitration Association is specified as the agency for this purpose. The following is a provision appearing in one agreement:

"That if any disagreement shall arise between the parties, in respect of the conduct of the partnership business, or of its dissolution, or in respect of any other matter, cause, or thing, whatsoever, not herein otherwise provided for, the same shall be decided and determined by arbitrators; and each of the parties shall select one of the arbitrators, and the decision of two of such arbitrators, when made in writing, shall be conclusive upon the parties hereto."

As a rule, such provisions provide that the two designated arbitrators select a third and that a decision of two of the three is conclusive. A typical, blanket provision is the following:

"Any controversy or claim arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the Rules, then obtaining, of the American Arbitration Association, and judgment upon the award rendered may be entered in the highest court of the forum, state or Federal, having jurisdiction."

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Appendix A

SPECIMEN FORM OF PARTNERSHIP AGREEMENT *

(Reprinted from pages 30-35, Volume 1, *Current Legal Forms with Tax Analysis*, by Rabkin and Johnson. Copyrighted 1948 by Matthew Bender & Company, Inc., 253 Orange Street, Albany, New York.)

AGREEMENT made January 2, 1947, among Henry Ayers, of New York, N. Y., Richard Bolton, of Forest Hills, N. Y., Bruce Clark, of Rye, N. Y., James Davis, of New York, N. Y., and George Wilson, of New York, N. Y.

1. *Name and Business.* The parties do hereby form a partnership to engage in the practice of public accountancy under the name of Ayers, Bolton, and Clark, the principal office to be in New York, N. Y.

2. *Term.* The partnership shall begin on January 1, 1947, and shall continue until terminated as herein provided.

3. *Capital.* Whenever required in the business of the partnership, capital shall be contributed by the partners in the proportions in which they share in partnership profits and losses. This paragraph shall not apply to the estate of a deceased partner.

4. *Profit and Loss.* The net profits of the partnership shall be divided and the net losses of the partnership shall be borne in the following proportions, except that all losses resulting from the wrongful act or gross negligence of any partner shall be charged to him in full:

Henry Ayers	40%
Richard Bolton	30%
Bruce Clark	20%
James Davis	5%
George Wilson	5%

The senior partners shall have the right to adjust the bases of participation by junior partners in profits and losses without the consent of the junior partners.

5. *Salaries and Drawings.* Any partner, except the estate of a deceased partner, shall have the right to draw against anticipated earnings, in monthly installments, an amount not in excess of 85% of his earnings for the preceding year, but in no event shall a partner's withdrawals exceed his interest in the partnership business. Any amounts so withdrawn shall be charged against that partner's distributive share of the

* This form provides for payment to a deceased partner's estate of a percentage of partnership income for a specified period after death. Readers interested in such a provision should examine carefully the explanatory comment of Messrs. Rabkin and Johnson as to the tax aspects and significance of such a provision. This comment appears on page 29, Volume 1 of their work immediately preceding the form.

profits of the partnership business. Any partner shall have the right, at the end of any calendar year, to withdraw the balance of his share of the partnership profits for that year. The drawings of partners during the first year of the partnership shall be agreed upon among all the partners.

6. *Interest.* No interest shall be paid to partners on any contributions to capital.

7. *Management, Duties and Restrictions.* The partnership shall be composed of senior partners and junior partners. Henry Ayers, Richard Bolton, and Bruce Clark shall be senior partners. The senior partners shall have the right to admit additional partners upon such terms as they may determine, but the participation percentage in net earnings of the estate of a deceased partner shall not be altered nor the period of participation curtailed. All of the partners shall participate in the conduct of partnership affairs and each partner shall devote his entire time thereto. In matters relating to the general management of the partnership business, a decision by the majority of the partners shall be binding upon the partnership, but on questions of firm policy the decision of a majority of the senior partners shall prevail. The estate of a deceased partner shall continue as a member of the partnership as herein-after provided, but such estate shall have no voice in the management of the partnership business.

8. *Banking.* All funds of the partnership are to be deposited in its name in such checking account or accounts as shall be designated by the partners. All withdrawals therefrom are to be made upon checks signed by any senior partner.

9. *Books.* The partnership books shall be maintained at the principal office of the partnership, and any partner shall at all times have access thereto. The books shall be kept on a cash basis, and shall be closed and balanced at the end of each calendar year. An audit shall be made as of the closing date.

10. *Termination.* In the event of the retirement of any partner or the voluntary liquidation of the partnership, the following procedure shall be observed:

a. *Retirement.* Any partner shall have the right to retire from the partnership at the end of any calendar year. Written notice of intention to retire shall be served upon the other partners at the office of the partnership at least three months before the end of the calendar year. The retirement of any partner shall have no effect upon the continuance of the partnership business. The partnership books shall be closed at the end of the calendar year in the regular way and the retiring partner shall be paid the amount of his capital account as then shown on the partnership books. Any partner who voluntarily withdraws from the partnership in accordance with the provisions of this paragraph shall not receive the benefits which accrue where withdrawal is caused by the death of a partner. The remaining partners, together with any new partners, shall have the right to continue the business under the same firm name, and if the business is so continued, the retiring partner shall not engage in the

practice of public accountancy in the State of New York, except as an employee, for a period of two years from the date of retirement.

b. *Liquidation.* In the event that all of the partners agree to terminate the partnership business, they shall share in any profits and losses of the business during the period of liquidation in the same proportions in which they shared the profits and losses prior to the termination of the partnership business. The proceeds of liquidation shall be distributed first in proportionate discharge of the undrawn earnings of the partners, then in such manner as to make the capital accounts of the partners proportionate to the capital accounts in the partnership as at the date of its organization, and the balance shall be distributed in proportionate discharge of the respective capital accounts of the partners. Notwithstanding the foregoing, if the surviving partners terminate the partnership before the expiration of the 5-year period following the end of the month in which a partner dies, the capital interest of a deceased partner and the post-death share of the earnings of the estate of a deceased partner, as hereinafter provided, shall be paid in full out of the liquidation proceeds of the partnership before any sums shall be paid to the surviving partners. For this purpose the earnings attributable to the estate of a deceased partner for the balance of the 5-year period shall be computed on the basis of the average annual net earnings of the partnership for the two preceding calendar years.

11. *Death.* Upon the death of any partner the partnership business shall not terminate but shall be continued as a partnership among the surviving partners and the estate of a deceased partner. In such event the division of income and the payment of the deceased partner's capital shall be as follows:

a. *Income.* The estate of a deceased partner shall participate in the net earnings and net losses of the partnership for a period of five years, from the first day of the month following the month of death of the partner, in the following proportions:

Henry Ayers	20%
Richard Bolton	15%
Bruce Clark	10%
James Davis	3%
George Wilson	3%

The share of profits to which the estate of a deceased partner is entitled shall be paid to the estate in quarterly installments based upon 85% of the participation of the deceased partner or of the estate in the net profits of the preceding year. Any necessary adjustments shall be made upon the closing of the books for each calendar year, and the final adjustment shall be made at the end of the 5-year participation period. Payments to the estate under this paragraph shall be based on calendar year quarterly periods, the first payment to cover the calendar year quarter ending next after the death of the partner, and the final payment to be made at the end of the 5-year period. To absorb the difference between the deceased partner's proportionate interest in the profits of the partnership and the participation percentage of his estate, the interests of the surviving partners in the partnership shall be increased in the proportions of their respective interests as stated in Paragraph 4.

b. *Capital.* The interest of a deceased partner in the capital of the partnership shall be determined as of the end of the month in which his death occurs, and shall be paid to his estate in equal quarterly installments, without interest, over a period of five years, the first payment to be made at the end of the

calendar year quarter in which the death occurs. The deceased partner's capital interest shall equal the sum of the following items:

1. His capital account as shown on the partnership books at the beginning of the calendar year in which his death occurred, increased by his share of partnership profits or decreased by his share of partnership losses for the period from the beginning of the calendar year in which his death occurred until the end of the month in which his death occurred, reduced by his drawings during such period.

2. His share of the value of the work in process at the time of death, which value shall be estimated by the surviving partners. The amount so payable with respect to work in process shall be capitalized on the partnership books. When the partnership shall receive payment on account of such work in process, the share attributable to the decedent shall be credited to that account, and shall be deducted in computing the amount otherwise payable to the estate under subdivision (a) of this paragraph.

12. *Termination of Deceased Partner's Interest.* When the estate of a deceased partner shall have received the payments provided in Paragraphs 10 and 11, such estate shall have no further interest in the partnership or in the partnership assets and property.

13. *Use of Name of Deceased Partner.* The surviving partners shall have the right to continue to use the name of any deceased partner in the partnership name.

14. *Expulsion.* In the event that any partner shall violate any of these articles, or by misconduct or willful inattention to the business welfare of the partnership seriously injure the business of the partnership, any two of the senior partners shall have the right to elect that the delinquent partner shall retire, the election to be exercised by written notice to the delinquent partner. If such notice is given, the delinquent partner shall be deemed to have retired from the partnership on the date fixed in such notice and shall not be entitled to participate in any future profits of the partnership. Any loss due to delinquency shall be charged against the capital account of the delinquent partner before he is entitled to withdraw his capital interest.

IN WITNESS WHEREOF the parties have signed and sealed this agreement.

_____(L.S.)
Henry Ayers

_____(L.S.)
Richard Bolton

_____(L.S.)
Bruce Clark

_____(L.S.)
James Davis

_____(L.S.)
George Wilson

Appendix B

CHECKLIST OF MAJOR POINTS WHICH MAY REQUIRE CONSIDERATION IN AN ACCOUNTING PARTNERSHIP AGREEMENT

The common provisions in accounting partnership agreements are here submitted, in outline form, as an aid in visualizing the full scope of such an understanding. Each one of these provisions is discussed, and many are illustrated, with actual excerpts from agreements, in this chapter. There will also be found in Appendix A of this chapter a copy of a simple partnership agreement suitable for accountants, as prepared by Messrs. Rabkin and Johnson. Another accounting partnership agreement appears in a book by Charles S. Rockey entitled *Accountant's Office Manual*.

Nevertheless, all of the data contained in this chapter and in the specimen agreements are intended to serve only as a general guide. Each agreement must be "custom-tailored" to fit the aggregation of individuals it is intended to serve. Nor is it possible to include in a chapter every conceivable provision that two or more men might desire to meet their particular needs. The outline which follows should, however, provide a framework around which most accountants should be able to build, or reconstruct, their mutual understandings.

- _____ 1. Nature and scope of firm's practice. p. 37.
- _____ 2. Designation of firm name. p. 60, 74.
- _____ 3. City in which only or head office to be located. p. 37.
- _____ 4. Branch offices authorized, and where. p. 37.
- _____ 5. Geographical area of operations. p. 37.
- _____ 6. Specification of duration of agreement. p. 38.
 - _____ a. Limited term of years.
 - _____ b. Perpetual (until formal dissolution).
 - _____ c. Termination on occurrence of specified event.
 - _____ d. No term fixed (equivalent to perpetual).
- _____ 7. Provision for renewal of agreement. p. 38.
 - _____ a. Specific provisions.
 - _____ b. Automatic renewal provision.

- _____ 8. Agreement binding on heirs, assigns, executors, administrators and other relevant successors in interest of contracting parties. p. 38.
- _____ 9. Capital contributions. p. 15.
 - _____ a. Requirements from junior partners.
 - _____ b. Interest on capital.
- _____ 10. Capital assessments. p. 16.
- _____ 11. Profit and loss sharing, and compensation arrangements. p. 18.
 - _____ a. Drawing accounts.
 - _____ b. Any employees to share in profits.
 - _____ c. Salaries for partners.
 - _____ d. Compensation for new clients.
 - _____ e. Consideration of probable tax consequences.
 - _____ f. Periodic or other revision of provisions.
- _____ 12. Management policies and functions. p. 27.
- _____ 13. Decisions by votes of partners. p. 29.
 - _____ a. What decisions require unanimous vote.
 - _____ b. What decisions require majority vote.
 - _____ c. What voting power is restricted to senior partners.
 - _____ d. Voting power based on capital apportionment.
- _____ 14. Restrictions on partners' actions within the firm (signing leases, engaging assistants, incurring special expense, borrowing in firm name, et cetera) p. 29.
- _____ 15. Restrictions on partners' outside activities and conduct (full time to be devoted to firm; exceptions for writings, lectures, speeches, et cetera) p. 9.
- _____ 16. Admission of new partners. p. 31.
 - _____ a. Classifications.
 - _____ b. Methods of admission.
 - _____ c. Requirements and qualifications.
 - _____ d. Each to sign (1) original agreement, or (2) supplemental agreement accepting all or specified clauses of original.
- _____ 17. Special provisions as to junior partners. p. 32.
 - _____ a. Admission.
 - _____ b. Withdrawal, retirement, or death.
 - _____ c. Profit and loss sharing and compensation arrangements.
 - _____ d. Limitation of participation in firm losses.

- ____ 18. Books of account to be kept. p. 14.
 - ____ a. Fiscal year.
 - ____ b. Cash or accrual basis.
 - ____ c. Where to be kept.
 - ____ d. Right of partners to examine.
 - ____ e. Periodic audit.
- ____ 19. Absence on military service. p. 30.
- ____ 20. Accountants' liability insurance to be carried (partners to be liable individually to firm for losses resulting from personal wrongful acts or negligence causing damages recoverable from firm). p. 21.
- ____ 21. Death benefits to widows or estates of deceased partners. p. 39.
 - ____ a. Method of determining amounts.
 - ____ b. Method and period of payments.
- ____ 22. Retirement for age. p. 43.
 - ____ a. Voluntary or compulsory.
 - ____ b. When effective.
 - ____ c. Retirement benefits.
 - ____ d. Determination of amounts.
 - ____ e. Method and period of payments.
 - ____ f. Limiting retirements within a given period.
 - ____ g. Noncompetition clause.
- ____ 23. Voluntary withdrawal. p. 48.
 - ____ a. Acceptable reasons.
 - ____ b. Withdrawal of clients, or compensation in lieu thereof.
 - ____ c. Participation in undistributed profits, goodwill, or future income.
 - ____ d. Noncompetition clause.
- ____ 24. Goodwill. p. 6, 67.
 - ____ a. Said to exist.
 - ____ b. Said not to exist.
 - ____ c. Ignored.
 - ____ d. Method of valuation under (a).
 - ____ e. Method of payment under (a).
- ____ 25. Contemplation of probable tax consequences under proposed provisions as to death benefits, retirement payments, goodwill payments, and liquidation distributions, and under noncompetition clauses. p. 6.

- _____ 26. Sick leave and permanent incapacity. p. 53.
 - _____ a. Duration of sick leave.
 - _____ b. Payments during sick leave.
 - _____ c. Nature of incapacity.
 - _____ d. Retirement for incapacity, and attendant benefits or payments.
- _____ 27. Required notice of intention to retire or withdraw. p. 48.
- _____ 28. Forced withdrawal for cause. p. 55.
 - _____ a. Cause defined.
 - _____ b. Notice to partner forced to withdraw.
 - _____ c. Penalties imposed on partner forced to withdraw.
- _____ 29. Effective date of withdrawal, voluntary or forced (resultant tax consequences). p. 62.
- _____ 30. Funds made available for death, retirement, and withdrawal benefits. p. 79.
 - _____ a. Life insurance.
 - _____ b. Annuities.
 - _____ c. Premiums payable by whom.
- _____ 31. Dissolution (final termination of practice). p. 56.
 - _____ a. Division of tangible capital and related problems.
 - _____ b. Division of intangible capital and related problems.
- _____ 32. Formal dissolution not to occur on deaths, retirements or withdrawals. p. 62.
- _____ 33. Financial statements to determine value of partners' interests. p. 64.
 - _____ a. Reports to be given active partners.
 - _____ b. Reports to be given partners retired or withdrawn or estates retaining financial interest.
- _____ 34. Valuation of work in process. p. 65.
 - _____ a. Method of valuation.
 - _____ b. Time of payment.
- _____ 35. Right to future use of name. p. 60, 74.
 - _____ a. To specific person or persons.
 - _____ b. Use of individual name of any deceased or retiring partner.

- 36. Liquidation of partners' capital accounts. p. 76.
 - a. Method of payments.
 - b. Reserve for uncollected accounts and work in progress.
 - c. Security for payments.
 - d. Life insurance.
- 37. Apportionment of interests of deceased, retiring or withdrawing partners among surviving partners. p. 81.
- 38. Arbitration of differences. p. 82.
- 39. Consideration of effect of ethics, laws, and regulations.
 - a. Rules of Professional Conduct, American Institute of Accountants.
 - b. Similar rules of state society.
 - c. Official Code of Ethics, if any, of State Board.
 - d. State laws applying to partnerships generally.
 - e. State laws applying to accountants' partnerships and to general practice of accountancy.
 - f. Treasury Department regulations.
- 40. Consultation with legal counsel as to proposed provisions, and preparation of partnership agreement by counsel.
 - a. One attorney to represent all contracting parties.
 - b. Each contracting party to have separate legal counsel.

Appendix C

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CHAPTER 4

PROFESSIONAL ORGANIZATIONS AND LITERATURE

AMERICAN INSTITUTE OF ACCOUNTANTS

Unity of Profession. Professional Standards. High Standards for the CPA Certificate. Safeguarding the Interests of Certified Public Accountants. To Advance Accounting Research. To Develop and Improve Accountancy Education. Cordial Relations Among Accountants.

STATE SOCIETIES

OTHER ACCOUNTING ORGANIZATIONS

American Accounting Association. National Association of Cost Accountants. Controllers Institute of America. The Institute of Internal Auditors. Student Organizations.

PROFESSIONAL LITERATURE

Institute Publications. Publications of Other Organizations (American Accounting Association; National Association of Cost Accountants; Controllers Institute of America; The Institute of Internal Auditors.) Government Publications. Tax and Financial Publications. Reference Books. Suggestions for a Library.

APPENDIX

Recommended 100-Volume Library. Addresses of Publishers.

CHAPTER 4

Professional Organizations and Literature

BY ARTHUR B. FOYE

THE ACCOUNTING PROFESSION came into being because people needed its services. Changing circumstances have altered the needs and broadened the scope and form of the services required, but the profession has kept pace with the increasing demands made upon it and has expanded rapidly. Greater numerical strength has not been the only characteristic of its phenomenal growth, however. A natural complement to this physical expansion has been the development of its professional organizations and literature, for it is only through organization that a profession's needs for self-regulation can be met, and it is only through its literature that the techniques and rules which have been developed for the guidance of its members can be communicated to them. It is the purpose of this chapter to discuss the objectives and activities of the principal associations of accountants and to list some of the books and other publications which constitute the literature of accounting.

AMERICAN INSTITUTE OF ACCOUNTANTS

The American Institute of Accountants, which today stands as the only national organization of certified public accountants, traces its lineage directly to all the leading national professional accounting societies which have existed in this country. The original organization, the American Association of Public Accountants, was founded in 1887, nine years before New York passed the nation's first certified public accountant law. Soon after the passage of the New York law, similar legislation was enacted in Pennsylvania, Maryland and California. As a means of maintaining the standards established by the new laws and of promoting such legislation in other states, the accountants in several states formed societies which, in 1902, were united in the Federation of Societies of Public Accountants in the United States of America. In 1905 the Federation merged with the American Association of Public

Accountants. In addition to individual membership, the constitution of the merged organization provided for membership by virtue of membership in a state society.

Because of the difficulty of maintaining a common standard of professional competence or attainment in view of the differing requirements for the CPA certificate in the various states, the Association's constitution was completely revised in 1916 and, in January 1917, the name was changed to the American Institute of Accountants. Membership in the Institute was to be on an individual basis only, and all applicants for membership were to be examined by a newly created Board of Examiners. In the years that followed, the strength, resources and influence of the Institute grew rapidly.

In 1921, however, another national organization, the American Society of Certified Public Accountants, was formed. The Society's founders looked upon its program as complementary to that of the Institute — the former seeking to unite all holders of CPA certificates, whether or not eligible for admission to the Institute, and the latter maintaining independent standards of admission and did not then require possession of the CPA certificate which, because of lack of uniformity in the requirements of the various states, did not have the same significance in different parts of the country. As early as 1924 a movement was started to bring about the consolidation of the Institute and the Society, but it was decided that consolidation at that time was impracticable. In 1936, however, after much discussion by special committees representing both organizations, a merger was effected. Since that year the American Institute has spoken for the entire profession.

During the years which have elapsed since its emergence as the single national association of certified public accountants, the Institute has grown from a small organization, concentrating on a few basic activities, to a large one, concerning itself with any and all problems affecting the professional practice of certified public accountants. The broad scope of the Institute's interests is evidenced by the varied activities in which it engages. Its objectives, as recited in the by-laws, are the following:

1. To unite the accountancy profession in the United States as constituted by the certified public accountants of the several states, territories, possessions and the District of Columbia.
2. To promote and maintain high professional and moral standards within the accountancy profession.
3. To assist in the maintenance of high standards for the certified public accountant certificate.
4. To develop and maintain standards for the examination of candidates for admission.
5. To safeguard the interests of certified public accountants.
6. To advance accounting research.
7. To develop and improve accountancy education.
8. To encourage cordial relations among certified public accountants practicing in the United States of America and accountants of similar status in the other countries of the world.

The work of the Institute, all of which is directed toward the achievement of these objectives, benefits each of its members in a different manner, depending upon the special problems connected with his practice. However, a general consideration of its activities, grouped according to the objectives at which they are aimed, will help to point out the many valuable ways in which the Institute serves its membership as a whole.

Unity of Profession

It is significant that the purpose which is stated first in the Institute's by-laws is "to unite the accountancy profession;" for unless the support of all eligible accountants is enlisted, none of the other objectives can be fully realized. It is particularly important for certified public accountants to join together for mutual advancement and protection. As members of a young and rapidly growing profession, they need a greater public understanding of their functions than they have yet attained and wider recognition of the importance of high standards for the CPA certificate. The Institute's influence in dealing with legislators, other professions, and the general public depends upon the extent to which it can claim to speak for the whole profession. Its rapid growth in recent years furnishes convincing evidence that the individual accountant realizes the value which he derives from his membership. In 1920 the Institute's membership totaled 1,363; by 1940 it had increased to 5,497; and in 1952 it exceeded 20,000. However, the continued expansion of the Institute depends upon the active co-operation of all eligible CPAs. Membership is open to holders of CPA certificates who have had two years of public accounting experience or its equivalent and who are in work related to accounting.

The Institute is achieving its objective of uniting the accounting profession not only by uniting the efforts of its individual members but also by co-ordinating the work of the state societies. Although the Institute exercises no authority of any kind over the policies or activities of the state societies, the existence of both state organizations and the national society makes for a type of unity which could not otherwise be achieved. The state societies are the sources of information and advice which, collected and interpreted in the Institute, accurately reflect a cross-section of professional opinion throughout the nation and permit the profession as a whole to work with maximum effectiveness.

In 1946 a state society service department was organized as a part of the headquarters staff of the Institute. This department provides a means for the exchange of information about the constitutions, dues, and activities of the state societies and disseminates material prepared by the Institute staff for their use. Instead of operating more or less independently to provide special services for the state societies and chapters, the state society service department has become to a considerable extent a connecting link between all of the other Institute departments and the state and local organizations. A monthly state society newsletter provides the officers

of state societies and the editors of state society bulletins with a regular channel of information. State society presidents who are members of the Institute serve on Council, its governing body, and in this way keep further informed of Institute policies and activities.

The Institute also works closely with other organizations in the accounting field. It maintains active co-operative relations with the American Accounting Association, the Controllers Institute of America, the National Association of Cost Accountants and The Institute of Internal Auditors.

Professional Standards

Early in its history the Institute began actively to develop standards of professional conduct, recognizing that self-discipline is a necessary foundation for public confidence. All members of the Institute subscribe to its Rules of Professional Conduct – rules which they themselves have developed and which they may amend from time to time as changing conditions require. These rules, which emphasize independence, standards of practice and ethical conduct, are the subject matter of Chapter 5 of this Handbook.

High Standards for the CPA Certificate

Since its founding, the Institute has worked for the establishment of uniform standards for accounting examinations throughout the country, for it recognizes that the prestige of the profession in one state is not independent of its standing in another and that its nationwide prestige depends on the maintenance of high standards in every state. The present plan of co-operation with state boards of accountancy in presenting the uniform certified public accountant examination was first proposed by the Institute in 1917. Today these examinations, which are prepared by the Board of Examiners of the Institute, are used by all of the states, the District of Columbia, Alaska, Hawaii, Puerto Rico and the Virgin Islands. Most of the states avail themselves of the Institute's grading service performed under the direction of the Board of Examiners. In all cases, however, it is the individual state board which makes the final evaluation of a candidate's ability as demonstrated by the examination.

Safeguarding the Interests of Certified Public Accountants

Because public opinion may effectively determine the extent of the profession's growth and development, the Institute has for many years carried on programs to inform the public about certified public accountants and their work. The rapid increase in the number of CPAs and their dispersion into smaller communities where no CPA has practiced before have added to the need for these activities. Therefore, the Institute has developed a long-range, national public relations program which designates the audiences the accounting profession desires to reach and gives a

detailed analysis of the central ideas and facts it wants them to know. An organized effort has been undertaken to inform small businessmen of what the CPA is, what his standards are, and what he can do for them. As a part of this program, the Institute provides pamphlets and reprints which can be distributed by state societies or individual members. It has articles published in scores of trade magazines and engages in co-operative activity with trade associations. The Institute furnishes speakers for meetings of many nonaccounting organizations. It presents network radio programs and also prepares transcriptions for presentation on local stations. As a result of all these Institute activities, many small businessmen are learning about the accounting profession and the advantages of good accounting service.

An important part of the Institute's work of safeguarding the interests of certified public accountants is accomplished through its co-operation with outside groups. In the governmental field, it maintains close relations with Federal agencies in order to preserve the standing of CPAs before these agencies, and it represents the profession in opposing any Federal legislation which would tend to limit its opportunities. The committee on relations with the Securities and Exchange Commission confers from time to time with the Commission's accounting staff and presents the profession's views on problems of current interest as well as on any proposed changes in the rules or regulations under the Acts administered by the Commission.

Among the national business and professional groups with which the Institute works are lawyers and bankers. Through long and patient negotiation between members of the Institute and members of the American Bar Association, a statement relating to practice in the field of Federal income taxation was prepared and, in 1951, approved by the governing bodies of both organizations. This statement serves as a guide in resolving such questions of jurisdiction as may arise between the two professions. The combined efforts of the committee on auditing procedure, the research department, and the public relations department have helped to develop among bankers and other credit men a better understanding of the CPA's work. In order to obtain the co-operation of credit grantors in the maintenance of high standards, the Institute arranges joint meetings of accountants and bankers at the community level and prepares articles on the CPA's responsibilities which are published in periodicals directed to bankers. In all of these ways it helps to increase the acceptance by bankers of audited financial statements.

As a means of improving its service to the growing number of smaller firms and individual practitioners represented in its membership, the Institute has in recent years formed an advisory committee of individual practitioners which is made up of members from every part of the nation. The purpose of this committee is to review all of the activities of the Institute, with the object of recommending to Council such

measures as will make the Institute more useful to its members, particularly in the smaller communities.

To Advance Accounting Research

In 1939 the work of several of the Institute's technical committees was consolidated in the hands of an enlarged committee on accounting procedure, and a research department was created to work under the direction of this committee. The Institute had two basic objectives in mind when it organized the research department—to contribute to the advance of accounting and auditing knowledge, and to develop information which would help the individual CPA. The committees on accounting procedure and auditing procedure, with the co-operation of the research department, are continuously working toward the advancement of accounting and auditing knowledge. Their pronouncements constitute a guide for the profession. The Accounting Research Bulletins, which are issued from time to time by the committee on accounting procedure, are recognized as authoritative statements of generally accepted accounting procedure. The statements and case studies of the committee on auditing procedure are designed to improve the standards and techniques of public accounting.

In 1950 a technical information service was organized in the research department of the Institute. Its purpose is to enable individual practitioners and members of smaller firms, whose opportunities for consultation with other informed practitioners are limited, to obtain an outside, competent opinion on problems which arise in their daily work. All written questions which are received are promptly answered through the co-operative effort of the research department and the technical committees.

To Develop and Improve Accountancy Education

The Institute has always maintained a keen interest in the development of accounting education at the university level. Its committee on education holds joint meetings with a corresponding committee of the American Accounting Association, a large part of whose membership is composed of teachers of accounting. Special committees also confer from time to time with representatives of colleges and universities regarding their accounting curricula. The Institute sponsors graduate study conferences which are held at various schools throughout the country and are attended by both practicing accountants and educators.

An important development in accountancy education in recent years has resulted from the work of the Institute committee on selection of personnel. Under the auspices of the Institute, a College Accounting Testing Program was developed. The scores made by the students taking these tests are evaluated on the basis of nationwide norms and now are

being used by many employers as an important factor in careful personnel selection and by colleges as a guidance aid.

Cordial Relations Among Accountants

Through its annual meeting and the regional meetings which it sponsors, the Institute seeks to foster a widening acquaintance among certified public accountants of different states and different sections of the country. In addition, field trips by the officers and staff of the Institute bring members in all parts of the country into personal contact with representatives of their national organization.

The Institute participates actively in the Inter-American Conference on Accounting and the International Congress on Accounting. In these ways it endeavors to develop and maintain friendly relations with accountants of similar status in other countries so that full co-operation among members of the profession will be possible throughout the world.

All the activities in which the Institute engages, regardless of the fact that they may be directed at different objectives, have one important characteristic in common — they are all a means of strengthening public confidence in the accounting profession as a whole. Each certified public accountant must have public understanding if he is to enjoy the fullest opportunity to maintain professional standards and to render maximum public service. Therefore, the work of the Institute cannot fail to be of real, though perhaps indirect, benefit to each of its members, regardless of the size of his practice.

STATE SOCIETIES

The American Institute can act as the listening post and keep the profession informed of current developments; it can help in the formulation of policies on the national level; but the state societies must act on the information and bring about application of the policies in each part of the country.

In 1897, a year after New York passed the nation's first Certified Public Accountant Law, sixteen men met to form The New York State Society of Certified Public Accountants. Similar societies were organized in other states shortly after the passage of CPA laws in those states, and by 1929 each state had its own society. At present over 25,000 certified public accountants are members of state societies.

The objectives of these societies, though applied over different areas, are parallel to those of the Institute, and the work of the national and local organizations is complementary. All of the state societies have as their basic aims the maintenance of high professional and ethical standards, the development of educational and technical services which will assist the members in their day-to-day work, and the protection of the interests of the public and of the members. Most societies have a strict code of ethics which is rigidly enforced.

Although the activities of the various state societies differ to some extent, the following are illustrative of the services which the societies provide. All of the societies' programs of membership services are geared to give members a maximum of practical aid in their work. During the year most of the societies schedule several tax lectures and technical meetings for their chapters. These meetings stimulate the interchange of ideas among members and provide for the discussion of problems of a local nature. The societies' technical committees are continually engaged in research in general as well as in specialized fields. The work of these committees culminates in papers which are read at the meetings, in articles in the societies' official publications, or in special reports. In these ways the benefits of their research are passed on to the entire membership. The technical committees are also available to answer the inquiries of members and to give them advice when needed. In addition to the regularly scheduled local meetings of the state societies, several regional conferences are held each year under the auspices of groups of state societies and with the co-operation of the American Institute.

The national public relations program developed by the Institute has already been mentioned. Because the most important part of public relations work is personal and local, the Institute distributed to the state societies copies of a handbook which outlines the national program and describes the methods to be used in organizing and carrying out state and local programs. One of the important objectives of these programs is the development of ways of improving the practice and status of small firms and individual practitioners. The societies' efforts to inform bankers and credit grantors of the types of service rendered by accountants have met with much success. Some of the societies which provide bankers and credit men with copies of their yearbooks, containing the roster of membership and the code of ethics, report that on several occasions they have received requests for more detailed information about certain of the members listed. Small firms and individual practitioners benefit from this distribution of the societies' yearbooks because often, in the past, only the larger accounting firms were considered for engagements in the absence of information as to the names and qualifications of others in practice.

Although the objectives of the state societies are parallel to those of the American Institute, certain functions can be performed by one group more effectively than by the other. State legislation, for example, is a subject that must be dealt with by state societies and members of the profession in the states in which there is legislative activity. The type of accounting legislation that will effectively serve the profession and the public interest is best determined by those who are fully aware of local problems. However, standards must be national in scope. Uniform legislation and interstate reciprocity are in the interests of the entire profession, and it is through the Institute that the views and experiences of different state societies can be brought together and uniform accountancy laws recommended.

There are two basic divisions to the task which the state societies must perform in connection with state legislation. First, they must make certain that no bill of interest to accountants escapes the societies' notice, and second, they must present the profession's views on every important bill to all those who may influence the bill's course. Whenever bills affecting accountancy are introduced, the societies must promptly take steps to get their views before the right people. This is a problem primarily of personal contact. To present the profession's position effectively requires direct lines of communication to committees, key legislators, and interested government officials. The state societies have done extensive work in establishing favorable contacts with members of these groups. In order to alert the societies to pending legislation which will affect the profession, the American Institute endeavors to provide them with all available information concerning bills which will be acted on at current sessions of the legislatures before the sessions convene. The Institute distributes to the societies legislative kits which contain suggestions and material for handling legislative problems. In addition, the Institute has on several occasions actively assisted various state societies in opposing undesirable legislation and in encouraging the passage of desirable measures.

Like the activities of the Institute, those of the state societies are a means of increasing the prestige of the accounting profession in the eyes of the public. While all members benefit greatly from the programs of the state societies, individual practitioners and those who practice in small communities derive particular advantage from their membership because of the societies' efforts to explain the status of the certified public accountant and the value of his services to local businessmen who are in need of these services.

OTHER ACCOUNTING ORGANIZATIONS

The American Institute of Accountants, on the national level, and the state societies of certified public accountants, on the local level, are the only organizations composed solely of certified public accountants. However, there are several professional organizations whose members work in closely allied fields and have many interests and problems in common with the practicing CPA. The activities of four of these associations will be described briefly at this point. Such descriptions are not intended to be exhaustive, but are given merely to review for the reader the scope of activity of these organizations and their contributions to the field of accounting.

American Accounting Association

The American Accounting Association is the successor organization to the American Association of University Instructors in Accounting, which

organization was founded in 1916. In its early years the Association's main objective was the stimulation of an interchange of ideas among teachers of accounting. Recognizing that the interests of teachers and practitioners are in many ways closely interrelated, the scope of the Association's objectives was widened in 1935, and the name was changed to the American Accounting Association. The objects of the Association, as stated in its bylaws, are:

1. To encourage and sponsor research in accounting, and to publish or aid in the publication of the results of research.
2. To develop accounting principles and standards, and to seek their endorsement or adoption by business enterprises, public and private accountants, and governmental bodies.
3. To promote studies of accounting as an agency of control of business enterprise and of economic affairs in general.
4. To improve methods of instruction, and to demonstrate the social benefits of a more widespread knowledge of accounting.

Members of the American Accounting Association derive considerable benefit from the Association's activities in sponsoring accounting research. The work of its committee on accounting concepts and standards is concerned with the determination and expression of desirable accounting objectives and principles. The committee's findings are published in the Association's quarterly journal and, from time to time, special studies and research monographs also are issued. In addition, close contacts are maintained with all research projects in the field of accounting and allied subjects.

The American Accounting Association co-operates closely with other professional accounting organizations. Its committees on CPA examinations, internship programs, and selection of personnel, work continually with the corresponding committees of the American Institute of Accountants. In recent years the American Accounting Association has formed committees on co-operation with the Controllers Institute and with The Institute of Internal Auditors. One objective of the Association's closer affiliation with these latter groups is the development of internship opportunities in the industrial field.

There are at present over 4,500 members in the American Accounting Association. Membership is open to accounting teachers, public and private accountants, governmental accountants, and other persons interested in the advancement of accounting. The teachers of accounting have had a large part in building the professional literature which has served to articulate the basic concepts of accounting as a framework for practice. There exists, therefore, a natural community of interest between teachers and practitioners. Anything which leads to a better acquaintance between the two groups, to mutual understanding, and to full and frank discussion of their common problems is of value to the profession. The work of the American Accounting Association assists in accomplishing all of these desirable objectives. Accordingly, member-

ship in the Association and participation in its activities benefit the individual certified public accountant as well as the profession as a whole.

National Association of Cost Accountants

The National Association of Cost Accountants is an organization devoted to the study of the problems of industrial accounting. It is not limited to cost accounting as its name might indicate. The Association was organized in Buffalo in 1919 by a group of thirty-seven leading accountants. Its membership has increased rapidly, particularly during World War II and the post-war era, and today it has more than 31,000 members. Local chapters have been organized in more than one hundred principal cities of the United States and in Cuba and Hawaii. In addition, many industrial accountants in nearly fifty foreign countries are members. Membership in the Association is open to anyone who is interested in its objectives which are:

1. To develop a better understanding of the true nature and value of accounting, especially cost accounting, in industry.
2. To study and improve technical methods and to establish sound general principles.
3. To study the relation of the accounting department to the other departments of industry and business and to develop the most effective means of supplying usable information to these departments.
4. To supply to its members information on the most up-to-date methods and to assist them in solving their individual problems.

Each of the Association's chapters has its own funds and conducts its own affairs under general rules of operation established by the National Association in order to insure uniformity. Monthly meetings are held by each chapter at which industrial accounting problems are discussed by members as well as by outstanding speakers from many fields throughout the country. It has always been the practice of the Association to restrict the subjects for all its meetings and discussions to practical problems. Case studies dealing with the accounting methods of specific industries or with accounting procedures in a particular area are presented frequently at chapter meetings. In addition to the regular monthly meetings, many chapters hold one or two special meetings each year to discuss industrial accounting matters of particular current importance. Every year, each chapter also presents one or more series of discussion forum meetings consisting of several sessions on some important phase of industrial accounting. These forums provide an intensive coverage of the subject and stimulate the interchange of experience and viewpoints.

The National Association conducts an International Cost Conference each year. The technical sessions at these conferences have gained a widespread reputation for the high standard of the material presented and the ability and experience of the men who enter into the discussions.

One of the distinguishing characteristics of these sessions is the emphasis which is placed upon actual practice. The Association also sponsors regional conferences in which sectional groups of chapters participate. These conferences are designed to bridge a gap between chapter meetings and the International Conference by providing a means for exchange of ideas among members located in a particular section of the country.

The Association maintains a research staff which studies industrial cost accounting problems and methods under the supervision of a committee on research. This committee of more than thirty members includes leading industrial executives, professional accountants, and educators. The results of the studies made by the research staff are distributed to the members from time to time.

A technical service department, devoted exclusively to the service of members, is maintained at national headquarters. Its files include several hundred uniform cost systems developed by various trade associations. There also is an extensive library of books on industrial accounting. Members of the Association may submit questions to the technical service department which furnishes them with answers prepared by other members who have had experience with the problem involved.

The concepts and practices of cost accounting are undergoing continual change as more complex needs and applications arise. Through its efforts to establish sound general principles and to develop improved technical methods to meet the changing requirements of industry, the National Association of Cost Accountants renders a service to the entire accounting profession.

Controllers Institute of America

The Controllers Institute of America is an organization in which active membership is limited exclusively to executives who perform the duties of a controller as defined by the Institute and who serve companies of sufficient size to qualify. It was established in 1931, and its membership now includes more than 3,800 financial and accounting officers of the leading business concerns. In addition to the class of active members, there is a class of associate members which is open only by invitation of the Board of Directors to educators, writers and others in the field of controllership and in related fields. Local chapters of the Controllers Institute have been established in more than forty cities of the United States and in Canada and Puerto Rico. The Institute's principal objectives are to develop a progressive concept of controllership, adequate to meet the requirements of modern business, to educate business management and the public in understanding this concept, and to assist the controller in giving it full expression in his own organization.

The Controllers Institute provides its members with a medium through which they may receive and exchange ideas in the field of business man-

agement. Each local chapter or "control" holds regularly scheduled monthly meetings. In addition to these individual chapter meetings, there are four regional Spring conferences and an annual meeting of the entire organization. An important feature of this annual meeting is the period set aside for industry conferences which enable members to have separate discussion meetings on problems peculiar to their own industries.

The research work of the Controllers Institute is carried on by the Controllership Foundation. Institute members and others send the Foundation suggestions for research, educational and other projects. After a thorough search of other work in the field concerned and of current projects of other research organizations in order to prevent possible duplication, several suggested subjects are submitted to the Institute membership for vote. The final decision as to which projects will be undertaken, however, is made by the Board of Trustees of the Foundation which then allocates the necessary funds. Each research project is guided by a specially chosen advisory panel of members of the Controllers Institute and, when completed, the results of the study are published.

Although active membership in Controllers Institute of America is not open to practicing CPAs, the Institute's work is of service to them because of the contribution which it makes to the development of sound techniques in the dynamic field of business management.

The Institute of Internal Auditors

The Institute of Internal Auditors is today the recognized professional organization in the field of internal auditing. It was organized in 1941 by a group of twenty-four men who felt that an organization was needed to develop the true professional status of internal auditing and to provide a medium for the interchange of ideas and information among those engaged in its practice. Growth in membership in the Institute has been steady, until today it exceeds 2,500 and includes representatives of every field of private and governmental enterprise. From the beginning, membership has been restricted to those who are directly concerned with internal auditing, in the belief that such a limitation is necessary if the organization's activities are to continue to be focused on its original objectives. However, the community of interest between internal auditors and certified public accountants has been recognized by the Institute since its formation, and it has made provision for the admission, as associate members, of CPAs as well as eligible educators and others engaged in fields related to internal auditing.

The maximum value of Institute membership comes with participation in the activities of a local chapter group. The first chapter was organized in New York, a little more than a year after the formation of the national body. At the close of the Institute's tenth year there were forty chapters, including four in Canada, two in the Philippine Islands, and two in

Europe. Most of the chapters hold monthly meetings, and a number of the larger ones have separate meetings of technical study groups. In addition, there are three regional conferences and a conference of the entire organization each year.

Since its foundation the Institute has been active in the field of research. Much work was done in the early years on various surveys and projects relating to audit techniques in specific industries, and in 1947 the research committee issued a statement defining the responsibilities of the internal auditor.

The importance of maintaining a close relationship between a company's internal audit department and its public accountants, to the mutual advantage of both the company and the outside auditors, has become increasingly evident in recent years. In the "Tentative Statement of Auditing Standards," published in 1947 by the committee on auditing procedure of the American Institute of Accountants, it is stated that "Where an internal auditing department exists the independent auditor very properly accords that fact appropriate weight in selecting and applying his auditing procedures. The advantages of strong internal auditing departments are becoming better recognized by many concerns of sufficient size to warrant maintaining such an organization." Because the work of a functioning internal audit department is helpful to the public accountant, all the activities of the Institute of Internal Auditors which are aimed at improving methods and winning wider acceptance by management are of benefit to him.

Student Organizations

There are some organizations composed of students of accounting in the colleges and business schools. Some, in the form of college professional fraternities, are national in scope; most school accounting clubs or societies are local. Some state societies of certified public accountants have established student affiliates or junior memberships.

Since such organizations are potentially effective media for developing an informed interest in the profession, members of the profession would do well to encourage and aid in their sound development.

PROFESSIONAL LITERATURE

The rapid advancement of the accounting profession in recent years has been due in no small part to the development of a professional literature adopted to the particular needs of American business. Without such a medium for the promulgation of current developments in accountancy practice, the present widespread uniformity of techniques and standards could not have been attained.

While the needs of each accountant vary according to the types of business which he serves, there are certain sources of information with which

all should be familiar. Some of them are periodicals or bulletins dealing with specific subjects, and some are standard texts. Most textbooks, by their very nature, deal in a generalized manner with a description of principles or procedures rather than with the wide variety of differing situations encountered in actual practice. It is the current periodicals, releases, and bulletins of the American Institute of Accountants, of other accounting organizations, and of regulatory bodies which keep the practitioner up to date on the methods of handling the varied problems which arise because of the complex structure of today's business. It is not feasible to present in this chapter a lengthy bibliography of the books and periodicals which comprise the literature of accounting. The average CPA is primarily interested in knowing which of the many available publications will be most useful to him in his practice. Reference to some worth-while literature will have been omitted, but a conscientious attempt has been made to provide representative, although limited coverage. Some of the principal periodicals and publications of these organizations will be mentioned in the following pages; textbooks are listed in Appendix A to this chapter, together with a list of the addresses of the publishers referred to.

Institute Publications

The official publication of the American Institute of Accountants is *The Journal of Accountancy* which is published monthly. An editorial in the first issue, published by the Institute's predecessor organization in November 1905, stated:

"The editors present the first issue of *The Journal of Accountancy* to the American accountants in the belief that this magazine marks the beginning of a movement which has for its object the establishment of accountancy in law and opinion as a learned profession."

That this movement has been successful has been adequately illustrated by the discussion of the Institute's growth. The rise in circulation of *The Journal*, which today is distributed not only to all Institute members, but to over 40,000 other subscribers as well, is a further indication of this success. In addition to presenting timely comment by the editors and articles by leading accountants and other authorities in their particular fields, *The Journal* conducts several regular departments designed especially to be of use to the CPA in his practice.

As an added means of keeping its members in touch with professional happenings, the Institute publishes a monthly internal membership bulletin, *The CPA*. Through its wide news coverage members are informed of recent developments which affect their interests in any way.

From time to time, the committees on accounting procedure and auditing procedure of the Institute issue formal pronouncements which are recognized by the profession as the most authoritative statements on the subjects involved. The Accounting Research Bulletins, which deal with

general accounting principles and their application to specific matters, summarize studies made by the committee on accounting procedure. The pronouncements of the committee on auditing procedure were originally issued as Statements on Auditing Procedure. In 1951 a single pamphlet, replacing the twenty-four statements issued up to that time, was published. This booklet, entitled "Codification of Statements on Auditing Procedure," * consolidates the more valuable and currently useful features of the previous pronouncements and is intended as a supplement to the material contained in other publications of the committee on auditing procedure and in auditing texts.

In 1947 the committee on auditing procedure issued a special report which was published under the title "Tentative Statement of Auditing Standards — Their Generally Accepted Significance and Scope." * At the 1948 annual meeting of the Institute the summarized statement of auditing standards contained in this report was approved by the membership. It is important to note that this statement is concerned primarily with auditing standards, as differentiated from auditing procedures. The committee believes that the most satisfactory method of presenting auditing procedures is by a series of case studies illustrating audit procedures adopted and applied in actual examinations. Up to the date of the publication of this Handbook, ten Case Studies in Auditing Procedure have been issued (two in No. 8), describing the audit procedures actually followed by practitioners in examinations of the following types of business organizations:

1. A Loading and Hauling Equipment Manufacturer
2. A Newspaper Publisher
3. A Department Store
4. A Public Utility
5. A Corn Processing Company
6. A Management Investment Company of the Open-End Type
7. A Grain Company
8. A Steel Fabricating Company
A Small Restaurant
9. A Wholesale Distributor of Newspapers and Magazines

The committee on auditing procedure also has made a comprehensive study of internal control. The results of this study were published in 1949 under the title "Internal Control — Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant." ** A series of case studies in internal control has since been instituted, and up to the date of the publication of this Handbook two studies have been issued, dealing with (1) The Textile Company, and (2) The Machine Manufacturing Company.

* Presented in full text in this Handbook as an Appendix to Chapter 13.

** Presented in full text in this Handbook as an Appendix to Chapter 16.

In 1949 the research department of the Institute, with the advice of the committee on auditing procedure, issued a pamphlet entitled "Audits by Certified Public Accountants — Their Nature and Significance." * This booklet, which is designed for the use of credit executives and others concerned with the work of the independent certified public accountant, describes in general terms what the CPA does in order that he may express an opinion on financial statements.

In 1951 the public relations department of the Institute prepared a pamphlet entitled "Your CPA's Responsibility" to explain Auditing Procedure Statement No. 23 to the clients of smaller CPA firms. Another public relations leaflet issued in 1951, "Why CPA Standards Are Important to You," answers some of the questions most frequently asked about certified public accountants and their professional standards. The pamphlet entitled "Small Business Has Big Problems," which was published in 1949, outlines some of the services which CPAs can perform for smaller businesses.

In 1940 the Institute published a booklet outlining an audit program for savings and loan associations. This booklet was an important factor in raising the standards of independent audits of these associations but, with the passage of time, new developments in their accounting practices took place which were not covered. In 1951, therefore, a revised edition of the booklet, under the title "Audits of Savings and Loan Associations by Independent Certified Public Accountants," was issued by the committee on auditing procedure.

In 1946 the Council of the Institute initiated a long-range program for the analysis of corporate reports. Each year since then the research department has reviewed hundreds of these reports and has published a survey showing the manner in which various items are treated in the financial statements. This survey, which is entitled "Accounting Trends & Techniques in Published Corporate Annual Reports," points up, by means of numerous comparative tabulations, significant accounting trends during the period since the studies were started. Special attention is given in each edition to matters which have been under consideration by the committee on accounting procedure.

A pamphlet published by the Institute under the title "The Natural Business Year — Its Advantages to Business Management" contains a chart to be used in determining a company's natural business year as well as a list of suggested fiscal closing dates for different types of business.

Each year the Institute publishes the complete text of all technical papers and committee reports presented at the annual meeting. It also publishes from time to time various pamphlets, all of which are designed to promote a general recognition of the professional stature of certified public accountants.

* Presented in full text in this Handbook as an Appendix to Chapter 26.

Publications of Other Organizations

American Accounting Association

The major publication of the American Accounting Association is the official quarterly journal, the *Accounting Review*, which was first issued in 1926. Articles in the *Review* cover practically the entire range of accounting subject matter. However, some attempt is made to feature articles on current developments in accounting theory, as contrasted with those of more specialized technical significance. Papers presented at the annual meetings of the Association also are included in the *Accounting Review*.

From time to time the American Accounting Association publishes research monographs, as well as special studies of various kinds. A research monograph entitled "An Introduction to Corporate Accounting Standards" by W. A. Paton and A. C. Littleton, which was originally published in 1940, was reprinted in 1951. In 1936 the executive committee of the Association issued "A Tentative Statement of Accounting Principles Affecting Corporate Reports." The second revision of this statement, published in 1948, is entitled "Accounting Concepts and Standards Underlying Corporate Financial Statements." Since 1948, the committee on concepts and standards of the Association has issued a number of "Supplementary Statements" dealing with various individual accounting subjects.

National Association of Cost Accountants

The official publication of the National Association of Cost Accountants is the *N.A.C.A. Bulletin* which is issued monthly in two sections. The first section of each issue is devoted to technical information, and the second section provides news and information on the activities of the Association and recent developments of interest to industrial accountants, as well as a review of books and articles in the field of current cost literature. The results of the studies made by the research staff of the Association are published from time to time in a special section of the *Bulletin*.

Each year the National Association of Cost Accountants publishes a volume entitled "Conference Proceedings" which contains a complete report of all papers and discussions presented at the annual conference. These papers cover practical cost and accounting information on a variety of subjects.

Controllers Institute of America

The Controllers Institute of America publishes a monthly magazine, *The Controller*. It also publishes pamphlets from time to time. While some of these deal solely with the functions and contributions of controllers, there are others, such as "Replacement Costs and Depreciation

Policies” and “Tax Principles and Problems,” which concern problems of more widespread interest.

The Controllershship Foundation, which carries out the research program of the Controllers Institute, issues a monthly bulletin, *Controllershship Research*, giving progress reports on its projects. Like the pamphlets of the Controllers Institute, several of the special reports of the Foundation, which are based on its research studies, deal with information that is particularly useful to controllers. One of the Foundation’s reports, published in 1948 under the title “Depreciation Policy When Price Levels Change” constitutes a source book of opinions and information published up to that time on the subject.

Institute of Internal Auditors

The Institute of Internal Auditors publishes a quarterly periodical, *The Internal Auditor*, which was started in 1944. Prior to 1949 both technical papers and Institute news were contained in each issue. Since that time, however, a separate publication, the *Members News Bulletin*, has been devoted to news items. The Institute also has published several books on various phases of internal auditing, and each year it issues a volume containing the complete text of all papers presented at the annual meeting.

Government Publications

Government publications cover a wide variety of subjects. Of those which are concerned with accounting matters, some are of interest to certain accountants and not to others, depending upon the types of business which they serve. For example, accountants with clients whose accounting methods are under the jurisdiction of regulatory authorities such as the Federal Power Commission, the Federal Communications Commission, and the Interstate Commerce Commission must use the current uniform systems of accounts prescribed by them. In addition, these accountants will be interested in the periodic releases and annual reports of the commissions. Regardless of the types of business represented in his practice, however, every accountant must keep abreast of the rules, regulations and official releases of the Securities and Exchange Commission. The series of accounting releases, which are incorporated by reference in Regulation S-X, contain the opinions expressed from time to time by the Chief Accountant on controversial questions arising in connection with registration statements and annual reports filed with the Commission. Information on current developments in accounting and auditing also is included in the Commission’s annual reports which outline its activities under the different statutes entrusted to it.

The Treasury Department issues many publications, such as the fortnightly *Internal Revenue Bulletin*, which supplement the Federal tax

service. The Excess Profits Tax Act provides for the use of certain industry classifications which, under the regulations, are to be determined in accordance with the specifications shown in the "Standard Industrial Classification Manual," prepared by the Division of Statistical Standards of the Bureau of the Budget.

The Department of Commerce publishes a monthly *Bulletin of Commerce* which contains material that is of interest to businessmen and is available without cost. Bulletins also are issued from time to time on many types of business and on methods of record-keeping for different businesses.

In 1951 the Superintendent of Documents published a booklet entitled "Suggestions for Improving the Language of Audit Reports." These suggestions were prepared by the report editor of the Corporation Audits Division, General Accounting Office for the use of that division. However, the booklet contains a great deal of information which can assist certified public accountants in the writing of more effective reports.

Tax and Financial Publications

Chapter 21, "Income Tax Practice," contains a section on recommended books and services for a tax library. At this point, therefore, the listing of tax publications will be limited to the following periodicals:

The Tax Barometer

Published weekly by Washington Publications, Inc.

Taxes, The Tax Magazine

Published monthly by Commerce Clearing House, Inc.

What's Happening in Taxation and Government Regulation

Published weekly by Prentice-Hall, Inc.

Every accountant, regardless of the size of his practice, needs to have dividend guides and stock and bond quotation records available for ready reference. Such records are published by Moody's Investors Service and by Standard & Poor's Corporation, among others. Moody's also publishes five yearly manuals which contain detailed historical financial information.

Reference Books

The accountant's library should include the standard reference works — an unabridged dictionary, an encyclopedia, almanacs, and directories of various types. The "Accountants' Handbook," the "Cost Accountants' Handbook," and the "Financial Handbook" furnish the accountant with a wealth of authoritative information. His library also should include the Federal and state tax services and any other services which can assist him and his clients in complying with government regulations.

Every accountant's library should include "The Accountants' Index," published by the library staff of the American Institute of Accountants.

This index provides a key to all works on accounting published in the English language. Material published up to the year 1920 was indexed in the original volume, and the accounting literature published since then has been indexed in supplements which now are issued biennially.

Suggestions for a Library

The accountant's library should be built around a core of reference books, standard texts on accounting and allied subjects, and periodicals which are of general interest to the profession as a whole. Once his library is satisfactorily equipped with publications of these types, each practitioner should endeavor to add to it such sources of information as will be helpful to his particular practice. In order to understand the problems of his clients in various lines of business, he should refer to technical periodicals, trade papers, and statistical data published by trade associations. Published corporate reports, prospectuses, and stock-listing applications should not be overlooked either, for they furnish a wealth of information on current thinking in the accounting profession.

There are many excellent texts in accounting, auditing, and related subjects, but naturally each practicing accountant will not find it necessary or feasible to include all of them in his library. All members of the American Institute of Accountants may borrow, either by mail or in person, from the Institute's library of over 41,000 books, periodicals and pamphlets. The books suggested in Appendix A to this chapter as suitable for inclusion in an accountant's library include representative texts dealing with the major topics of general interest to the accounting profession. Of course, this list is not intended to be either definitive or exhaustive. In some instances, the books listed for a particular subject are the most recent ones published in that field, and for this reason they have been given preference over earlier texts which, however, may deal equally well with the subject. In order to furnish a guide to accountants who, because of the nature of their practice, require books on specialized accounting, some books of this type have been included in this list. However, most of the available information on specialized types of accounting is published in periodicals, such as *The Journal of Accountancy*, the *N.A.C.A. Bulletin*, and the publications of the state societies. An extensive bibliography of specialized accounting literature is contained in J. K. Lasser's "Handbook of Accounting Methods" and in his "Handbook of Cost Accounting Methods." In addition, information which has been published on any phase of specialized accounting can be located through "The Accountants' Index." Volume 2 of this Handbook, especially Chapter 20, contains a considerable amount of material on specialized areas.

Appendix A

RECOMMENDED 100-VOLUME LIBRARY

(Those titles marked * are suggested for a library of approximately fifty volumes)

<i>Author</i>	<i>Title</i>	<i>Publisher</i>
*American Institute of Accountants	Accountants' Index (Supplements published biennially.)	American Institute of Accountants
<i>Accounting, General Theory and Practice</i>		
*Childs, William H.	Consolidated Financial Statements, 1949	Cornell University Press
Finney, H. A. and Miller, Herbert E.	Principles of Accounting, Advanced, 4th Edition, 1952	Prentice-Hall, Inc.
*Finney, H. A. and Miller, Herbert E.	Principles of Accounting, Intermediate, 4th Edition, 1951	Prentice-Hall, Inc.
Holmes, Arthur W. and Meier, Robert A.	Advanced Accounting, 1950	Richard D. Irwin, Inc.
Holmes, Arthur W. and Meier, Robert A.	Intermediate Accounting, 1949	Richard D. Irwin, Inc.
*Kester, Roy B.	Advanced Accounting, 4th Edition, 1946	The Ronald Press Co.
*Kester, Roy B.	Principles of Accounting, 4th Edition, 1939	The Ronald Press Co.
*Kohler, Eric L.	A Dictionary for Accountants, 1952	Prentice-Hall, Inc.
*May, George O.	Financial Accounting, 1943	The Macmillan Co.
Moonitz, Maurice and Staehling, Charles C.	Accounting: An Analysis of its Problems, 1952 Volume 1—Valuation of Assets and Liabilities and the Determination of Periodic Profit Volume 2—Multiple Proprietorship	The Foundation Press, Inc.
Newlove, George Hillis	Consolidated Statements, 1948	D. C. Heath and Co.

<i>Author</i>	<i>Title</i>	<i>Publisher</i>
Newlove, George Hillis, and Garner, S. Paul	Advanced Accounting Volume 1—Corporate Capital and Income, 1951 Volume 2—Reorganizations, Bankruptcies, Fiduciaries, and Partnerships, 1950	D. C. Heath and Co.
*Paton, W. A., Editor	Accountants' Handbook, 3rd Edition, 1943	The Ronald Press Co.
*Paton, W. A.	Advanced Accounting, 1941	The Macmillan Co.
*Paton, W. A. and Littleton, A. C.	An Introduction to Corporate Accounting Standards, 1940	American Accounting Association
Paton, W. A. and Paton, W. A., Jr.	Asset Accounting (An Intermediate Course), 1952	The Macmillan Co.
Study Group on Business Income	Changing Concepts of Business Income, 1952	The Macmillan Co.
Sunley, William T. and Carter, William L.	Corporation Accounting, Revised Edition, 1944	The Ronald Press Co.

Auditing

*Bell, William H. and Johns, Ralph S.	Auditing, Revised Edition, 1941	Prentice-Hall, Inc.
Byrnes, Thomas W., Baker, K. Lanneau, and Smith, C. Aubrey	Auditing, 1948	The Ronald Press Co.
Eggleston, DeWitt C.	Auditing Procedure, 3rd Edition, 1947	John Wiley & Sons, Inc.
Holmes, Arthur W.	Auditing, 3rd Edition, 1951	Richard D. Irwin, Inc.
*Montgomery, Robert H., Lenhart, Norman J., and Jennings, Alvin R.	Montgomery's Auditing, 7th Edition, 1949	The Ronald Press Co.
*Palmer, Leslie E. and Bell, William H.	Accountants' Working Papers, 3rd Edition, Revised by Ralph S. Johns, 1950	The Ronald Press Co.
*Peloubet, Maurice E.	Audit Working Papers, 1949	McGraw-Hill Book Co.
Wellington, C. Oliver	Audit Working Papers, 1948	D. Van Nostrand Co.

Budgeting

*Heckert, J. Brooks	Business Budgeting and Control, 1946	The Ronald Press Co.
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<i>Author</i>	<i>Title</i>	<i>Publisher</i>
Rautenstrauch, Walter and Villers, Raymond	Budgetary Control, 1950	Funk & Wagnalls Co.
*Sinclair, Prior	Budgeting, 1934	The Ronald Press Co.
*Wellington, C. Oliver	Primer on Budgeting, 1949	D. Van Nostrand Co.

Business Organization and Management

Alford, L. P.	Principles of Industrial Management, Revised Edition, Revised and Rewritten by H. Russell Beatty, 1951	The Ronald Press Co.
*Alford, L. P. and Bangs, John R., Editors	Production Handbook, 1944	The Ronald Press Co.
Brown, Stanley M. and Doris, Lillian, Editors	Business Executive's Handbook, 1947	Prentice-Hall, Inc.
Cherrington, Homer V.	Business Organization and Finance, 1948	The Ronald Press Co.
Gerstenberg, Charles W.	Financial Organization and Management of Business, 3rd Edition, Revised, 1951	Prentice-Hall, Inc.
Heckert, J. Brooks and Willson, James D.	Controllership — The Work of the Accounting Executive, 1952	The Ronald Press Co.
Lasser, J. K.	How to Run a Small Business, 1950	McGraw-Hill Book Co.
*MacDonald, John H.	Office Management, 3rd Edition, 1951	Prentice-Hall, Inc.

Commercial Law

*Conyngton, Thomas and Bergh, Louis O.	Business Law, 4th Edition, 1949	The Ronald Press Co.
National Association of Credit Men	Credit Manual of Commercial Laws, Published Annually	National Association of Credit Men

Corporations

Dewing, Arthur Stone	Financial Policy of Corporations, 2 Volumes, 4th Edition, 1941	The Ronald Press Co.
Doris, Lillian, Editor	Corporate Treasurer's and Controller's Handbook, 1950	Prentice-Hall, Inc.

<i>Author</i>	<i>Title</i>	<i>Publisher</i>
Washington, George T. and Rothschild, V. Henry 2nd	Compensating the Corporate Executive, Revised Edition, 1951	The Ronald Press Co.

Cost Accounting

*Dohr, James L. and Inghram, Howell A.	Cost Accounting Principles and Practice, 3rd Edition, 1946	The Ronald Press Co.
*Gillespie, Cecil M.	Accounting Procedure for Standard Costs, Revised Edition, 1952	The Ronald Press Co.
Heckert, J. Brooks	Analysis and Control of Distribution Costs, 1940	The Ronald Press Co.
*Lang, Theodore, Editor	Cost Accountants' Handbook, 1944	The Ronald Press Co.
*Lawrence, W. B.	Cost Accounting, 3rd Edition, 1946	Prentice-Hall, Inc.

Depreciation

*Grant, Eugene L. and Norton, Paul T.	Depreciation, 1949	The Ronald Press Co.
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Investment		
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Mathematics and Finance		
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*Carey, John L.	Professional Ethics of Public Accounting, 1946	American Institute of Accountants
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*Bell, William H.	Accountants' Reports, 4th Edition, 1949	The Ronald Press Co.
*Clapp, John Mantle	Accountants' Writing, 1948	The Ronald Press Co.
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Pace, Homer S.	Insurance Organization and Accounting, 1948	Business Text-Book Publishers, Inc.
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Willcox, Frank	Mine Accounting and Financial Administration, 1949	Pitman Publishing Corp.
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American Accounting Association	College of Commerce and Business Administration, University of Illinois, Urbana, Ill.
American Book Company	55 Fifth Ave., New York 3, N. Y.
American Council on Education	1785 Massachusetts Ave., N.W., Washington 6, D. C.
American Hospital Association	18 E. Division St., Chicago 10, Ill.
American Institute of Accountants	270 Madison Ave., New York 16, N. Y.
Business Text-Book Publishers, Inc.	225 Broadway, New York 7, N. Y.
Clark Boardman Co., Ltd.	11 Park Place, New York 7, N. Y.
Commerce Clearing House, Inc.	214 N. Michigan Ave., Chicago 1, Ill.
Controllers Institute of America	1 East 42nd St., New York 17, N. Y.
Cornell University Press	124 Roberts Place, Cornell Heights, Ithaca, N. Y.
The Foundation Press, Inc.	268 Flatbush Ave., Brooklyn 1, N. Y.
Funk & Wagnalls Co.	153 East 24th St., New York 10, N. Y.
Harvard University Graduate School of Business Administration	Soldiers Field, Boston 63, Mass.
D. C. Heath and Company	285 Columbus Ave., Boston 16, Mass.
The Institute of Internal Auditors	120 Wall St., New York 5, N. Y.
Richard D. Irwin, Inc.	1818 Ridge Road, Homewood, Ill.
Louisiana State University Press	University Station, Baton Rouge 3, La.
The Macmillan Company	60 Fifth Ave., New York 11, N. Y.
McGraw-Hill Book Company, Inc.	330 West 42nd St., New York 18, N. Y.
Moody's Investors Service	65 Broadway, New York 6, N. Y.
Municipal Finance Officers' Association	1313 East 60th St., Chicago 37, Ill.
National Association of Cost Accountants	505 Park Ave., New York 22, N. Y.
National Association of Credit Men	1 Park Ave., New York 16, N. Y.
National Bureau of Economic Research, Inc.	1819 Broadway, New York 23, N. Y.
National Committee on Governmental Accounting	1313 East 60th St., Chicago 37, Ill.
Physicians' Record Co.	161 W. Harrison St., Chicago 5, Ill.
Pitman Publishing Corp.	2 - 6 West 45th St., New York 19, N. Y.
Prentice-Hall, Inc.	70 Fifth Ave., New York 11, N. Y.

The Ronald Press Company	15 East 26th St., New York 10, N. Y.
Ross-Martin Company	423 East 4th St., Tulsa 1, Okla.
Securities and Exchange Commission	425 Second St., N.W., Washington 25, D. C.
Standard & Poor's Corporation	345 Hudson St., New York 14, N. Y.
Superintendent of Documents	Government Printing Office, Washington 25, D. C.
D. Van Nostrand Co.	250 Fourth Ave., New York 3, N. Y.
Frank R. Walker Co.	173 W. Madison St., Chicago 2, Ill.
Washington Publications, Inc.	444 Madison Ave., New York 22, N. Y.
John Wiley & Sons, Inc.	440 Fourth Ave., New York 16, N. Y.

CHAPTER 5

PRACTICAL APPLICATIONS OF PROFESSIONAL ETHICS

GENERAL DISCUSSION

Professional Attitude. Confidence of Clients. Confidence of Third Parties.

FORMS OF ORGANIZATION AND DESCRIPTIONS

ANNOUNCEMENTS

ADVERTISING AND SOLICITATION

FEES

RELATIONS WITH CLIENTS

RELATIONS WITH STAFF

INDEPENDENCE

Substantial Financial Interest. Services as Director and Auditor. Book-keeping Service and Auditing. Financial Relations with Personnel of Client Companies.

RESPONSIBILITIES OF INDEPENDENT AUDITOR

COMBINING OTHER OCCUPATIONS WITH PUBLIC ACCOUNTING

GENERAL ETHICAL REQUIREMENTS

APPENDIXES

Selected Opinions of the Committee on Professional Ethics. Institute By-Laws and Rules of Professional Conduct.

Practical Applications of Professional Ethics

BY JOHN L. CAREY

A CODE OF ETHICS is a practical working tool. It is useful to a professional practitioner in the same sense that his theoretical principles and technical procedures are useful. Without a system of professional ethics he would be incomplete.

Professional ethics form a small part of a great, complex system of discipline which civilized society has imposed on itself through laws, customs, moral standards, social etiquette — rules of many kinds enforced in many ways. Discipline is necessary, if people are to live together in large numbers, to restrain the primitive animal instincts with which man is born.

The assurance that such discipline exists is also the basis of man's faith in his fellow man, which, despite frequent disappointments, is essential to the continuation of the highly involved and ramified economic structure which now supports most of the free world's population. Credit and investment are the underpinning of that structure, and they rest to a greater extent on faith in moral standards, and ethical considerations, than on the formal law. There could never be enough policemen to enforce the laws if all the people chose to violate them at one time. A code of professional ethics is a voluntary assumption of the obligation of self-discipline above and beyond the requirements of the law. It therefore serves the highly practical purpose of notifying the public that the profession intends to do a good job in the public interest. In effect, the existence of the code suggests that in return for the faith which the public reposes in members of the profession, they accept certain obligations to behave in a way that will be beneficial to the public. This is so obviously good business, aside from any higher considerations, that one wonders why certified public accountants have not publicized their rules of professional conduct more widely. The rules should be familiar to every client, to bankers and credit men, to lawyers and others concerned with certified public accountants, simply as a matter of public relations.

The ethical code also serves the highly practical purpose of providing members of the profession with guides to the type of behavior which the historical experience of the group as a whole has indicated is most likely to attract the confidence of the public.

The reason such guides are needed is that natural human instinct and common sense, and even a fine sense of right and wrong, are not always enough to point out the best way for a professional man to behave in a given situation. His relations with other people can be extraordinarily complicated, and sometimes it is best for him to behave in a way that would seem unnatural and even illogical to others.

When people need a doctor, or a lawyer, or a CPA, they seek someone whom they can trust to do the best he can — not for himself, but for them. They have to trust him, since there is no practicable way to appraise the quality of his “product.” And so they must believe that his primary motive is to help them.

That is why professions are distinguished from businesses — and why professional men are looked up to with respect.

Professional men are accepted as men highly skilled in some science or art, who desire to minister to other people — who want to serve the public, and who place service ahead of personal gain. If they were not regarded in this light they would have no patients or clients. Who would engage a doctor, or a lawyer, or a certified public accountant who was known to put personal gain ahead of service to his patient or client? How could anyone know whether to take his advice or not? If the practitioner were mainly interested in selling his services and building up fees, he might be expected to keep his patients sick, or keep his client in litigation, or extend his examination of the clients’ accounts beyond the necessary scope. Who would engage such a man?

Not only must people believe that the professional man will not take advantage of them financially, but also that they can safely entrust him with their most private and vital affairs. He must be regarded as a man of character. So he must behave himself in a way that strengthens their confidence. He must display a professional attitude toward his work.

A professional attitude must be learned. It is not a natural gift. It is natural to be selfish and greedy — to place personal gain ahead of service. (That is precisely why the people as a whole honor the relatively few — like professional men and other true public servants, who have disciplined themselves to follow the nobler way.) A professional attitude, like a golf swing, must be acquired by self-discipline. The rules of ethics are guides to right action — to action that will develop the professional attitude, and thus win public confidence.

Now, public confidence is even more important to a certified public accountant than to other professional men. He must have not only the confidence of those who become his clients, but also the confidence of those who rely on his reports. His service may be of little value to a client if a bank will not accept his report. And the bank, or the credit agency, or the government agency, or other “third parties” who may rely on the report, will accept it only if they believe that the CPA feels a responsibility to look out for their interests as well as the client’s.

And since all the multitude of "third parties" who may rely on the reports of certified public accountants are not likely to know the CPAs personally, this means that they must have confidence in CPAs as such — in the whole accounting profession — as men who can be trusted to do a good job for all concerned.

So, the rules of professional conduct of the accounting profession serve highly practical purposes:

1. They show the practitioner how to maintain a professional attitude which experience indicates will help him to succeed.
2. They give clients and potential clients a basis for confidence that CPAs sincerely desire to serve them well, and place service ahead of reward.
3. They give "third parties" who may rely on financial statements a basis for confidence that the CPA has done his work in conformity with objective standards and is independent in expressing his opinion.

The best way of demonstrating the practical value of a code of ethics, perhaps, is to imagine that it did not exist. Suppose each practitioner had to decide for himself, in the light of his own particular training and experience, what would be the best way to behave in any of the situations in which he might find himself. It would be too much to expect that everyone would perceive the right answers. The professional attitude would be likely to disappear rapidly. Public accounting would come more and more to resemble a business service. Public confidence would correspondingly decline, and eventually some other means would have to be found to provide "third parties" who risk money on financial statements of business enterprises with some evidence of the reliability of such statements. In view of the present trend of society, it may be presumed that this would be accomplished through audits by government staffs. The practice of accounting would remain only to the extent that businesses not large enough to employ competent accountants on a full-time basis made use of accounting firms to help them with their internal administrative accounting problems.

While the Rules of Professional Conduct of the American Institute of Accountants are officially stated in chronological order of adoption, they may be grouped according to subject matter quite conveniently around the following three objectives:

Professional Attitude

1. Firm name, style, and descriptions must be appropriate.
2. Practice as a corporation is forbidden.
3. Occupations incompatible with public accounting are prohibited.
4. Members in practice but also engaged in other related occupations must also observe rules of conduct in such occupations.
5. Advertising is prohibited.
6. Solicitation is prohibited.
7. Institute members must observe state rules on competitive bidding.
8. Offers of employment to employees of other accountants are prohibited.

Confidence of Clients

1. Confidential relationship with client must not be violated.
2. Splitting fees or paying commissions to laity is prohibited.
3. Member may not permit another to use his name except his partners and employees.
4. Member may not sign work prepared by others than his own associates or other accredited accountants.
5. In certifying statements members must conform with generally accepted accounting and auditing standards.

Confidence of Third Parties

1. In certifying statements; accountants must conform with generally accepted accounting and auditing standards.
2. Contingent fees in conjunction with audit work are prohibited.
3. Members must not vouch for the accuracy of forecasts of earnings.
4. Member may not express opinion on financial statements of an enterprise financed by public distribution of securities if he, or one of his immediate family, has a substantial financial interest in the enterprise; if the enterprise is not publicly financed but the statements are used as basis of credit, he may not express an opinion unless in his report he discloses any substantial financial interest which he, or his family, may have in that enterprise.

It is immediately evident that the present rules do not deal with all the ethical questions which may arise in the practice of public accounting.

The basic ethical concept of independence, for example, is not nearly so fully presented in these rules as it has been in literature of the profession. Many specific ethical questions not covered in the rules have been answered in opinions of the Institute's committee on professional ethics.

Still other ethical questions have not yet been answered decisively at all. The evolutionary processes of accumulating wisdom are still at work.

Since this CPA Handbook is intended to be a practical aid to the reader, and a source of continuing reference, the remainder of this chapter is devoted to specific questions of ethics likely to be encountered in practice. The answers are based on the best authorities available — sometimes a rule, sometimes a committee opinion, sometimes only a published article.

Authorities are indicated as follows: RPC — Rules of Professional Conduct, American Institute of Accountants; CE — opinion of Committee on Professional Ethics, American Institute of Accountants; other sources are named in full.

Space does not permit consideration of all questions that may arise, nor full discussion of the reasoning underlying the answers. More extended discussion of some of these matters may be found in "Professional Ethics of Public Accounting."¹

The purpose here is to provide the quickest possible answers to the most common practical questions of professional ethics.

¹ See reference 1 at end of this chapter.

FORMS OF ORGANIZATION AND DESCRIPTIONS

1. *Can an individual certified public accountant style himself as "John Doe and Company"?*

The Institute's rules do not prohibit such a description, but Treasury Department Circular 230, which applies to all agents enrolled to practice before the Treasury, does contain such a prohibition. Section 10.2 (e) of Circular 230 says: "Every enrolled attorney or agent practicing as an individual shall use his legal name in the conduct of his legal, accounting, or other professional practice. The term 'company,' 'associates,' 'accountants,' 'auditors' . . . or other plural forms suggesting a partnership, or language of similar import, used in connection with a name or title, or any fictitious title, or trade name, shall be used only by a bona fide partnership consisting of two or more members, and all stationery, listings, advertisements, and announcements of enrolled persons shall conform to the principles herein stated."

Rule No. 1 of the Rules of Professional Conduct (RPC) states that an individual practicing under a style denoting a partnership when in fact there is no partner or partners shall not use the designation "members of the American Institute of Accountants."

Most state accountancy laws contain provisions similar to Rule No. 1 with respect to the use of the designation "certified public accountants"; that is, the designation may not be used unless a partnership actually exists (and, of course, all the partners are certified public accountants).

2. *What types of firm name or "style" are appropriate for a partnership?*

The following are appropriate:

Smith & Jones
Smith & Company
The John Smith Company
Smith & Associates

The committee on professional ethics (CE) has held that the name of a firm of practicing accountants should denote a personal association. Such a firm should not adopt for its name any nonpersonal or misleading title. A corporate form of name, such as "Unique Audit Company" would not be appropriate as the name of a firm of professional accountants.

3. *How can a partnership of CPAs describe itself?*

The designation "certified public accountants" may be used in conjunction with the firm name, if all the partners are certified public accountants of the state in which the firm practices. If some partners are certified in one state and some in another, then the laws of the state in which the practice is being carried on should be consulted — provisions differ among the several states.

If all the partners of the firm are members of the American Institute

of Accountants, the designation "Members, American Institute of Accountants" may be used in conjunction with the firm name.

If some of the partners are members of the Institute and others are not, the designation may not be used in conjunction with the firm name, but the names of the individual partners who are members may be listed in the corner of the letterhead with the designation "Member, American Institute of Accountants" following each name as appropriate.

Occasionally a firm may wish to show on its letterhead the names of accountants with the firm who are not partners. The CE has approved the listing of both partners and staff, provided the partners are shown first in order, followed by a line to separate them from members of the staff who may be named. In this way, the public is put on notice that those below the line have some other status than that of partner.

4. Can certified public accountants practice public accounting in the corporate form of organization?

No. RPC No. 11 says a member shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States, or the District of Columbia.

Most state accountancy laws also forbid practice in the corporate form.

5. Can a certified public accountant practice in partnership with a CPA of another state?

Generally, yes, but the laws of the states in which offices are to be maintained should be consulted. Under some "regulatory" laws it is necessary for all members of a partnership practicing in a state to be registered, and particular attention should be paid to the statutory provisions related to use of the designation "certified public accountants" in conjunction with the firm name.

6. Can a certified public accountant practice in partnership with a noncertified public accountant?

There is nothing in the rules of the Institute which would prevent a member from entering into partnership with a noncertified public accountant.

There is nothing in most CPA laws to prevent the partnership of a CPA with a non-CPA. However, in "regulatory" states, the noncertified accountant would have to be registered and licensed to practice accounting in the state.

Naturally, the description "Members, American Institute of Accountants" or "certified public accountants" would not be permissible in conjunction with the firm name of a partnership composed of a certified public accountant and a noncertified public accountant.

The letterhead of a firm composed of both certified and noncertified public accountants may show the names of individual partners, and in this case the designation CPA may follow each name entitled to it.

It should be borne in mind in a partnership of this type that the CPA is ethically responsible for all the acts of the partnership. In other words, if his noncertified partner should violate the Rules of Professional Conduct, the CPA would be held accountable.

The Canons of Ethics of the legal profession do not permit partnerships between lawyers and "laymen." The rules of the Institute of Chartered Accountants in England and Wales permit a chartered accountant to form a partnership only with another chartered accountant. It has been suggested that similar restrictions should be imposed upon CPAs in the United States, but no action has been taken.

7. Can a CPA practice public accounting in partnership with a lawyer, an engineer, or a member of another profession?

The rules of professional conduct of the Institute have not been construed to prevent such a partnership. It should be noted, however, that the legal profession frowns on partnerships between lawyers and non-lawyers, and in no event could the CPA practice law unless he is also a lawyer and practices as such. Again it should be noted that in "regulatory" states only accountants registered and licensed to practice may engage in public accounting and it would therefore not be appropriate for a CPA to associate himself in partnership with a lawyer or an engineer for the practice of public accounting unless the lawyer or engineer also were registered as a public accountant.

Again it should be noted that the CPA would be responsible for any violations of the Rules of Professional Conduct on the part of his non-accountant partner.

8. Is it ethical to buy a public accounting practice?

The purchase of public accounting practices has been, and continues to be, a generally accepted method of acquisition. There has been no intimation by any of the professional accounting societies that there is anything unethical about it.

9. Is it ethical to pay the estate of a deceased partner a share of the profits of the partnership over an agreed period?

RPC No. 3 forbids participation by the "laity" in fees or profits of professional work, but the CE has held that payments to a widow or the estate of a former partner would not be considered a violation of that rule. It would be improper, CE has held, for a former partner's widow to be included as a partner of a firm of certified public accountants (unless she were personally professionally qualified).

10. Is it ethical to practice under a firm name composed of the names of persons who are no longer partners of the firm?

Inclusion in the firm name of the name of a former partner or former partners has been held by the Council of the American Institute of Accountants to be entirely appropriate.

11. *May the sole survivor of a partnership continue practice as an individual under the old partnership name?*

This apparently would be a violation of Treasury Department Circular No. 230, which provides that a firm name suggesting a partnership shall be used only by a bona fide partnership consisting of two or more members.

The CE has expressed the view that it would be improper for an individual CPA to practice under the name of a deceased CPA. It was suggested in such a case, where the goodwill had been purchased from the estate, the purchaser, who would practice in his own name, might show on his letterhead that he was successor to the deceased accountant.

The designation "certified public accountants" or "Members, American Institute of Accountants," used in conjunction with the firm name, would be inappropriate if in actuality the practice were being conducted as a sole proprietorship.

12. *Is it proper to practice in association with another accountant without any actual partnership arrangement?*

There is nothing in RPC which would prohibit the sharing of office space by two certified public accountants not actually in partnership, nor is there anything in the rules to prohibit two such certified public accountants from assisting one another in the conduct of engagements from time to time. Such arrangements, however, should be specific and a matter of record. Each CPA should be compensated by the other for whatever time he might spend in assisting the other.

Loose arrangements of this sort might lead to violation of RPC No. 2, which states that a member shall not allow any person to practice in his name who is not in partnership with him or in his employ. If the association is between a CPA and a noncertified public accountant, then the CPA should also be aware of Rule No. 6, which states that a member shall not sign a report purporting to express his opinion on the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

13. *What information may properly appear on letterheads, cards and legends on office doors, windows, and building directories?*

Such information should be restricted to the name of the firm, the designations "certified public accountants," "Members, American Institute of Accountants," or similar designations, when permissible; and, if desired, the names of individual partners, and cities in which offices are maintained, but not a listing of services rendered.

No lettering on office windows or building directories or signs of any kind should be so large or prominent as to constitute in effect "display advertising."

ANNOUNCEMENTS

1. *What type of announcements may certified public accountants have published in newspapers or magazines?*

RPC No. 10 provides that announcements may be published in newspapers or magazines only for the purpose of announcing a change of address or a change of personnel of firm. This is construed to include the announcement of the opening of a new office by a new firm.

A change of personnel of firm is considered to mean a change in the partnership, not in the staff.

Such announcements are not to exceed two columns in width and three inches in depth if appearing in a newspaper, and are not to exceed one-quarter of a page if appearing in a magazine or similar publication.

The information which may be included in the announcement is the name; designation, such as "Member, American Institute of Accountants," "CPA," or other professional affiliation; class of service; and address of the person or firm.

In describing "class of service" it should be borne in mind that the designation "tax consultant," and similar designations, have been held to be improper by the National Conference of Lawyers and Certified Public Accountants in a Statement of Principles which has been approved by the Council of the American Institute of Accountants.

Bearing in mind that the Canons of Ethics of the bar prohibit lawyers from advertising any specialty in the law, many certified public accountants believe it desirable, even though the Institute has no similar rule, not to describe the "class of service" rendered — that is, audits, taxes, systems, et cetera. At this stage of the profession's development, it is generally felt that the description "certified public accountants" sufficiently informs the public of the nature of the services offered.

2. *What type of announcements may be sent through the mails, and to whom?*

Cards bearing announcements of the nature and in the form permissible for publication in newspapers or magazines (see 1 above) may properly be sent through the mails to clients and friends.

Such announcements should not be sent to complete lists of bankers, lawyers, or businessmen, or the memberships of any organization, and should not be mailed to persons who are already served by other public accountants.

The CE has ruled that it is undesirable to send such announcements to clients of a former employer.

3. *What restrictions are there on listings in classified telephone directories and other directories?*

RPC No. 10 provides that a paid listing in a directory should be restricted to the name, title, class of service, address, and telephone number

of the person or firm, and shall not appear in bold type, box, or other form of display or in a style which differentiates it from other listings in the same directory.

The CE has held that use of the designation, "Member, American Institute of Accountants," when used in a directory listing, differentiates the listing from others in the list, and therefore the designation should not be included.

ADVERTISING AND SOLICITATION

1. *What are the restrictions on advertising?*

RPC No. 10 says "A member shall not advertise his professional attainments or services." Except for the publication of announcements as described in the preceding section, no advertising of any kind is permitted.

2. *Is it permissible to publish a blind ad, not giving the name of the accountant but only a box number, indicating a willingness to accept accounting engagements?*

No. CE has held this constitutes advertising professional attainments or services regardless of whether the accountant's name appears or not.

3. *Is it proper for an accounting firm to advertise for personnel?*

Yes. An advertisement for staff assistants is not considered an advertisement of professional attainments or services, and it may be published with the name of the accounting firm concerned.

4. *What are the restrictions on solicitation of clients?*

RPC No. 7 says a member shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview, not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant.

This seems to mean that a CPA may not properly solicit clients generally, may personally offer his services only when personal relationships warrant such an approach, and in no event may he solicit a client presently served by another public accountant.

The CE has not yet interpreted the phrase "warranted by existing personal relations."

5. *Is the publication of firm bulletins permissible?*

Yes, but they may be distributed only to clients and staff.

Even when distribution is confined to clients, CE does not regard with favor the distribution of material prepared by commercial publishers on which the accountant's name has been imprinted in such a way as to indicate that he prepared the material when such is not the case.

6. *Is unsolicited publicity about a certified public accountant objectionable?*

No. Advertising is defined as something which is paid for by the accountant concerned. If his activities are regarded as news and they are publicized without effort on his part, he should not be accused of unethical conduct.

7. Are there restrictions on public speaking or writing for publication?

The Institute's rules contain no such restrictions. Treasury Department Circular No. 230, however, prohibits the publication of articles or the delivery of addresses on Federal tax questions by an enrolled person in connection with which the name of the firm of which he is a member or otherwise associated or his address is given either by the writer, speaker, announcer, or publisher.

8. How can a CPA properly make himself well known in his community?

By taking an active part in civic affairs and community organizations of all kinds, including his professional societies of certified public accountants. Publicity arising from public service activities is entirely legitimate.

9. May a CPA properly engage in politics?

Yes. There is nothing in the Rules of Professional Conduct that denies a CPA his full rights as a citizen. Many CPAs consider it desirable for members of their profession to stand for political office, as many lawyers do. CPAs have served as mayors of their cities, as members of state legislatures, as members of the Federal Congress, as state auditors, and in other public offices.

FEES

1. Is it unethical to give an estimate of the cost of a professional service?

No. A CPA is entitled to give a client an estimate of what he thinks it will cost — or what he thinks the maximum cost will be — to perform a specified piece of work.

However, many CPAs refuse to submit "bids" for professional accounting engagements. An estimate may be considered a bid if it is offered in competition with other public accountants.

Some state societies of certified public accountants have adopted rules against competitive bidding. The Institute's Rule No. 14 says that a member shall not make a competitive bid for professional engagements in any state, territory, or the District of Columbia, if such a bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or district.

Some businessmen "shop around" in an attempt to obtain professional accounting services as cheaply as possible. Sometimes a request for an

estimate of the cost of an audit may be in effect a request for a bid, because other firms are being asked for estimates at the same time.

2. Must fees be based wholly on per diem rates?

No. In computing his fee, a CPA is entitled to give consideration to all related factors — the time and effort required, the novelty and difficulty of the questions involved, the skill requisite properly to perform the engagement, the customary charges by certified public accountants for similar services, the amounts involved in the transactions to which the accountant's work relates, the extent of the benefit to the client resulting from the accountant's services, and the character of the employment whether casual or for an established and constant client,

3. Is there any objection to annual retainers?

No. They are generally considered desirable.

4. Is it proper to undertake an engagement on a contingent-fee basis — the amount of the fee to depend on the accountant's findings or the results thereof?

No. RPC No. 9 says that professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service.

However, the rule states that it does not apply to cases involving Federal, state or other taxes, in which the findings are those of the tax authorities and not those of the accountant.

Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

With respect to Federal income tax matters, Treasury Department Circular No. 230 permits a wholly contingent fee agreement only when the financial status of the client is such that he would otherwise be unable to obtain the services of an agent. Partially contingent fee agreements are permissible where provision is made for the payment of a minimum fee. Such minimum fee must be paid and retained without regard to the outcome of the proceedings and must be substantial in relation to the maximum fee.

5. Is it proper to accept a "forwarding fee" or "referral fee" for work referred to another accountant?

There is nothing improper in accepting "forwarding fees" so long as they are reasonable in amount. A "forwarding fee" should not be so great as to allow only a small margin of profit to the firm doing the work. Actually, many certified public accountants will not accept "forwarding fees," since they regard it as a favor on the part of the other accountant involved to have undertaken to perform an engagement at their request.

A "forwarding fee" paid to a nonaccountant would be a commission, brokerage, or other participation in the fees of professional work, and consequently would be a violation of Rule No. 3.

6. Is it proper to accept a fee for signing statements or reports prepared by another accountant?

No. Rule No. 6 states that a member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or employee of his firm, or another CPA or foreign accountant of equivalent standing.

The last exception is made in order to permit arrangements to be made through which certified public accountants in different parts of the country, or foreign accountants of equivalent standing, may examine branches or subsidiaries of corporations, and the results of their examinations may be consolidated with those of a larger group.

This type of "joint engagement" is fairly common and permits great savings in traveling expenses.

7. Is it proper for a CPA to split fees with persons not CPAs who may have helped him to secure engagements?

No. This would be a clear violation of RPC No. 3.

RELATIONS WITH CLIENTS

1. Is it necessary to find out how a prospective client happened to get in touch with the CPA?

While there is no rule on the subject, it is customary for all professional men to endeavor to ascertain how a new client or prospective client learned of them. One purpose is to ascertain whether or not the prospective client is "shopping around" in an effort to obtain professional services at low cost.

2. What should a CPA learn about a prospective client before agreeing to do work for him?

It is desirable to ascertain whether or not the prospective client has been or is being served by other public accountants. If so, it is desirable to learn the reasons for a change. It is considered good practice, in such a case, to request the prospective client's permission to discuss the situation with the former accountants. If such permission is refused, it may be grounds for suspicion either that the prospective client is not financially responsible, or that he desired the former accountants to do something which they did not consider ethically proper.

In any event a CPA should satisfy himself that a prospective client is reputable and responsible and is engaged in a legitimate business; otherwise the CPA may find himself subsequently embarrassed by the association.

3. *Is it ethical to discuss with a client of another public accountant, at that client's invitation, the possibility of rendering accounting services to that client?*

Yes. RPC No. 7 says that a member may furnish service to those who request it. Obviously, then, he may properly respond to an invitation to discuss the possibility of furnishing such service. But it is considered good practice to communicate with the prospective client's present public accountant (see 2 on preceding page). In no event should the CPA solicit the opportunity to initiate such a discussion.

4. *Is it ethical to furnish income tax system work or other services to a client whose accounts are audited by another public accountant?*

Yes, if the services are furnished at the client's request, without solicitation. Such arrangements, while not common, have occurred fairly frequently.

5. *Just what is meant by the "confidential relationship between CPA and client"?*

It means that the certified public accountant should not voluntarily disclose information about his client which he acquired in the course of his professional service. RPC No. 16 says "a member shall not violate the confidential relationship between himself and his client."

The CE has held in one case that even if a CPA learned through performance of his professional duties of fraud or other wrongdoing on the part of his client, he could not properly report the facts to others without the client's consent, but should withdraw from the engagement and write a letter to the client stating the reasons therefor. (In some situations of this kind there may be legal responsibilities involved, and the CPA should always consult his attorney as to the proper action in view of the specific facts of the situation.) Except in some eleven states,* communications between certified public accountants and clients are not "privileged" under the law. Elsewhere the courts may compel a certified public accountant to disclose information acquired in the course of his professional service. Even in the eleven states Federal courts may not sustain the privilege, particularly in matters of Federal taxation.

Certified public accountants should make such disclosures, however, only under compulsion, and not voluntarily.

6. *Does the certified public accountant own his own working papers?*

Yes. The Supreme Judicial Court of Massachusetts, in the case of *Ipswich Mills v. Dillon*² held that the accountant's working papers are his property and not even the client can require their surrender. The

* Arizona, Florida, Georgia, Illinois, Iowa, Kentucky, Louisiana, Maryland, Michigan, New Mexico, and Tennessee, and Puerto Rico.

laws of nine additional states * have since made similar provision.

However, working papers may be required to be produced in court by subpoena in the absence of statutory privilege. For his own protection, it has been suggested that in such cases the accountant should make photostatic copies of the working papers for his own files.

7. To what extent does the rule against advertising restrict a CPA in sending information to his clients through the mails?

He is entitled to send his clients anything he wishes, but it is considered poor form for him to send them materials like blotters, calendars, rulers, and similar materials which might be displayed in the clients' offices and noticed by other visitors there.

As indicated previously, it is also considered poor taste to send clients material prepared by commercial publishers which bears the accountant's name in such a manner as to indicate that he is the author of such material.

8. May a CPA accept a commission from a supplier on the sale of products or services to a client at the recommendation of the CPA?

No. RPC No. 3 says that commissions, brokerage or other participation in the fees, charges or profits of work recommended or turned over to the laity as an incident to services for clients shall not be accepted directly or indirectly by a member.

RELATIONS WITH STAFF

1. Does a CPA have any ethical obligation to his staff employees?

No such obligation is mentioned in the Rules of Professional Conduct. However, it is traditional in all the professions that the practitioner has a duty to instruct his staff and to train them in the skills of the profession. Proper consideration for the health, comfort, and happiness of employees is considered a general obligation of all employers.

2. May a CPA properly offer employment to an accountant in the employ of another CPA?

RPC No. 8 says that direct or indirect offer of employment shall not be made by a member to an employee of another public accountant, without first informing such accountant.

However, a CPA is free to negotiate with any prospective employee who, of his own initiative, or in response to a public advertisement, shall apply to that certified public accountant for employment.

Even in such cases it is considered good manners to check with the present employer of the applicant, with the applicant's consent.

* California, Florida, Kentucky, Missouri, New Hampshire, Oregon, Pennsylvania, Virginia, and Washington, and Puerto Rico.

3. *May a CPA employ lawyers, engineers, or other specialists as members of his staff?*

There is no provision in the Rules of Professional Conduct which would prevent it. However, the bar generally looks with disfavor on the employment of lawyers by laymen if it appears that such lawyers render legal services to others on behalf of the employer. Presumably a lawyer employed by a CPA would not be considered entitled to "practice law." He would be entitled to perform only such services as his employer was legally authorized to perform.

Naturally, a CPA employing members of other professions would be responsible for any violation of the Rules of Professional Conduct of the accounting profession by the firm as a whole or by any employee thereof.

4. *Is it proper to require staff accountants to sign agreements restricting the extent of their practice if they should leave a CPA's employ?*

There is no ethical rule governing this point. There is a difference of opinion within the profession as to whether or not such agreements are psychologically helpful. Whether or not they are legally enforceable probably depends on the facts of each case, and should be the subject of legal advice.

The committee on professional ethics has taken the position that an employee is morally bound by any agreement which he enters into voluntarily with his employer. In any event, a staff accountant, undertaking practice on his own account, is prohibited by the Rules of Professional Conduct from the solicitation of clients of other public accountants, including those of his former employer.

INDEPENDENCE

1. *What is the general concept of independence as it applies to public accounting practice?*

RPC do not define independence, but the Council of the American Institute of Accountants adopted a general statement on the concept in 1947 and which was published in *The Journal of Accountancy*.³ Boiled down, the statement says, in effect: "... Independence is traditionally associated with the CPA's function of auditing and expressing an opinion on financial statements, of vital importance to stockholders, creditors, and others who rely on such statements. ... It has become of great value to those who rely on financial statements of business enterprises that they be reviewed by persons skilled in accounting whose judgment is uncolored by any interest in the enterprise, and upon whom the obligation has been imposed to disclose all material facts."

The established rules of conduct require disclosure of all material facts, and of material departures from generally accepted accounting or auditing principles applicable in the circumstances. (RPC No. 5) The

rules also prohibit a CPA from having a substantial financial interest in a company of which he is auditor, if its securities are widely held. Any such interest in a closely held company of which he is auditor must be disclosed in his report. (RPC No. 13)

"Rules of conduct," continued the Council's statement, "can only deal with objective standards and cannot assure independence. Independence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession, and upon its maintenance depends the profession's strength and its stature."

The Securities and Exchange Commission (SEC) has given great emphasis to the concept of independence, and has adopted a rule on the subject which has been applied in a number of cases.

Full discussions of the SEC's view and of the profession's view are contained in papers delivered at the Institute's 63rd Annual Meeting in 1950: "The Concept of Independence in Accounting," by Donald C. Cook,⁴ CPA, Commissioner, SEC; and "Independence from the Viewpoint of the Certified Public Accountant," by Edward B. Wilcox,⁵ CPA, past president of the Institute.

If there is a distinction between the SEC's view and the profession's view of independence, it may, perhaps, be put this way:

The SEC emphasizes the specific relationships between an accountant and his client which give rise to a presumption of lack of independence — the SEC will not recognize an accountant as independent if any of the proscribed relationships exist.

The Institute emphasizes the fact of independence — the state of mind which the word denotes. It recognizes that an accountant may be independent in spite of close relationships with his client — or that he may lack independence in spite of the most correct appearances. The Institute, therefore, has not chosen to prohibit a great variety of relationships which might conceivably tend to introduce a subconscious bias into the accountant's judgment, but rather relies mainly on Rule No. 5 to determine whether independence has actually been impaired or not. If accepted accounting and auditing standards are observed, and all material facts are fully disclosed, it may be presumed that independence exists.

2. Specifically what relations with the client does the SEC consider to impair independence?

Because of the differing approaches of the Institute and the SEC to the question of independence, accountants whose clients must file statements with SEC, and who therefore become subject to the Commission's rules, must be familiar with SEC requirements relating to independence.

SEC Regulation S-X, Rule 2-01 provides that an accountant will not

be considered independent with respect to any client with which he has the following relationships:

Substantial financial interest	Voting trustee
Promoter	Director
Underwriter	Officer
	Employee

In specific cases, the SEC has held that the following factual situations tended to impair independence of certifying accountants:

1. Employee of certifying accountants was controller of registrant.
2. Accountants consciously falsified facts.
3. Accountant relied on unverified information furnished by client.
4. Accountant subordinated his judgment to that of client.
5. Employee of certifying accountants did much of the bookkeeping for registrant.
6. Private audit report to management differed from report made public.
7. Client and accountant made substantial personal loans to each other.
8. Close personal relations existed between accountants and management, plus various personal services by accountants for management in their individual capacities (together with other factors).
9. Accountant was officer of, and was intimately associated with, a large holding company system, of which registrant was only a segment.
10. Accountant permitted his name to be used for an account through which officers of client traded in client's stock.
11. Accountants engaged treasurer and bookkeeper of registrant to do detailed auditing work.
12. Accountants failed to make sufficient investigation of intercorporate transactions.
13. Partner of accounting firm actively participated in promotion of registrant.
14. Agreement between client and accountant indemnified accountant against liability.
15. Accounting firm acted as custodian of securities of registered investment company.
16. Accountant maintained open account, represented by cash and securities with registered broker dealer, financial statements of which accountant certified.
17. Partners of accounting firm were also partners of a law firm passing on legality of securities being issued by registrant.
18. Accountant posted to general ledger entries covering a month's transactions and made all closing entries.
19. Accountant served as salesman for securities dealer, not a client, but audited accounts of other registered securities dealers.

These examples do not cover all, or even a majority, of the actual rulings on independence by the SEC, but they do indicate the principal relationships which have been held to impair independence. The questions arising most frequently involve financial interest and employment of accountants in other capacities as well as that of auditor.

3. What relationships does the Institute regard as impairing independence?

The Institute has specifically considered only a few of the relationships with which the SEC has found it necessary to deal.

The Institute's views on these relationships may be summarized as follows:

Substantial Financial Interest

1. RPC No. 13 provides that a member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise.
2. If the client is not financed by public distribution of securities, but the financial statements on which the member expresses his opinion are to be used as a basis of credit, the rule provides that the member shall disclose in his report any such financial interest as described previously.

Service as Director and Auditor

1. RPC are silent on this point, but CE has ruled on numerous occasions that it is unwise for an independent auditor to serve as member of the Board of Directors of a corporate client, and that if he does, the relationship should be disclosed. The New York State Society of Certified Public Accountants has a rule requiring disclosure of such a relationship.
2. It has been contended that a permissible exception may be in the case of charitable or other nonprofit organizations, but even here it must be recognized that the accountant who serves both as auditor and director assumes additional responsibility.

Bookkeeping Service and Auditing

1. The question has often been raised whether an accountant can appropriately express an opinion on financial statements when he has participated in keeping the client's books. SEC would probably hold that the accountant could not be regarded as independent in these circumstances. However, it can be strongly argued that the accountant's independence is not necessarily impaired by his participation in the bookkeeping.
2. This question was considered at length by the committees on auditing procedure and professional ethics of the American Institute of Accountants. The conclusion is stated in the report of the committee on auditing procedure to the Council of the Institute dated October 6, 1951 as follows: "Both committees were in agreement that if an accountant is in fact independent, and if he has performed all the auditing procedures necessary to supplement the information obtained through keeping the books, he should be entitled to express any opinion he may have formed. However, there was some uncertainty as to whether the two committees were in agreement regarding whether the accountant should disclose in his report the fact that he kept the books. After further consideration, the committees have agreed that this is a question which should be left to the judgment of the accountant in the light of the facts of each case. The committees believe that disclosure of the fact that he has kept the books is not usually necessary."

Financial Relations with Personnel of Client Companies

1. The Council of the American Institute of Accountants, sitting as a trial board in 1941, expressed the view that all public accountants should avoid any

financial relationship with officers or employees of client corporations, in the form of borrowing or lending, or participation in the profits of investments, or in any similar manner.

4. *May a CPA serve two or more clients whose interests conflict without impairing his independence?*

It is an accepted precept in the legal profession that a lawyer generally should not serve two clients whose interests conflict, and by analogy it is often assumed that certified public accountants may not properly do so either. The analogy, however, is believed to be unsound. Lawyers act as advocates, and a single lawyer could obviously not be the advocate for two opposing views. The fact that a CPA is independent permits him without impropriety to serve two or more clients whose interests may be in conflict. However, there may be circumstances in which the relationships should be disclosed to all concerned in order that there may be no misunderstanding.

This question was raised before the Council of the Institute in May 1944 with particular reference to situations in which CPAs had been called upon by governmental agencies to undertake examinations of the accounts of corporations for which the accountants had been acting as regular auditors.

The Council adopted the following resolution:

"WHEREAS, independent public accountants have been called upon by governmental agencies and others to undertake on their behalf examinations of the accountants of corporations for whom the accountants have been acting as regular auditors; and

"WHEREAS, questions have been raised as to the propriety of selecting for such examinations the public accountants who are the regular auditors of such corporations because of the possibility of a conflict of interests; and,

"WHEREAS, independence of viewpoint is one of the essential qualifications of the public accounting profession, in that reports made by auditors for their clients are quite generally intended to be used, and are used, by third parties, such as, creditors, stockholders, directors, and others whose interests are frequently diverse;

"BE IT RESOLVED that it is the opinion of Council of the American Institute of Accountants, assembled at its regular semiannual meeting on May 9, 1944: That an independent public accountant may properly undertake accounting or auditing engagements for or on behalf of government agencies or other third parties involving the accounts of a regular client, provided his relationship to the various parties interested is fully disclosed."

RESPONSIBILITIES OF INDEPENDENT AUDITOR

1. *What are the ethical responsibilities of a CPA in the capacity of independent auditor in expressing an opinion on ("certifying") financial statements?*

These responsibilities are set forth specifically in RPC No. 5:

"In expressing an opinion on representations in financial statements which

he has examined, a member may be held guilty of an act discreditable to the profession if

- (a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
- (b) he fails to report any material misstatement known to him to appear in the financial statements; or
- (c) he is materially negligent in the conduct of his examination or in making his report thereon; or
- (d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
- (e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any omission of generally accepted auditing procedures applicable in the circumstances."

Subparagraphs (a) and (b) require no comment.

Subparagraph (c) refers not to what the auditor does, but how he does it. If he is careless or thoughtless in planning or conducting his examination, if he relies on assistants whose competence is questionable, if he fails to exercise due professional care in the performance of his work, he may be held to have violated subparagraph (e).

The standards of adequacy in the conduct of an audit are outlined generally in Tentative Statement of Auditing Standards — Their Generally Accepted Significance and Scope,* issued by the American Institute committee on auditing procedure in 1947, approved by the membership of the Institute in September 1948.

Subparagraph (d) covers two points. First, an auditor may be held in violation of the rule if he expresses an opinion on financial statements without having acquired sufficient information to warrant such expression of an opinion. In other words, he may not properly express an opinion unless the scope of his examination has been as extensive as he considers necessary to acquire sufficient information to warrant an opinion. Second, if the auditor's exceptions in his opinion relate to items in the financial statements which are so material in relation to financial position or results of operations that, with those items excluded, the opinion on the financial statements as a whole have little value, the rule may be held to have been violated. In other words, the auditor's exceptions may be considered such as to "negative the opinion."

Subparagraph (e) requires the auditor to disclose any material departure from generally accepted accounting principles or generally accepted auditing procedures.

Generally accepted accounting principles are not easy to define. They are usually considered to be embodied in the following sources:

1. Accounting research bulletins issued by the committee on accounting procedure of the American Institute of Accountants.
2. Accounting releases of the SEC.

* Included in full as Appendix A of Chapter 13.

3. Accounting opinions issued by the American Accounting Association in formal statements and monographs.
4. Authoritative literature of the accounting profession — books and articles in periodicals.
5. Proceedings of meetings of the American Institute of Accountants and other accounting societies.
6. The practices of corporations whose reports are published, as reflected, for example, in the analysis "Accounting Trends and Techniques in Published Corporate Reports" published annually by the American Institute of Accountants.

Generally accepted auditing procedures are summarized in the pamphlet entitled *Codification of Statements on Auditing Procedure* * issued by the American Institute of Accountants in 1951. This pamphlet summarizes earlier pronouncements by the Institute's committee on auditing procedure and refers to the source material.

Authoritative textbooks and articles in accounting journals, as well as papers presented at meetings of the accounting societies, may also be accepted as sources of information on generally accepted auditing procedures.

2...What are the ethical responsibilities of a certified public accountant in permitting his name to be associated with financial statements on which he does not express an opinion?

This point is not covered in the Rules of Professional Conduct. It is the subject, however, of Statement on Auditing Procedure No. 23, issued by the committee on auditing procedure of the American Institute of Accountants and approved by the membership of the American Institute of Accountants at its annual meeting in 1949. The essential passages are as follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

Whenever the accountant permits his name to be associated with financial statements, he should determine whether in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a

* This pamphlet is included in full as Appendix B of Chapter 13.

whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit*, appearing prominently on each page of the financial statements is considered sufficient.

It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

The substance of Statement on Auditing Procedure No. 23 is incorporated in the previously mentioned booklet *Codification of Statements on Auditing Procedure*.

3. *May a CPA sign a forecast of financial results?*

RPC No. 12 states that a member shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member vouches for the accuracy of the forecast.

4. *May a CPA properly sign an audit report individually on behalf of the firm of which he is a partner? Does it make any difference if he is in partnership with an uncertified accountant?*

The CE has expressed the opinion that it is not in itself necessarily improper for a partner of a firm who is a certified public accountant to sign reports with the firm name and below it affix his own signature with the designation "certified public accountant" — even if other partners of the firm are not certified public accountants. However, any practice which might lead the reader to believe that the firm was entirely composed of CPAs, when such was not the case, would be grounds for criticism.

5. *Is a CPA required to know the accounting rules of government agencies insofar as they apply to his client's accounts?*

A report issued on behalf of the Council of the American Institute of Accountants states that an accountant undertaking an examination is charged with the responsibility of familiarizing himself with accounting or auditing requirements of government agencies empowered to pre-

scribe rules on accounting or auditing to which the client is subject. If the accountant fails to familiarize himself with such requirements, or if he finds that these requirements have not been fairly met in the financial statements and he issues a report in which he fails to state the fact, and to take a clear exception, he may properly be subject to discipline under the provisions of the Institute's by-laws, just as fully as if the statements failed to conform to accepted accounting principles.

COMBINING OTHER OCCUPATIONS WITH PUBLIC ACCOUNTING

1. *May a CPA properly engage in the part-time practice of public accounting while employed on a salary by a business enterprise?*

Yes. There is nothing in the Rules of Professional Conduct to prevent part-time practice of public accounting. It is hardly necessary to state, of course, that the CPA in this position should not undertake to conduct an "independent" audit of the enterprise by which he is employed.

2. *May a CPA combine the practice of accounting with the practice of law or engineering if he is also licensed or qualified to practice the other profession?*

There is nothing in the RPC to prevent such a combination of practice. The committee on professional ethics of the New York County Lawyers Association has held that lawyers who are also CPAs may practice both professions in the same office. However, the corresponding committee of the American Bar Association had issued an earlier ruling which might be construed to the contrary.

3. *Are there any occupations in which a CPA may not properly engage simultaneously with the practice of public accounting?*

Yes. RPC No. 4 says that a member of the Institute shall not engage in any business or occupation conjointly with that of a public accountant which is incompatible or inconsistent therewith. Any occupation which casts doubt on the independence of the CPA as an auditor would probably be held to be incompatible.

The CE has held that it would be inconsistent with standards of independence and not in the best interests of the profession for a CPA in public practice to be simultaneously a limited partner of a brokerage firm engaged in the purchase and sale of securities and commodities to the public on a commission basis.

CE has also held that a CPA in practice should not, at the same time, be an investment dealer or securities salesman.

4. *May a CPA own and operate a bookkeeping service company independently of his public accounting practice?*

RPC contains nothing which would prevent the simultaneous conduct of a public accounting practice and the operation of a bookkeeping service company, but Rule No. 15 provides that a member engaged in an

occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and Rules of Professional Conduct of the Institute in the conduct of that occupation.

This means that the bookkeeping service company owned and operated by the CPA could not engage in advertising or solicitation, or otherwise be conducted in a manner inconsistent with the Institute's Rules of Professional Conduct.

5. May a CPA own or manage or teach in a private profit-making accounting or business school while also engaged in the practice of public accounting?

Yes, so long as the school conducts its operations and solicits its prospective students and advertises its courses by methods which are not discreditable to the accounting profession.

Association with a school or any other enterprise which is conducted in a manner likely to reflect discredit on the certified public accountant associated with it, may be held to render him susceptible to charges of conduct discreditable to the profession.

GENERAL ETHICAL REQUIREMENTS

1. Are there any general ethical responsibilities imposed on the CPA not specified in the rules of conduct or brought out in the foregoing questions?

The by-laws of the Institute provide that a member may be admonished, suspended, or expelled if found guilty of "an act discreditable to the profession." While the Rules of Professional Conduct and the rulings of the committee on professional ethics enumerate many prohibited acts, they are not intended to be all-inclusive, and a member is under obligation to exercise his judgment and his conscience in doubtful areas not covered by the rules.

It may be safely assumed that any violation of the moral standards of the community would be considered as conduct discreditable to the accounting profession. In other words, a member of the accounting profession is expected not only to conform with the specific rules of conduct applicable to his profession, but also to conform with the standards of good citizenship generally accepted in his community.

The by-laws of the Institute specifically provide for the expulsion or suspension of a member who refuses or neglects to give effect to any decision of the Institute or of the Council, who is declared by a court of competent jurisdiction to have committed any fraud, or whose certificate as a CPA has been revoked or withdrawn.

Appendixes

Selected opinions of the committee on professional ethics are given in Appendix A, and excerpts of the Institute by-laws and the full Rules

of Professional Conduct of the American Institute of Accountants are reprinted here as Appendix B to this chapter. A selected bibliography is given in Appendix C.

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Appendix A

SELECTED OPINIONS OF THE COMMITTEE ON PROFESSIONAL ETHICS

The following opinions of the committee on professional ethics were given in response to questions received. They have been classified under the principal rule of professional conduct which is applicable. These opinions were selected on the basis of their representing typical or common inquiries and because the answers may be helpful in interpreting the various rules:

Rule 1

1. Is it possible for a certified public accountant to become a member of a firm of public accountants, all members of which are noncertified, and at the same time retain for himself only, a practice on his own account?

There would be no violation of the Institute Rules of Professional Conduct in such a procedure. However, clients and others interested should be advised as to the dual position of the certified public accountant, to prevent any misunderstanding or misrepresentation.

2. Another member of the Institute and myself would like to form two partnerships, one in his city and one in mine. The firm in his city will be John Doe and Company, and the letterhead will contain my name in small print at the side. The firm in my city will be called Thomas Brown and Company, with his name in small print at the side. Due to our being at extreme ends of the state, we do not think one partnership would accomplish our purpose. Would this be a violation of the Rules of Professional Conduct?

There is nothing in the Institute's by-laws or Rules of Professional Conduct to prohibit the formation of the two proposed partnerships. The suggestion has been made that it might be desirable to have both names used in the partnership title, and designate the partnership in the city where John Doe resides as "Doe and Brown" and the partnership in the city where you live as "Brown and Doe." Both partnerships should, of course, conform to the Institute's by-laws and Rules of Professional Conduct.

3. Is it proper for an accounting firm to show on its letterhead the cities in which are located firms with which correspondent relations exist, if such relationship is clearly indicated?

There is no objection to the procedure of showing on your letterhead cities in which correspondent relations exist, provided such relationship is indicated clearly.

4. *We are an accounting firm composed of two partners, both CPAs. We contemplate organizing a new partnership composed of both partners and one staff member, to conduct business surveys and systems work, while at the same time continuing our public accounting firm. Would such a procedure be in violation of the Rules of Professional Conduct, providing the new firm were not at any time designated as certified public accountants, and would there be any objection to incorporating the new company? The business will occupy separate quarters from those of the public accounting firm, and will use a firm name of "Business Surveys and Systems."*

There is nothing in the Rules of Professional Conduct to prevent a member from forming a partnership with noncertified public accountants to carry out accounting and system work. It is very important that such a partnership comply with Rule 15 of the Rules of Professional Conduct which provides that "A member of the American Institute of Accountants engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and rules of professional conduct of the Institute in the conduct of that occupation." Special attention is called to Rules 1, 10, and 11, which would have to be strictly complied with. The use of an impersonal name for a partnership was dealt with by the committee several years ago in the following memorandum:

"The purpose of this memorandum is to indicate the principles that should be observed by certified public accountants in partnership in choosing a firm name and style for the partnership.

The name of a firm of practicing accountants should denote a personal association. Such a firm should not adopt for its name any nonpersonal or misleading title. A corporate form of name would not be appropriate as the name of a firm of professional accountants.

Inclusion in the firm name of the name of a former partner or former partners has been held by the council of the American Institute of Accountants to be entirely appropriate."

5. *Would there be any violation of the Rules of Professional Conduct of the Institute if a member became a limited partner of his present firm?*

It might be possible to work out such an arrangement legally, but the public could hardly be expected to inquire into the details of every partnership arrangement to determine the relative liability of the individual partners with respect to the certificates issued by the firm. It would be better for the partner to sever his connections with the firm and make some arrangement to render consulting services on a fee basis.

Rule 2

The city of which I am a resident is planning to have an audit made of its accounts. A few accounting firms have been approached, but no single firm in the state has the necessary staff to properly audit the books.

Most of the citizens of the city want an audit, but funds are not available to have a complete audit made. From a professional standpoint, would it be proper for several firms to submit a joint proposal to audit the accounts during the slack season at lower rates than the prevailing rates?

There seems to be no reason why the plan suggested would not be a proper one. There is nothing in the rules of conduct of the Institute to prevent any member from working for nothing if he pleases, nor is there anything to prevent the collaboration of several firms of accountants in performing a single engagement. Care should be taken to avoid violation of Rules 2 and 6, however.

Rule 3

I have been approached by a salesman of a bookkeeping service, not an accountant, to act as his professional adviser when technical problems arise. This person will make all contacts to complete sales, and will call me in to assist his customer in starting with the system. He will no doubt inform his prospective customers that he has a CPA assisting him and available for special problems. This party would be another client to me. I would have no investment in the business nor would I be considered a partner. My fee might be based on a percentage of gross income or might be based on an hourly rate. Would this sort of arrangement violate any of the Rules of Professional Conduct?

The arrangement proposed might place you in the position of having the bookkeeping service indirectly solicit business for you, and might therefore be a violation of the Rules of Professional Conduct. Your attention is directed to Rules 3, 7, and 15.

Rule 4

1. I am a practicing public accountant and have been approached by a large insurance company with a proposition that I act as broker in handling industrial and commercial loans. This work is not with clients. However, it is possible that some of my clients would be interested in obtaining funds of this kind. Would such an arrangement be incompatible with the practice of public accounting?

Under the Rules of Professional Conduct of the Institute, you cannot act as a broker and an independent accountant at the same time. To do so would place you in violation of Rules 4 and 15.

2. I specialize in motor carrier accounting and have many contacts in that industry. A broker handling the purchase and sale of motor carrier operating rights desires to rent space in my office and work with me either on a partnership or fee basis. Mail and periodical advertising will be necessary. I will be remunerated on a fee basis for time and advice necessary to complete transactions, based upon a percentage on all com-

pleted transactions. A trade name will be used. Would such an arrangement be permitted under the Rules of Professional Conduct of the Institute?

The arrangement described would result in violation of Rules 4, 10, and 15.

3. Is it proper for an accounting firm listing itself in the telephone directory and practicing as "Certified Public Accountants" to own and operate an "Industrial Engineering Department" and as such to render industrial engineering services to the clients of other certified public accountants not owning and operating a like industrial engineering department? Is the practicing of industrial engineering simultaneously with the practice of public accounting under the same name and within the same office contrary to Rule 4 of the Institute Rules of Professional Conduct? In consideration of the fact that the state has established a State Board of Registration for Professional Engineers, which requires the licensing of all engineers engaged in public practice within the state, can it therefore be interpreted that the owning and operating of an industrial engineering department is compatible and consistent with the practice of public accounting?

An engineering or systems department in an accounting firm is not an activity that is incompatible with public accounting. Such departments in an accounting firm represented in the Institute must, under Rule 15 of the Rules of Professional Conduct, observe the by-laws and rules of conduct. Rules 7 and 10, concerning solicitation and advertising, would have to be strictly adhered to.

Rule 6

Would a member of the Institute violate professional ethics by accepting a mailing service for the confirmation of accounts receivable and accounts payable? The service would be to mail requests for confirmations for accounting firms. The returned confirmations would be removed from the envelopes and returned to the public accounting firm.

A member of the Institute would be in violation of Rule 6 if he subscribed to such a service, in that he would be relying for an important and essential feature of his examination upon the work of another upon whom he had no right to rely. Another objection to such a plan would be that information relative to the client's affairs would be disclosed to a third party without the client's knowledge or consent, in violation of Rule 16.

Rule 7

1. I am now employed as a staff accountant with a firm of certified public accountants, and am contemplating entering public practice under

my own name. Would there be any violation of the rules of conduct if I sent announcements to clients of the firm by which I am now employed, such clients having indicated that they would like me to continue to do their work, as well as to personal friends and acquaintances?

Announcements may be sent to personal friends and acquaintances, but the sending of such a card to clients of a former employer would be a violation of Rule 7 of the Rules of Professional Conduct.

2. For eight years we have had a refinery and its subsidiaries as a client. Due to a reorganization several years ago, the controlling stock interest of the client-company was acquired by an oil company in another state, and this last year the oil company was acquired by another company. The company which has acquired the refinery and oil company is the client of one of the large national accounting firms. Would it be contrary to the rules of conduct of the Institute for my firm to write to the petroleum company and possibly to the accounting firm, in an effort to retain this client?

There would be no violation of the rules of conduct of the Institute involved if you should communicate with the petroleum company and the accounting firm in an effort to retain your client.

3. Several civic luncheon clubs make a practice of having one member sponsor each weekly meeting. Premeeting announcements are usually mimeographed on the letterhead of the firm of the sponsor and mailed in his firm's envelopes. Although occasionally remarks are made about the member in question, these are not in the nature of advertising for his firm. Would it be a violation of the Rules of Professional Conduct for a firm of CPAs to allow its letterheads and envelopes to be used in this manner?

There is no objection to the practice of sending occasional announcements of weekly meetings by a service club on firm stationery.

4. Would widespread distribution of a book outlining the history and accomplishments of an accounting firm by the firm in question be considered a violation of the Rules of Professional Conduct?

Inasmuch as distribution of the book in question was limited to one each for all of the officers and directors of the corporations audited by the accounting firm, all members of partnerships audited by them, individual bankers who were personal acquaintances, lawyers with whom partners of the accounting firm were acquainted or had worked with on accounting engagements, and to personal friends of the partners, the committee believes that the method used in distribution of the book was proper.

5. Would the following procedure be considered an ethical practice under the Institute by-laws and Rules of Professional Conduct:?

A trade association has requested several accountants to join with the association in distributing profit-and-loss percentages to all of its members. These percentages would be taken from the reports of the accountants' clients and mailed to every member of the industry by the association, indicating that the figures are submitted through the courtesy of "John Jones, Robert Brown, and so forth, CPAs." The information would go to members of the association whose accountants are not in this special group.

There would be no violation of the rules of conduct in the proposed procedure, provided the accounting firms involved have permission from their own clients to compile and distribute the figures in question. It might be more appropriate to indicate that the information is submitted with the permission of the clients of the certified public accountants, rather than through the courtesy of the CPAs.

Rule 9

I have been approached by an attorney to perform some accounting services in connection with a trade-mark infringement damage suit. A fee based on a percentage of the damages collected is proposed. Does this violate Rule 9 of the Rules of Professional Conduct?

The suggested fee arrangement based on a percentage of the damages collected, for accounting services performed in connection with a trade-mark infringement damage suit, would be a violation of Rule 9 of the Rules of Professional Conduct. Such an arrangement would not appear to fall within the exception covered by the last sentence of Rule 9.

Rule 10

1. I have recently moved to another building and the management has suggested that I attach a bronze plaque to the outside wall of the building, containing my name, title, and room number. Would this violate any of the rules of conduct?

There would be no objection to the plaque proposed, so long as it is modest in size and not in such a form as to be considered advertising.

2. The local radio station last night broadcast a lengthy advertisement concerning a new tax book written by a member of the Institute. Do the Rules of Professional Conduct allow radio campaigns of this type?

Advertisement of a book written by a member of the Institute has not been held to be a violation of the Rules of Professional Conduct of the Institute. The rules prohibit advertisement of the professional attainments or services of a member. If a member is the author of a book, however, the advertising is done by his publishers, not by himself, and there seems nothing improper in reference to the author's professional qualifications.

3. Would there be any violation of the Rules of Professional Conduct

if I supplied to the local bar association, which is conducting a course of tax education, a master tax guide bearing my name as a practicing certified public accountant on the cover?

Distribution of such a pamphlet among lawyers with whom you had no personal acquaintance would be regarded as advertising within the meaning of Rule 10. In the circumstances you describe, the material could be provided without your name imprinted on the cover, without any disadvantage to those who would make use of it.

4. *Would there be any impropriety in a member having his name and the words "Certified Public Accountant" or "Public Accountant" imprinted on his checks?*

There is no objection to the use of either designation on checks by practicing accountants inasmuch as they go only to persons with whom the accountant has had some business relationship.

5. *Is there any violation of the Rules of Professional Conduct if a member frequently advertises in the daily press for staff personnel?*

Such advertisements are not a violation of Rule 10 of the Rules of Professional Conduct. This rule does not cover advertisements for personnel, but specifically refers to advertisements of "professional attainments, or services."

Rule 10(b)

Would it be permissible to list in small type in future issues of the classified telephone directory the names of the certified public accountants on our staff, with the firm name and business address?

To list in a classified telephone directory in addition to the name and address of the firm, the names of the certified employees followed by the firm name and address, would be contrary to Rule 10. Presumably the firm would pay for the supplemental listings. The repetition of the firm name, even if scattered throughout the list, would constitute display with the effect of advertising.

Rule 13

1. *A and B are partners in the practice of public accounting. An enterprise in which A has a 19 per cent interest will require an examination in the near future, such report to be furnished to banks, credit agencies, and vendors. Can B make an examination (without using the partnership personnel or facilities) of this enterprise in which A has an interest and render an independent opinion without disclosure of B's affiliation with A in a public accounting practice?*

In the opinion of the committee, accountant B could not make an examination of an enterprise in which his partner A has a 19 per cent

interest, and be in a position to render an independent opinion, without disclosure of B's affiliation with A as partners in public accounting practice. If the enterprise is financed through the public distribution of securities, B as a partner of A might be precluded from furnishing an opinion on the financial statements under the provisions of Rule 13 of the Rules of Professional Conduct.

2. We have been engaged to audit a partnership, one of the members of which is a brother-in-law of one of the partners of our accounting firm. In addition, the client's office manager is a brother of this partner in our accounting firm. Should disclosure of this relationship be made in our report? We also are to audit a corporation in which this brother-in-law is a minority stockholder.

In the light of the obvious purpose of Rule 13 of the Rules of Professional Conduct of the Institute, it would be most desirable for you to disclose the relationships mentioned in your reports on the audits of the enterprises concerned. A simple statement in your report to the effect that Mr. X, partner of your firm, is related to the individuals who occupy important positions or hold stock, as the case may be, in the clients concerned should be sufficient.

3. Another member of the Institute and I propose to form a partnership for the practice of public accounting. Both of us are members of the Institute. My proposed partner is and will remain controller of a client of mine. It will be distinctly agreed that this client will be serviced from my office in another state and that my partner will have no interest directly or indirectly in the services rendered by me to the client, its subsidiaries, or related interests, or to any employees or stockholders of said client, its subsidiaries, or related organizations. Before entering into such a partnership, I should like to get your opinion as to whether such a relationship would be contrary or may be considered improper under the Rules of Professional Conduct.

You would be wise to avoid the arrangement through which you would enter into a partnership with another member of the Institute while such member was serving as controller of a client-company, unless you were willing to give up the audit of the client-company.

Rule 16

Is the purchaser of an entire practice or certain accounts of the seller practitioner entitled to receive working papers, copies of income tax returns, correspondence, and so forth, pertaining to the accounts being sold? Is it possible to transfer such vital data without violating the confidential relationship of the practitioner and his clients?

In no event has the practitioner who sells an accounting practice the right to transfer working papers, and so forth, of a client without first obtaining his permission to do so.

Appendix B

INSTITUTE BY-LAWS AND RULES

The following are excerpts from the Institute's by-law provisions concerning discipline:

Article V, Sections 4 and 5

Section 4. A member renders himself liable to expulsion or suspension by the trial board if

- a. he refuses or neglects to give effect to any decision of the Institute or of the council, or
- b. he infringes any of these by-laws or any of the Rules of Professional Conduct as approved by the council of the Institute, or
- c. he is declared by a court of competent jurisdiction to have committed any fraud, or
- d. he is held by the trial board to have been guilty of an act discreditable to the profession, or
- e. he is declared by any competent court to be insane or otherwise incompetent, or
- f. his certificate as a certified public accountant is revoked or withdrawn by the authority of any state, territory, or territorial possession of the United States or of the District of Columbia, or
- g. his certificate as a certified public accountant shall have been revoked or withdrawn by the authority of any state, territory, or territorial possession of the United States or of the District of Columbia and such revocation or withdrawal remains in effect.

Section 5. A member shall be expelled if the trial board finds by a majority vote of the members present and entitled to vote that he has been convicted of a felony or other crime or misdemeanor involving moral turpitude. If in such case the conviction shall be reversed by a higher court, such member may request reinstatement and such request shall be referred to the committee on professional ethics which, after investigating all related circumstances, shall report the matter to the trial board, with the committee's recommendation, whereupon the trial board may, by a majority vote of the members present and entitled to vote, reinstate said member.

Article VI, Sections 1, 2, 3, 4

Trials and Penalties

Section 1. Any complaint preferred against a member under Section 4 of Article V shall be submitted to the committee on professional ethics. If, upon consideration of a complaint, it appears to the committee that a prima facie case is established showing a violation of any by-law or rule of conduct of the Institute or conduct discreditable to a public accountant, the committee on professional ethics shall report the matter to the

executive committee, which shall summon the member involved thereby to appear in answer at the next meeting of the trial board.

Section 2. If the committee on professional ethics shall dismiss any complaint preferred against a member, or shall fail to act thereon within ninety days after such complaint is presented to it in writing, the member preferring the complaint may present the complaint in writing to the trial board.

The trial board shall make such investigation of the matter as it may deem necessary and shall either dismiss the complaint or refer it to the executive committee, which shall summon the member involved thereby to appear in answer at the next meeting of the trial board.

Section 3. For the purposes of adjudicating charges against members of the Institute as provided in the foregoing sections, the executive committee shall instruct the secretary to send due notice to the parties concerned at least thirty days prior to the proposed session. After hearing the evidence presented by the committee on professional ethics or other complainant and by the defense, the trial board by a majority vote of the members present and voting may admonish or suspend for a period of not more than two years the member against whom complaint is made, or by a two-thirds vote of the members present and voting may expel the member against whom complaint is made. The trial board shall decide, by majority vote of the members present and voting, whether the statement to be published shall disclose the name of the member involved. A statement of the case and the decision of the trial board thereon shall be prepared by a member or members of the trial board, under a procedure to be established by it, and the statement and decision as released by the trial board shall be published in *The CPA*.

Section 4. At any time after the publication in *The CPA* of a statement of the case and decision, the trial board may, by a two-thirds vote of the members present and voting, recall, rescind, or modify such expulsion or suspension, a statement of such action to be published in *The CPA*.

Article IX, Sections 2(a) and (c)

Section 2. a. The council shall elect from its present and former members a trial board of twenty-one members to be first created by electing seven members for a term of one year, seven members for a term of two years and seven members for a term of three years. Thereafter, beginning with the second year of the trial board's existence seven new members shall be elected each year to serve for a term of three years. Vacancies shall be filled by the council for the unexpired term. No member of the committee on professional ethics shall be a member of the trial board. A quorum shall consist of fifteen members.

c. The committee on professional ethics shall be elected by the council and shall consist of five members of the council not members of the executive committee.

Article X, Section 3

Section 3. The committee on professional ethics shall perform the duties set forth in Section 1 of Article VI and may advise anyone applying to it as to whether or not a submitted action or state of facts warrants a complaint against a member of the Institute, provided, however, that if the committee finds itself unable to express an opinion, such inability shall not be construed as an endorsement of the action or state of facts.

Rules of Professional Conduct**American Institute of Accountants****As Revised December 19, 1950**

(These rules of conduct supplement the disciplinary clauses of the By-Laws.)

1. A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, not all the individual members of which are members of the Institute, or an individual practicing under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practicing under a style denoting a corporate organization shall not use the designation "Members of the American Institute of Accountants."

2. A member shall not allow any person to practice in his name who is not in partnership with him or in his employ.

3. Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member.

Commissions, brokerage, or other participation in the fees, charges, or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member.

4. A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.

5. In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

- a. he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
- b. he fails to report any material misstatement known to him to appear in the financial statement; or
- c. he is materially negligent in the conduct of his examination or in making his report thereon; or
- d. he fails to acquire sufficient information to warrant expression of an opinion,

or his exceptions are sufficiently material to negative the expression of an opinion; or

- e. he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

6. A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

7. A member shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview, not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant. A member may furnish service to those who request it.

8. Direct or indirect offer of employment shall not be made by a member to an employee of another public accountant without first informing such accountant. 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 for employment.

9. Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving Federal, state, or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

10. A member shall not advertise his professional attainments or services:

- a. The publication of what is technically known as a card is restricted to an announcement of the name, title (member of the American Institute of Accountants, CPA, or other professional affiliation or designation), class or service, and address of the person or firm, issued in connection with the announcement of change of address or personnel of firm, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed one-quarter of a page if appearing in a magazine or similar publication.
- b. A paid listing in a directory is restricted to the name, title, class of service, address and telephone number of the person or firm, and it shall not appear in bold type, box, or other form of display, or in a style which differentiates it from other listings in the same directory.

11. A member shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

12. A member shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member vouches for the accuracy of the forecast.

13. A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.

14. A member shall not make a competitive bid for professional engagement in any state, territory, or the District of Columbia, if such a bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or district.

15. A member of the American Institute of Accountants engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and Rules of Professional Conduct of the Institute in the conduct of that occupation.

16. A member shall not violate the confidential relationship between himself and his client.

Appendix C

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CHAPTER 6

LEGAL RESPONSIBILITY AND CIVIL LIABILITY

FUNDAMENTAL CONSIDERATIONS

Members of a Skilled Profession. Public Accountancy, a Relatively New Profession. The Nature of Accounting Services. Parties Other Than Clients Often Rely Upon Accountant's Opinions.

LIABILITY TO CLIENTS

Craig v. Anyon. National Surety Corporation Case. Flagg v. Seng. Suits by Surety Companies.

LIABILITY TO THIRD PARTIES — AT COMMON LAW

The Landell Case. The Ultramares Case. The State Street Trust Company Case. The O'Connor Case. General Comments.

LIABILITY TO THIRD PARTIES — BY STATUTE

DISCIPLINARY PROCEEDINGS

WORKING PAPERS

Relevancy From an Evidentiary Viewpoint. Ownership of Working Papers — The Ipswich Mills Case. The New York Surrogate's Court Case. The Frye Case.

PRIVILEGED COMMUNICATIONS

CHAPTER 6

Legal Responsibility and Civil Liability

BY SAUL LEVY

FUNDAMENTAL CONSIDERATIONS

THERE ARE CERTAIN fundamental considerations with which the accountant is confronted. Some of these matters apply in general to practitioners in all professional fields, and some have special importance and special emphasis only in relation to accounting activities.

This preliminary phase will be approached from the following four angles:

1. Certified public accountants are members of a skilled and learned profession and as such are subject generally to the same responsibilities as members of other skilled professions.
2. Public accountancy is a relatively new profession, the status of which has been growing steadily in importance in these recent decades of dynamic economic change.
3. The nature of accounting services has an important relation to questions of legal responsibility.
4. Numerous parties other than clients often rely upon the opinions of accountants.

Members of a Skilled Profession

The general principles affecting the responsibilities of members of learned professions, and, for that matter, the responsibility of anyone who undertakes employment because of his possession of exceptional skill, have been concisely summarized in Cooley on Torts, which is nearly always quoted as the primary authority on this subject. So many essential aspects of the accountant's problem are here touched upon that the quotation itself bears repetition:

"In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for

good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment.”¹

The relatively recent Restatement of the Law of Torts, (1938) in discussing negligent misrepresentations, comments upon “expectable care and competence” in the following language:

“Where the information concerns a fact not known to the recipient, he is entitled to expect that the supplier will exercise that care and competence in its ascertainment which the supplier’s business or profession requires and which, therefore, the supplier professes to have by engaging in it. . . . Where the information consists of an opinion upon facts supplied by the recipient or otherwise known to him, the recipient is entitled to expect a careful consideration of the facts and competence in arriving at an intelligent judgment thereon.”²

These principles have long been applied to public accountants in jurisdictions abroad where the accounting profession has an older history and where the principles of common law govern. In the United States, as early as 1905, there was specific judicial recognition “that public accountants now constitute a skilled professional class, and are subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions.”³

Certified public accountants have always recognized their professional responsibility for care and competence in the performance of their work. However, the precise boundaries of civil liability have posed many practical problems as well as highly technical legal questions, many of which will be dealt with in this chapter. The general attitude of the profession in the relatively early years of its growth and development was set forth in an address by J. E. Sterrett, in a paper read at the annual meeting of the American Economic Association in 1908, from which the following is quoted:

“It must be borne in mind that a balance sheet of any large corporation is not a statement of facts that can be demonstrated with mathematical accuracy so much as it is an expression of an honest and intelligent opinion. In this expression of opinion the public accountant is now being recognized as an authority, and what is being widely done through the voluntary action of corporations that desire to deal fairly with their investors will doubtless become a legal requirement, and before many years the independent audit of all corporations offering their securities to the public will be firmly established.

With this, or possibly preceding it, will also come a civil liability on the part of the accountant for the faithful and diligent performance of his duties. As yet there are no decisions in this country upon the question of the liability of an auditor, but under the English law his liability both civil and criminal is pretty well established. . . .

Civil liability on the part of the accountant is, I believe, certain to come in this country, and while each member of the profession may well pray that the offense shall not come by him, it is, nevertheless, true that the effect

of a clearly defined civil liability will be salutary. It will give confidence to the business public in the accountant's certificate as nothing else will do, and while the best accountants to-day recognize their moral responsibility quite as much as it will ever be necessary for them to recognize any legal responsibility, the knowledge that a civil and possibly a criminal liability attaches to them will deter the careless or the indifferent."⁴

This statement by one of the most distinguished leaders in the accounting profession is remarkable for its prophetic anticipation of the present Federal regulation of securities and the vital role of public accountancy in connection with it. It also expresses a positive and constructive acceptance of legal responsibility growing out of the work which accountants do, an attitude which is as relevant to the accounting profession today as it was when expressed. It recognizes the fact that civil liability is a normal aspect of professional status and that being subject to it is an inevitable attribute of the development of the profession. It follows that the accountant's understanding of the problem is an essential part of his educational equipment for the performance of technical functions.

Public Accountancy, a Relatively New Profession

When speaking of public accountancy as a learned profession it must be realized that in this country, at any rate, it is a relatively new profession, one, however, which has been steadily growing in importance and usefulness in these recent decades of dynamic economic change. All of this has been so generally recognized in the business community that it hardly requires documentation.^{5,6}

Legal precedents involving public accountants in the United States are relatively few and are closely tied up with the facts involved in each situation and with the then existing practices of the profession. Even at this date, the standards are still in a state of development and clarification. As members of a skilled profession, it is the right of every accountant to be judged by the standards of the accounting profession. Correlatively, it is the duty of the accountant to establish and clarify these standards, not only for the public but for themselves, otherwise, standards not of their own making will be imposed upon them.⁷

Expanding opportunities to serve inevitably create broader responsibilities. This has been recognized in the continuing drive within the profession to measure up to growing obligations. Without further elaboration, the following lines of endeavor have been followed:

1. The movement for obtaining legislative recognition and control of our professional activities has already resulted in CPA laws in all forty-eight states.* The accountant should continue to seek improvement of these laws, based upon judgment and experience. In many states there has been a transition from the permissive type of legislation to a form of regulatory statute which places accountants in a status more closely comparable to that of the medical and legal professions.

* The Accountancy Law Service (Commerce Clearing House) gives full text of all legislation for states, territories and the District of Columbia.

2. The development of higher educational standards and techniques for a professional career in accountancy, and the contemporaneous lifting of educational requirements for admission to the profession.
3. The development, acceptance and enforcement of a code of ethical conduct consistent with professional ideals and essential for the protection of the public interest. While this is a usual feature in the case of the regulatory type of statute, there is a trend to provide for an enforceable code of professional conduct in permissive statutes as well. In 1952, a statute of this latter type was enacted in the State of New York.
4. The growth in size, influence and effectiveness of professional societies devoted to the clarification and codification of ethical and technical standards and the extension of the usefulness of the profession in terms of the public interest. The expanding program of the American Institute of Accountants is addressed toward these objectives. More than twenty thousand members are co-operating actively in this endeavor.

The Nature of Accounting Services

Although accountants render many other types of services, it is chiefly the auditing work which differentiates the problem of legal responsibility from that of other professions. Accountants review, examine into, and consider the factual representations of management or others, and report thereon in the form of a professional opinion (where the accountant so believes) that the statements of management fairly present financial position and results of operations.

The accountant's responsibility is for the expression of a professional opinion in accordance with generally accepted accounting principles as the result of an examination conducted in accordance with generally accepted auditing standards.⁸ The accountant does *not* make factual representations as to the content of financial statements; that is the function of management. He does *not* insure, guarantee, or warrant the accuracy of management's representations, which in turn include matters of estimate, judgment and opinion. He does assume responsibility for his own opinions, and represents, that in order to place himself in a position to express such opinions, he has complied with generally accepted auditing standards,^{9,10} which provide for:

1. *An expert opinion* -- implying adequate technical training, proficiency and due care in the performance of the audit;
2. *An independent opinion* -- the result of an objective, impartial and unbiased mental attitude;
3. *An informed opinion* -- the result of a proper study and evaluation of internal control as a basis for reliance thereon and for determining the extent of tests in the application of auditing procedures; and based upon competent evidential matter sufficient to supply a reasonable basis for the expression of an auditor's opinion;
4. *A technical opinion* -- that the statements are presented in accordance with generally accepted principles of accounting applied on a basis consistent with that of the previous year;
5. *A candid opinion* -- that the financial statements are reasonably informative as to all material facts, unless otherwise stated.

Parties Other Than Our Clients Often Rely Upon Accountant's Opinions

In many instances the opinions which are expressed and the reports which embody such opinions reach innumerable interested parties other than the clients by whom the accountant has been engaged. The occasional claims of such "third parties" against accountants have raised some difficult problems of legal responsibility. Some of the leading cases dealing with such claims will be dealt with in considerable detail later in this chapter.

The potential and largely undefined duty under the common law to third parties has led to statutory rules of civil liability to investors, which go far beyond the limitations of the common law in such matters as duty, proof of reliance and burden of proof as to negligence or fraud.

It is in this area particularly that the accountant must realize the growing need for informing the public as to the nature of the services rendered and the standards by which such services should be judged.

LIABILITY TO CLIENTS

In order to obtain a better understanding of possible civil liability, both to clients and to third parties, it is helpful to draw upon decided cases which may serve as legal precedents in future situations.

With respect to clients, there is a contractual relationship which is the foundation of the accountants' responsibilities and rights. This contract may be formalized in a very explicit writing. More than likely, however, if a writing exists, it is apt to be very general in its terms, setting out little more than the period to be covered, the arrangement concerning fees, with a statement that an audit is to be made in accordance with generally accepted auditing standards. Compliance with such standards ordinarily would be implied even if not expressly included in the writing. In this regard, recent literature of the American Institute of Accountants^{9, 10, 11, 12, 13} serves a most useful function in defining the nature and content of what the accountant undertakes to do in making the usual audit which is to culminate in the expression of an opinion on financial position and operating results. Not so long ago, it was often an open question as to whether a so-called cash audit, a balance sheet audit, a detailed audit or some other variety of examination was contemplated. Not only was the accountant lax in definitely confirming the scope of his work at the outset of an engagement, but there was great variety and often little clarity in the form of certificate or opinion that was issued at the end of the engagement.¹⁴ When the public accountant became involved in litigation concerning his work, the heart of the controversy often related to what he had agreed to do. Courts were inclined to take the accountant to task if he had failed to be explicit in his engagement writing. This judicial attitude is illustrated in the following admonition by the court in the case

of *Maryland Casualty Company v. Jonathon Cook, et al.*¹⁵ where the court said:

"I think that it is high time for accountants to know that if they want a particular contract which they enter into to be measured in the technical terms of a cash audit, or a balance sheet audit, or a detailed audit, they should insist that their contract and the specifications which they agree to comply with in their contract should plainly state the facts.

So I interpret this contract with its specifications according to the plain language used.

The witnesses have all agreed that no technical terms or language has been used in either the contract or the specifications. Ordinary, everyday English has been used. It is easily understood and interpreted. *If accountants wish a contract construed in accordance with their own technical language, then they must see to it that their technical language is used in their contracts.*" (Emphasis added)

This case dealt with an audit of the accounts of a municipal treasurer where the engagement had been accepted subject to "specifications for audit" which had been prepared by the client, which provided, among other things, that "any other duties or procedures which ordinarily become a part of a complete audit although not specifically stated herein shall be deemed a part of these specifications." The defendant-accountant sought to construe the vague expression "complete audit" in terms of the more technical concepts of a cash audit, a balance sheet audit, or a combination of the two. Such efforts were unavailing for the reason stated above. There was a further attempt by the defendant to construe the audit contract in the light of prior conversations and instructions. The court disposed of this effort in the following manner:

"The defendant, Jonathon Cook testified that on receiving these specifications and on reading the specifications, he did not know just what work was required to be performed for the City of Flint and so he went to the City of Flint and had a talk with the Director of Finance and thereafter entered into the contract in reliance upon that conversation had prior to the execution of the contract. That conversation with the Director of Finance does not mean a thing. The contract was with the City of Flint and not with the Director of Finance. It is the contract which Jonathon Cook made with the City of Flint which must be construed and not conversations or oral agreements reached with independent officers of the City prior to the execution of the contract. Those prior conversations, in order to become binding, should have been embodied in the written contract and signed pursuant to proper authority. Therefore, the court has no alternative but to hold this defendant to performance in accordance with the terms of his written contract. Restatement, Contracts, Sec. 237."

This case emphasizes the need for being explicit if the accountant is to rely upon technical terms and technical concepts in defining the scope of his duty. Obviously the use of such vague terms as "complete audit" or "detailed audit" must be avoided. If technical terms such as "generally accepted auditing standards" are used the security of the accountant's

position depends upon the extent to which such terms have been clarified by accountants in their own practices and in the literature of the accounting profession. While established standards of today afford substantially better grounds for reliance¹⁶ than they did during the years 1931-1932 (which were involved in the above quoted case) it is important to realize that the situation has improved only relatively. Accountants must continue to develop and clarify their own standards so that they may be judged by professional criteria of their own making and not by the factual findings of juries of laymen.

Another fairly recent case which involved construction of a contract for audit services was that of *O'Neill, et al v. Atlas Automobile Finance Corporation*.¹⁷ Here the firm of certified public accountants contended that their contract was for a limited examination and a financial review of the client's books without verification. The client contended that the engagement "contemplated the making of a complete and detailed audit and the furnishing of certified reports which should have uncovered the shortage" here involved. It was admitted that the original retainer had been under an oral contract. The accountants testified that it was not agreed or contemplated that "certified reports" would be issued and in support of their testimony offered the letters of transmittal of their reports which used this phraseology:

"We have prepared *from the records* of Atlas Automobile Finance Corporation and *information* submitted to us balance sheet as of (designated month and year) and a comparative statement of profit and loss based on the month of (name of month) together with relating schedules." (Italics supplied)

When the accountants were re-engaged, the extent of their undertaking was set forth by them in a letter to the client which was accepted by it as satisfactory. The letter read, in part:

"Confirming our recent conversation we agree, . . . to make a monthly examination of the transactions and submit monthly reports in substantially the same form as heretofore. . . ."

The accountants produced an expert witness who corroborated their own testimony with respect to the difference between "an ordinary audit and report and a certified one verified from independent sources." The client offered no expert testimony to contradict that offered by the accountants. Because the contract was partly oral and partly written and its terms were disputed, the courts submitted the question of its construction to the jury. The jury accepted the accountants' version of the terms of the audit contract and the nature of the accountants' duties under it. Incidentally, the Appellate Court confirmed the charge to the jury on the following points, citing Cooley on Torts¹ as one of the supporting authorities:

"Magee, Liebman, and O'Neill, as accountants, are not guarantors or insurers of the correctness of their accounts.

Magee, Liebman and O'Neill as accountants, do not say to the public 'Let us

examine your books and vouchers, and we will with absolute certainty discover any dishonesty, every mistake, that exists in those books, and we will protect you against that.' That is not what they undertook to do. They agreed to use such skill in the performance of their agreement as reasonably prudent, skillful accountants would use under the circumstances."

The result in this case in comparison with that in the *Maryland Casualty Company* case,¹⁵ does not support a conclusion that the accountant is likely to be better off with an oral agreement than with a detailed contract specifying particular procedures. The weakness of the accountant's position in the *Maryland Casualty Company* case was that there was an omnibus provision which used the vague term "complete audit".

Had the more technical phraseology "generally accepted auditing standards" been used, the court doubtless would have given greater weight to technical literature and expert testimony as an aid to the interpretation of the contract. Of special interest in the *O'Neill* case are the facts that there was a course of conduct in performing prior audits which was continued by specific reference in the letter of arrangements with the client, and there was further confirmation of the client's acceptance of the scope of prior audits in the letters of transmittal which were an integral part of the audit reports. All of this was persuasive corroboration of the testimony of the accountant as to the limited scope of his engagement.

In this branch of the subject, namely the accountant's possible liability to clients, the claims usually are based upon the failure of the auditor to discover defalcations or other similar irregularities. It may be the client who presses the claim. It may be a surety company that is the plaintiff, having been subrogated to the rights of the client upon payment of a loss under the terms of a fidelity bond.

Where it is claimed that the accountant was negligent in the performance of his duty, and that the loss occasioned by the dishonesty of the client's employee or agent went undiscovered and unrecovered because of that negligence, the controversy concerning the accountant's work usually raises these basic factual questions:

1. What was the scope of the audit for which the accountant was engaged and which he agreed to make?
2. Was the negligent conduct of that audit responsible for the failure to uncover the defalcations and for the resulting loss?
3. Were there circumstances present which aroused or should have aroused the suspicion of the accountant and should have resulted in a more searching inquiry than would have been obligatory in the absence of suspicious circumstances?

The responsibility of the accountant in this situation is limited necessarily to the competent performance of the audit which he has been engaged to make. This usually involves compliance with generally accepted auditing standards. The accountant does not insure or guarantee the client against loss through the dishonesty of his employees, nor does he

warrant that the audit will uncover any and every irregularity. The audit is nevertheless likely to safeguard the client against dishonest manipulation of his accounts. Such protection to the client might well result from the work of the auditor in reviewing the system of internal accounting control and suggesting needed improvements therein; an audit will deter dishonest practices because, from the culprit's viewpoint, it enlarges the danger of discovery; very often an audit results in the actual discovery and exposure of dishonest practices when they do occur. All of these advantages to the client are substantial and add measurably to the value of an audit. They should not be minimized in any of the discussions of the limitations of the accountant's responsibility. On the other hand, it should be recognized that in the usual audit the primary purpose is not the discovery of defalcations but rather the expression of a professional opinion concerning financial position and operating results. The audit program involves a judicious amount of testing and sampling. It does not contemplate an all-inclusive detailed examination of all transactions and all entries with respect thereto. Thus it is not intended or designed for the purpose of uncovering or preventing all conceivable irregularities in the accounts. It should be accepted and relied upon for what it is, an examination not unlimited in scope but adequate for the purpose of expressing an opinion concerning financial position and operating results. All this has been summarized recently by the committee on auditing procedure of the Institute, as follows:

"The well-established custom of making test checks of accounting records and related data and, beyond that, relying upon the system of internal control after investigation, through appropriate checks, of its adequacy and effective functioning, has with very few exceptions proved sufficient for the purpose of expressing an opinion.

The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and *cannot be relied upon* to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organized concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive. It is generally recognized that good internal control and surety bonds provide protection much more cheaply. On the basis of his examination by tests and checks, made in the light of his review and tests of the system of internal control, the auditor relies upon the integrity of the client's organization unless circumstances are such as to arouse his suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In no sense is the independent certified public accountant an insurer or guarantor, nor do his training and experience qualify him to act as a general appraiser, valuer, or expert in materials. Obviously his functions do not include matters of law which require the judgment of an attorney."¹⁸

The foregoing is implied in the standard short-form of accountant's

report or certificate which defines the scope of the audit in the following general terms:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

It should be noted, however, that while the report or opinion of the accountant is always evidence of what he understood the scope of his audit to be, and while it is always evidence of what was the client contract, it is not necessarily conclusive evidence. Unless confirmed by a writing signed by the client, either in the form of a letter of arrangements before the commencement of the audit or included in the letter of representations of the client at the conclusion of the audit, it would be a self-serving document which the client might dispute. Of course, it also might be confirmed by a continuous course of conduct over a series of prior years when the same type of audit had been made, reported upon in the same way, and the reports had been accepted by the client. This is what happened in the O'Neill case¹⁷ mentioned previously.

There has recently been some difference of opinion among leading accountants as to whether there is adequate protection for the accountant against unfair claims for failure to discover defalcations unless the limited responsibility of the accountant in this area has been defined and confirmed in an explicit written contract signed by the client. Some accountants have gone so far as to state specifically in letters to clients outlining the conditions under which an engagement is accepted, "that their examination cannot be relied on to disclose defalcations and other irregularities of the same general nature, and they therefore do not assume responsibility for detecting such irregularities."¹⁹

Other accountants have felt that a disclaimer, so worded, is too broad and unqualified, and consequently it might reflect unfavorably on the value of the ordinary audit. They would contend that our position should be that such examinations cannot be relied upon to disclose *all* defalcations, and that therefore the accountant does not assume responsibility for detecting irregularities where he has complied with generally accepted auditing standards and the irregularities have nevertheless remained undiscovered. Furthermore, while it may be desirable to have a written agreement or letter of arrangements confirmed by the client it is argued that it should not be considered mandatory to have such a letter. In many instances, the audit engagement is renewed from year to year in a more or less informal manner. The scope of the examination is evidenced by a continuous course of conduct by the accountant and the acceptance of his work by the client on the basis of the representations concerning the scope of the audit as set forth in the standard short-form certificate or opinion. The practice with respect to formalizing the audit contract varies to such an extent that the preferences of those who consider an

explicit written client contract desirable should not, by implication, leave the accountant unprotected who chooses to place his chief reliance upon our professional standards and his compliance with them. The latter viewpoint is discussed fully in a recent article²⁰ which quotes many relevant statements from authoritative literature and concludes with the following:

"It should be evident to all thinking people that the work of the independent public accountant is not intended to take the place of, or duplicate the protection afforded by, a system of internal control supplemented by various types of dishonesty insurance. The fact that accountants have an understandable fear of the publicity resulting from legal action may have motivated those who have suffered losses from defalcations and similar irregularities to threaten suit against an accountant who did not assume responsibility for discovery of the losses. Such tactics should be resisted by the profession. A written contract with each client, however, does not go to the root of the problem. In any case, the problem seems to call for a uniform position on the part of the profession, and the above citations would appear to mean that the profession has taken a position which it has repeatedly and consistently promulgated in its authoritative statements of auditing procedure. If further clarification seems desirable, the place for that clarification is in our published statements defining generally accepted auditing standards. These standards are the yardstick of our professional responsibility and for this reason are specifically incorporated in our opinions. Our contractual relations with clients as well as our third party responsibility will, in any event, depend upon our adherence to our generally accepted auditing standards."

It should be added, however, that in any situation where there are limitations upon the scope of the ordinary audit, such as the requested omission of the independent confirmation of receivables or the omission of the usual procedures with respect to observation and checking of inventory, it is without doubt advisable to confirm such limitations in a writing which is countersigned or acknowledged by the client. If the engagement contemplates the preparation of statements without audit, obviously it is advantageous, if not altogether necessary, to reduce such an engagement to some explicit form.

In Great Britain there is the distinction between the type of audit which the accountant is required to make to fulfill his obligations under the Companies Act as against the varying types of work he may be engaged to perform for so-called private companies. There it is urged that in the latter situations an explicit client contract is essential. This warning was repeated in a recent edition of one of the leading English texts on *The Principles of Auditing*²¹ where it was stated:

"In the case of a company, the auditor's responsibilities are governed by statute, and it is impossible for the auditor to limit his responsibilities. In the case of a private concern, the auditor's responsibilities are governed by the terms of the contract with his client and therefore his responsibilities can be limited by agreement, but in practice it is feared that in many cases there is no written evidence of the exact terms of the contract. This position is fraught with grave danger, and in every case the practitioner is strongly

advised to see that the exact terms of the contract are clearly understood by both his client and himself, and that these terms are recorded in writing.

In the event of a loss through fraud occurring and remaining undetected by the auditor he may be placed in a position of grave difficulty. It is easy to be wise after the event and to see what audit tests must have revealed the fraud. On the other hand it is so difficult to define exactly what is reasonable care and skill, which is governed by the general standard of the profession. In a case before the courts expert evidence would be called, but here again the expert would have knowledge of the exact form the fraud took, and it is therefore very easy to see what checks should have been applied in order to detect the fraud and to form the opinion that one would without question have adopted them."

Although adjudicated cases in the courts of the United States involving claims of clients against accountants are limited in number, they are of great significance. The earlier English cases supply important legal background and have usually been cited as authority in the opinions of American judges. These English cases are quite numerous and go back more than sixty years. Apparently the profession in Great Britain has directed considerable attention to these precedents. This is reflected by the fact that Dicksee's *Auditing*, the leading English text, in its seventeenth edition, published in 1951, assigns almost three hundred pages of fine print to a collection of some fifty-seven cases, reprinting most of the opinions in full. Numerous other cases are referred to and discussed elsewhere in the text. Apparently the British practitioner considers this source material an indispensable part of his technical equipment.

Those English cases which deal with claims arising out of defalcations add little, if anything, to the law established by our own leading cases. For the most part, the English cases deal with the responsibilities of accountants' functioning under the authority and jurisdiction of the English Companies Act. In such situations, the accountant is held to be an officer of the corporation and is responsible as such to its stockholders. This relationship, of course, is technically different from that assumed by the auditor of the accounts of a corporation in the United States, even of a corporation whose stock is publicly held and traded in on a stock exchange. However, since the enactment of the Federal Securities Act of 1933 and the Federal Securities Exchange Act of 1934, statutory obligations have been imposed upon the independent accountant (to be considered later in this chapter) which make some of these English cases significant in relation to our possible liability to investors. This is all the more so in view of the absence of adjudicated cases under our own statutes.

Some of the pronouncements of the English cases concerning their understanding of the responsibilities of public accountants have been cited so frequently that they have acquired the status of classic utterances. Thus, in 1895, it was said of the auditor in the famous *London and General Bank* case ²²:

"His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then

comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce . . . An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part — say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

Such I take to be the duty of the auditor; he must be honest — that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases haphazardly, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. . . .

. . . A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. . . . An auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty."

This was followed shortly thereafter by the Kingston Cotton Mill Co.²³ case which exonerated the accountants from responsibility concerning the independent verification of inventory and approved the accountants' acceptance of and reliance upon the management's certificate with respect thereto in the absence of circumstances which would arouse suspicion. This case is no longer an authority for American practitioners with respect to inventory verification, since it has been superseded by our own extensions of auditing procedure which impose mandatory obligations in this area. However, it will continue to be quoted as a basic authority for the reasonable limitations upon the responsibility of accountants where an audit has failed to uncover defalcations and other similar irregularities. In this connection it was there stated:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion

or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but, in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.

... Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

It remained for the Irish Court of Appeal in *The Irish Woolen Co. Ltd. v. Tyson*²⁴ to indicate how precarious it is to rely upon a figure of speech as a substitute for a more technical statement of legal principle, when it stated in discussing the foregoing quotation from the Kingston Cotton Mill Co. case:

"Now, time after time, this passage about the 'watch-dog and the bloodhound' has been made use of, and I would wish to say a word regarding it, too. His lordship then read from Lord Justice Lindley's judgment the passages dealing with the duties of auditors, in one of which it was laid down that 'an auditor was a watch-dog, but not a bloodhound'. This, Lord Justice Fitzgibbon remarked, was very unfair to the bloodhound, who was just as little likely to have his sense of suspicion aroused as the watch-dog. Applying this instance of the dogs to the present case, was not the watch-dog bound to bark? and if, when sniffing round, you hit upon a trail of something wrong, surely you must follow it up, and there is just as much obligation on the auditor, who is bound to keep his eyes open, and his nose, too. As in the case of the hound, the auditor will follow up this trail to the end, and the first things he will 'root up' are those statements of account, and then the fraud is discovered."

Attention will now be directed to outstanding American cases which have dealt with the responsibility of public accountants.

Craig v. Anyon

The plaintiffs²⁵ in this action were members of a firm of brokers in stocks and commodities operating on the New York, New Orleans and Chicago exchanges. Their accounts were audited by the defendant firm of accountants during the years 1913 to 1917, under an arrangement which provided for quarterly audits and reports. The business was apparently prosperous. In May 1917, through the confession of Moore, an employee in charge of their commodities department, following an office investigation, the plaintiffs learned that their prosperity had been an illusion. Their books had been falsified by Moore throughout a period of nearly five years during which time they had been defrauded of over one million dollars. In this action they alleged that the audits by defendants had been negligently made and that had the audits been made with reasonable care

the falsification of the books would have been discovered and the losses would not have occurred.

The case was tried in May 1922 in the Supreme Court of New York County, before a jury, to whom were submitted the following two specific questions:

1. "Were the defendants negligent in the performance of their agreement with Craig and Company?"
2. "If so, what damages to the plaintiffs resulted directly and proximately from such negligence?"

The trial judge charged that if the defendants were found to be liable, the verdict must be either for \$2,000, the aggregate amount paid as compensation for the defendants' services, or for \$1,177,805.26, the amount of plaintiffs' actual loss as proved. The jury found the accountants negligent and brought in a verdict for \$1,177,805.26. Upon motion, the court then directed a general verdict for the plaintiffs in an amount limited to \$2,000 "on the ground that as a matter of law the only loss which resulted directly and proximately from negligence of the defendants was the sum of \$2,000." Thereupon the case was carried on appeal to the Appellate Division, which affirmed the trial court. Three judges concurred in this result. The chief justice dissented and set out his views in a short dissenting opinion, to which reference will be made later. The litigation was then carried to the Court of Appeals, the highest appellate tribunal, which in turn affirmed the judgment and the order of the Trial Court and the Appellate Division, without opinion, with a single judge again dissenting. This final decision on appeal was handed down in April 1926.

Upon the trial the defense rested without offering evidence in its own behalf, thus limiting its own proof to the cross-examination of the witnesses produced by the plaintiffs. The chief issue in the case became the contributory negligence of the plaintiffs themselves. Did such negligence contribute predominantly or materially to the loss sustained, or were the damages the proximate result of the accountants' negligence? The accountants had been paid an annual fee of only \$500 for four quarterly audits. There was no independent confirmation of customers' accounts nor was any attempt made to compute the status of the open contracts which would have been necessary in order to calculate the actual liability of customers at the time of each audit. Plaintiffs testified that many years before it had been agreed that the audit would include this work, as a member of the accounting firm himself had said: "We have to make that calculation both for straddles and open accounts before we can tell you what is the actual standing of this firm." The alleged arrangement was oral and the member of the accounting firm who made it was no longer living at the time of the trial. However, plaintiffs admitted that they were aware that these calculations had not been made by the accountants for many years nor during any part of the period when the defalcations occurred.

The losses arose in a single account in the commodities department. This was a discretionary account operated by Moore, who was in charge of the department. It had been started with a margin of only \$200 with instructions that it be closed as soon as the losses exceeded that amount. These facts had not been communicated to the accountants nor did they become aware of them in the course of their audits. The accounting records relating to commodities were all kept in the commodities department and under the control of Moore. This had been done over the objections of the accountants, who protested that a certain ledger previously maintained in the general office was a check on this subsidiary commodities department and should not be transferred to it. The account involved was so active that it represented between 75% and 85% of the firm's Chicago commodities business. Between audit dates plaintiffs paid out large sums of money from day to day and executed orders from hour to hour without any investigation or examination of the account or check on the sufficiency of margin, relying implicitly upon the honesty of Moore. The Appellate Division found that the plaintiffs could have prevented the loss by the exercise of reasonable care and that "they should not have relied exclusively on the accountants." It was further stated:

"We think the damages cannot be said to flow naturally and directly from defendants' negligence or breach of contract. Plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care. . . .

The plaintiffs in effect contend that defendants are chargeable with negligence because of failure to detect Moore's wrongdoing, wholly overlooking the fact that, although they were closely affiliated with Moore, who was constantly under their supervision, they were negligent in failing properly to supervise his acts, or to learn the true condition of their own business and to detect his wrongdoing."

It should be noted that the Appellate Court *did* affirm the verdict of the jury that the accountants had been negligent in the performance of their audit. This was so in the face of the court's instructions to the jury that these auditors did not guarantee the correctness of their accounts; that they do not say to the public: "Let us examine your books and vouchers, and we will with absolute certainty discover any dishonesty, every mistake that exists in those books, and we will protect you against that"; that that is not what the auditors undertook to do; that they agreed to use "such skill in the performance of their agreements as reasonably prudent, skillful accountants would use under the circumstances".

In limiting the recovery of the client to the amount of the fees paid, the courts followed through on the theory that the client was damaged to that extent by the failure of the accountants to render competent services,^{26*} but that any additional losses were the result of the client's own

* Even in the absence of proof that the client suffered any other damage, if the audit report was one which involved defective performance on the part of the accountant, it has been held that the client was damaged to the extent of the fees paid.

negligence. However, a decision relieving the accountants from liability cannot be regarded as the inevitable result where contributory negligence is proved. The result in *Craig v. Anyon* must be confined to the extraordinary facts of this case, which nevertheless failed to impress the jury before whom the case was tried. The question as to what damage was proximately caused by the negligence of the accountants, as well as the question as to whether the contributory negligence of the plaintiffs was predominantly the cause of the damage, are ordinarily factual issues for the jury. All this was emphasized in the National Surety Corporation case ²⁷ which is about to be discussed.

Particularly in the light of the adverse verdict of the jury, it should be obvious how vital to the accountant it is clearly to define and evidence his own limited responsibility in situations where the client insists upon limiting the scope of the examination. Such limitations should be confirmed in writing at the outset of the audit and should be reiterated in the letter of representations signed by the client before the completion of the audit. They should again be set out explicitly in the report of the accountant on the audit. If the limitations are as material as they were in this case, there should be an express denial of an opinion on the statements as a whole (see Statement on Auditing Procedure No. 23 in reference 10, page 18). Our present-day standards and practices make all of this mandatory. Had these standards been observed in the *Craig v. Anyon* case ²⁵ the accountants would have been in a position to put in an affirmative defense and the jury's verdict in the first instance might have been favorable to the accountants.

Before concluding the discussion of this case, it would be well to quote the dissenting opinion of Chief Justice Clarke:

"I dissent from the affirmance of so much of the judgment as sets aside the verdict of the jury assessing the damages at \$1,177,805.26. The contract of audit was not one merely to discover if inadvertent clerical errors had been made in the bookkeeping, but was one of protection of the plaintiffs' firm from their own failure to find any error in their books of account. This contract the defendants failed to perform. Admitting the neglect of the plaintiffs to discover the embezzlement and falsification of the accounts through an examination of the books on their own part, the defendants' work in pursuance of the contract, owing to the manner in which it was performed, failed to save plaintiffs from the consequences of such failure and neglect, which was the very subject of the contract."

This minority viewpoint seemed to influence the court in the later National Surety Corporation case, which now follows:

National Surety Corporation Case

The plaintiff ²⁷ in this action was the surety company on a fidelity bond issued by them to the stock brokerage firm of Halle & Stieglitz under the terms of which the surety had paid the losses sustained through the defalcations of the cashier in the main office of Halle & Stieglitz. The

defendants were members of three different firms of certified public accountants who had at different times, during the years 1928 to 1933, audited the books of account of the stock brokerage firm. The plaintiff claimed that the losses which its assignor had incurred had resulted from the failure of the accountants to discover and report substantial cash shortages, which had continued during all of these years and had finally amounted to a total of \$329,300.

Four separate causes of action were stated as against each of the three firms, namely: *breach of contract* in the alleged faulty performance of the audit, *breach of warranty* in representations in their reports as to cash in bank, *negligence* in the conduct of the audit, and *fraud* in the alleged misrepresentation of material facts in their reports.*

The case was tried before a judge and jury in the Supreme Court, New York County in May 1937. At the conclusion of the case, and before its submission to the jury, the trial judge dismissed the complaint and discharged the jury, stating that "the Court is unable to discover anything in the testimony indicating a violation of the obligations of an expert accountant", and on the further ground that "the principle laid down in *Craig v. Anyon* . . . is the one to be here applied". It appeared obvious to the trial judge that "more glaring than any negligence on the part of the defendants is the contributory negligence of the plaintiff's assignor," and accordingly that the loss incurred could not "be said to flow naturally and directly from defendants' negligence or breach of contract."

An appeal was taken to the Appellate Division, where the dismissal below was reversed and a new trial was ordered. The Appellate Court could not have been more closely divided; three judges voted for reversal, and two judges dissented and voted to affirm. This appeal did not dispose of the issue of negligence on its merits. It merely decided that on the whole record plaintiff had established a *prima facie* case which should have been submitted to the jury, and that the trial judge was in error in

* In *Dantzer Lumber & Export Co. et al. v. Columbia Casualty Co.*,²⁸ the court held that in these situations, causes of action for breach of contract, for negligence and for fraud might exist simultaneously. The action in that case was held to be not for the mere nonperformance of the contract but was said to be based ". . . upon an alleged breach of duty to skillfully perform and truly report the condition of accounts. . . ." The court quoted from 26 R.C.L. (Recent Case Law) 758:

"Whenever a negligent breach of a contract is also a violation of a common-law duty, an action *ex delicto* will lie. Accompanying every contract is a common-law duty to perform the thing agreed to be done with care, skill, reasonable expediency, and faithfulness, and a negligent failure to observe any of these conditions is a tort, as well as a breach of the contract. If the transaction complained of had its origin in a contract which placed the parties in such a relation that in attempting to perform the promised service the tort was committed, then the breach of the contract is not the gravamen of the suit. The contract in such case is mere inducement, creating the state of things which furnishes the occasion of the tort. And in all such cases the remedy is an action on the case. Based on the principle above indicated, the firmly established rule is that for injuries resulting from unskillful or otherwise negligent performance of a thing agreed to be done, an action *ex delicto* will lie, notwithstanding the act complained of would also be ground for an action *ex contractu*."

not so doing. It was pointed out also that it was for the jury to say whether the defendants were liable for defalcations subsequent to their audits "depending upon whether such losses could reasonably have been anticipated at the time they were engaged in the performance of the work."

The Appellate Court also dealt at some length with the question of contributory negligence. Not only did it hold that this defense presented a factual issue which should have been submitted to the jury, but it discussed and interpreted the rule of *Craig v. Anyon*²⁵ and stated views with respect thereto which would indicate that such a defense might not be effective unless the facts relating to it were extraordinary, as they were in *Craig v. Anyon*. In this connection it was said:

"The defendants assert that they are not liable, no matter how negligent they may have been, because Halle & Stieglitz were guilty of contributory negligence. If it be true that Halle & Stieglitz so conducted their business as to make possible Wallach's defalcations, it did not necessarily excuse the defendants from the consequences of their negligence in failing to discover and report the facts. The action here, it must be remembered, is not to recover for the thefts committed by Wallach as it would be if it were against Wallach or against the surety. The action is for errors of the accountants in failing to discover Wallach's defalcations, thereby making further defalcations possible and rendering more difficult recovery for defalcations of the past. The measure of damages in two such classes of actions is not the same.

We are, therefore, not prepared to admit that accountants are immune from the consequences of their negligence because those who employ them have conducted their own business negligently. . . . Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible. Accordingly, we see no reason to hold that the accountant is not liable to his employer in such cases. *Negligence of the employer is a defense only when it has contributed to the accountant's failure to perform his contract and to report the truth.* Thus, by way of illustration, if it were found that the members of the firm of Halle & Stieglitz had been negligent in connection with the transfer of funds which occurred at about the time of each audit and that such negligence contributed to the defendants' false reports it would be a defense to the action for it could then be said that the defendants' failure to perform their contracts was attributable, in part at least, to the negligent conduct of the firm. That was the principle applied in *Craig v. Anyon*, . . . where the embezzler had been negligently represented to the accountants as a person to be trusted. In the present case, the loss consisted of thefts by a cashier not so represented 'whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry.' Matter of Kingston Cotton Mill Company, No. 2, (1896) L.R. 2 Ch. Div. 279." (Emphasis added)

While this decision was not carried to the Court of Appeals, and therefore it cannot be said to overrule *Craig v. Anyon* which was affirmed by the higher court, nevertheless it lends support to those who have contended that the result in *Craig v. Anyon* was to be limited to its facts and was not to be construed as a holding that contributory negligence, as a matter of law, would necessarily limit the plaintiff's recovery to the amount of fees paid.

This case also is of interest to the profession because of the method employed by the embezzler in concealing his abstractions from petty cash. The shortages thus created were in the first instance covered up by temporarily placing in the petty cash box checks which should have been promptly deposited. This resulted in a series of delayed and substituted bank deposits from day to day. During the period involved, Halle & Stieglitz maintained about twenty-seven accounts, nine of which were in New York City. Wallach, the cashier, apparently knew when audits were to be made and boldly resorted to "kiting" from one bank to another at the audit date. Through the use of this system of "lapping" deposits almost from day to day, and "kiting" checks at the audit date, he succeeded in avoiding detection for a period of years, while his defalcations mounted steadily. It was contended that these fraudulent practices were well known to all accountants and that the normal audit procedures usually employed in the verification of cash to guard against such practices were negligently omitted. The Appellate Court made the following reference to this phase of the case:

"The evidence in this case discloses similar conditions at the time of all the audits in question. It was for the jury to say whether the practice of 'lapping' and 'kiting' of checks should have put the defendants upon inquiry which would have led to discovery of the defalcations, and whether, if defendants had exercised ordinary care and used proper methods of accounting as established by the expert testimony, they would have observed checks drawn out of numerical order. If they had checked 'outstandings' they would have noted that the check or checks used by Wallach at the audit dates were returned with the cancelled vouchers accompanying the next bank statement. Again, if there had been any substantial compliance with the requirements for verifying cash in banks, the cash shortages would have been detected, as the jury might have found. Their representations that there had been a verification of cash was a pretense of knowledge when they did not know the condition of the bank accounts and had no reasonable basis to assume that they did. This, the jury could have found amounted at least to a constructive fraud. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 190, 191, 174 N.E. 441, 74 A.L.R. 1139; *State Street Trust Co. v. Ernst*, supra, page 112, 15 N.E.2d 416."

Flagg v. Seng

This was an action ²⁹ by a trustee of a bankrupt corporation for damages for alleged fraud where the defendants, who were accountants, were employed by the corporation to make periodic audits of its books and reports to its directors. The case was tried on the issue as to whether the defendant-accountants knowingly submitted false reports which deceived the directors and which caused them to declare dividends which could not be legally declared. The trial court found in all respects in favor of the defendants. The judgment in favor of the accountants was affirmed on appeal.

The case is of special interest because of the activity and knowledge of the directors who were alleged to have been deceived and because of the

reliance of the accountants upon the opinion of the attorney for the corporation concerning matters which, upon the trial of the case, were alleged to be illegal. These aspects of the case are discussed in the following excerpts from the Appellate Court's opinion:

"Appellant's main contention seems to be that stock in the corporation was exchanged for real estate in violation of the permit issued by the state corporation department and that when a parcel of real estate was exchanged for other property at a price in excess of its original cost, the difference was entered on the books as a profit before the second piece was sold. The matter last referred to represents an established policy on the part of the directors, the books were thus kept on their order, and they were in no way deceived by anything done by the respondents in this connection. With respect to the other matter it appears that stock was, in effect, exchanged for real property. This was done by putting through escrows whereby the corporation's check was given in payment for the land and the other party's check was given in payment for the stock. While there is some evidence that certain papers in the files of the corporation indicated the true situation, although the same was not indicated by the books of the corporation, there is other evidence to the effect that this could not be learned from an examination of the books and records of the corporation, that *it was unknown to the respondents except in one instance, and that in that case the respondents took the matter up with the attorney for the corporation who assured them that the matter was perfectly legal.* It further appears that whatever illegality existed and whatever harm arose therefrom was caused directly by the action of the board of directors, and that all such exchanges were made with their full knowledge and consent and in accordance with their fixed policy, and no inference could be drawn that anything done by the respondents had any casual relation to any part of this situation. (Emphasis added)

Not only are the findings sustained by the evidence, but we are unable to see how the matters particularly relied upon by the appellant can justify or compel any other conclusions than those drawn by the court. Conceding that certain sales of stock were illegally made this was not only well known to the directors but was intentionally done by them. They were not only not deceived by the audits and reports but they had intentionally handled the transactions in such a manner as to make them appear on the books as a cash transaction. While the court found upon sufficient evidence that the respondents had no knowledge of those parts of these transactions which had been thus covered up and conceding, for the sake of argument, that the respondents might have found out the true situation by a more extensive investigation, it in no way appears that any discovery they might have made would have affected the result. The method pursued by the directors was followed on the advice of their attorneys and although the same has since been declared illegal, no such blame can be attached to the respondents, under the circumstances here appearing, as would justify a reversal of the judgment."

Suits by Surety Companies

Where losses occur as the result of defalcations by an employee of the client or through similar irregularities, it often happens that the client is protected by a fidelity bond. As a result, the surety company which issued the bond will indemnify the client for such losses to the extent of

the fidelity bond coverage. Upon such payment, the surety company becomes subrogated to whatever claims the client may have had against the accountant for alleged negligence or fraud in the performance of auditing services. That is to say, a surety company, to the extent that it has made good such losses, succeeds to whatever rights the client may have had against the accountant for the failure of the accountant to discover such defalcations. This equitable principle of subrogation is defined as follows in Section 141, Restatement of Security:

"Where the duty of the principal to the creditor is fully satisfied, the surety to the extent that he has contributed to this satisfaction is subrogated to the rights of the creditor against persons other than the principal whose negligence or willful conduct has made them liable to the creditor for the same default. . . ."

Whether the surety company asserts a claim against the accountant by way of subrogation or assignment, this gives the surety company no greater rights than the client himself would have had, had he become the party plaintiff. Accordingly, the defense of the contributory negligence of the client may be asserted against the surety company.

Furthermore, the surety company cannot be neglectful in enforcing its remedies against the primary obligor (the defaulting employee) to the detriment of the accountant. Thus, in the fairly recent case of *Fidelity & Deposit Company of Maryland v. Atherton*,³⁰ where the County Treasurer was primarily responsible for the defalcations of his deputy, he had made substantial payment to the surety company on account of the loss and had given his note for the balance, secured by a mortgage on property valued in excess of the amount due the surety company. The surety company had made no attempt to collect on this note, though it was long past due. The court held that the negligence of the surety to collect from the County Treasurer (the man who was primarily liable for the loss) was a sufficiently equitable ground for estopping the surety from attempting to collect this unpaid portion of its loss from the accountants.

In recent years, it has become increasingly clear to the business community and to surety companies that while an audit offers a large measure of protection as a preventive of loss resulting from defalcations, the accountant does not undertake to uncover all such irregularities. Circumstances may arise where such frauds are perpetrated and remain undetected despite the fact that the audit complied with generally accepted auditing standards. In such circumstances, the accountant does not assume the responsibility of an insurer. This is the function of the surety company and generally it is recognized as such by all parties involved.

This problem of the division of responsibility between the accounting profession and the surety companies has been widely discussed over the years. Such discussions culminated in December 1945 in an agreement between the American Institute of Accountants and some twenty-three of the companies issuing fidelity bonds, by the terms of which, the surety

companies agreed that it was not their intention to assert claims against accountants, except on the basis of affirmatively dishonest or criminal acts or gross negligence on the part of the accountants.³¹ It was stipulated that prior to asserting such claim, the matter would be submitted to an impartial committee of three persons who were not accountants, who would consider the evidence relating to the audit performed. It was agreed by the surety companies that unless the committee concluded that the claim involved an affirmatively dishonest or criminal act or gross negligence on the part of the auditor, the surety company would not press any claim by way of subrogation against the accountant. Subsequent to 1945, an additional number of surety companies became parties to this arrangement. It is encouraging to note that the use of this quasi-arbitration machinery has not yet been invoked. However, it has served to clear the atmosphere in defining the respective responsibilities of the accounting profession and of surety companies in these situations. It does not relieve accountants from their responsibility to comply with generally accepted auditing standards. It does, however, recognize the fact that accountants are not insurers against loss by defalcation and that an audit, as valuable as it may be, is not the legal equivalent of a fidelity bond.

LIABILITY TO THIRD PARTIES — AT COMMON LAW

The legal responsibility of accountants and auditors to parties other than their clients (herein referred to as third parties) has been dealt with in a number of highly important American cases. These cases have defined and limited the accountant's responsibility for negligence, but they have emphasized the accountant's exposure to claims of third parties on grounds of fraud, misrepresentation or deceit. These cases have also influenced the enactment of legislation which has broadened the responsibility for negligence where the claims of investors or securities purchasers are involved. These statutory rules will be outlined at a later point in this chapter.

The landmark cases relating to accountant's liability to third parties now will be discussed.

The Landell Case

This was an action brought against a firm of certified public accountants by a plaintiff³² who claimed that he had suffered loss through the purchase of shares of the Employers Indemnity Company, in reliance upon their financial statement which had been audited and certified to by the defendant-accountants. The complaint further alleged that the financial statement was false and untrue, that the stock purchased by him turned out to be valueless, that the loss he sustained was due to the negligence of the accountants in the conduct of their audit and that they were consequently liable for the loss he had sustained. The court below

entered judgment for the defendants on the ground that, as a matter of law, the complaint failed to state a cause of action. On appeal, this judgment for the defendants was affirmed, for the following stated reasons:

"There were no contractual relations between the plaintiff and defendants, and, if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report; but the plaintiff was a stranger to them and to it, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain: *Schiffer v. Sauer Company et al.*, 238 Pa. 550. This was the correct view of the court below, and the judgment is accordingly affirmed."

The Ultramares Case

The Ultramares case³³ is undoubtedly the leading American case dealing with the legal responsibility of accountants. Early in 1924, the defendants, a firm of certified public accountants, had audited the books of account of Fred Stern & Co., Inc., who were importers and dealers in rubber, and had certified to their balance sheet as of December 31, 1923; the said certificate of the accountants reading as follows:

"We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923."

The accountants supplied their clients with thirty-two copies of the certified balance sheet, knowing in a general way that it would be exhibited by their client to banks and other creditors. The plaintiff in this action was one of the creditors to whom the balance sheet was later submitted, who claimed that he relied upon it in making substantial advances to Fred Stern & Co., Inc. It was not known to the accountants that the balance sheet would be submitted to this specific creditor.

The balance sheet as certified, showed a net worth of approximately \$1,070,000, when, as a matter of fact, the corporation was at the time insolvent and its liabilities exceeded its assets by approximately \$200,000. The assets had been overstated by the inclusion of over \$950,000 of fictitious and nonexistent accounts receivable. The liabilities had been understated by over \$300,000 through failure to record accounts payable covering merchandise which had been purchased, received, and dealt with as assets of the business. The audit had failed to detect these fraudulent entries, and for the loss suffered by the plaintiff-creditor it brought this action against the accountants.

The action was brought in November 1926. It was not until April 1929 that it was tried before a judge and jury in the Supreme Court of New York County. In its inception the complaint alleged a single cause of action based upon the alleged negligence of the accountants. Upon

the trial the complaint was amended to add a second cause of action in fraud. At the conclusion of the trial the complaint was dismissed as to fraud. However, the trial judge reserved decision on the motion to dismiss the negligence action and submitted the question of negligence to the jury. The jury brought in a verdict for the plaintiff in the amount of \$187,576.32. The trial judge thereupon dismissed the complaint and set aside the verdict based on negligence, stating that his decision was based on the law and not on the facts. The case was taken to the Appellate Division which unanimously affirmed the dismissal of the cause of action for fraud, but, by a divided court of three to two, reversed the dismissal of negligence and reinstated the verdict.

The case was then taken on cross appeals to the Court of Appeals, which handed down its unanimous decision in 1931, reversing the Appellate Division on both causes of action. As to the cause of action for negligence, the judgment of the trial judge was affirmed, dismissing the cause of action *as a matter of law*. As to the second cause of action, based on fraud, the judgment of dismissal was reversed and a new trial granted. The opinion for the unanimous court was written by Judge Cardozo. The court expressed the view that the evidence supported a finding that the audit was negligently made, but it reached the conclusion that even if negligence existed, it did not create liability to the plaintiff in the circumstances of this case. In this connection, the court stated:

"The defendants owed to their employer a duty imposed by law to make their certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself. . . . A different question develops when we ask whether they owed a duty to these to make it without negligence. *If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.*" (Emphasis added)

In this connection the court distinguished the facts in this case from those in *Glanzer v. Shepard*.³⁴ In that case a public weigher, hired by the seller of beans, issued a false certificate of weight which was relied upon by the purchaser. The purchaser sued the weigher on the ground of negligence and was permitted to recover. This earlier case was not reversed by the Court of Appeals. It was merely distinguished on its facts and not considered applicable to the *Ultramares* case. Accordingly, it is thought by many that if a case should arise where the third party who relies upon an accountant's statement was specifically identified and known to the accountant as one who would rely upon

the statement, then there might be liability even for negligence to such a third party. In comparing the facts of the *Ultramares* case, the court stated:

"In *Glanzer v. Shepard*, the seller of beans requested the defendants, public weighers, to make return of the weight and furnish the buyer with a copy. This the defendants did. Their return, which was made out in duplicate, one copy to the seller and the other to the buyer, *recites that it was made by order of the former for the use of the latter*. The buyer paid the seller on the faith of the certificate which turned out to be erroneous. We held that the weighers were liable at the suit of the buyer for the moneys overpaid. Here was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction,' as certain and immediate and deliberately willed as if a husband were to order a gown to be delivered to his wife, or a telegraph company, contracting with the sender of a message, were to telegraph it wrongly to the damage of the person expected to receive it. . . . The bond was so close as to approach that of privity, if not completely one with it. Not so in the case at hand. No one would be likely to urge that there was a contractual relation, or even one approaching it, at the root of any duty that was owing from the defendants now before us to the indeterminate class of persons who, presently or in the future, might deal with the Stern Company in reliance on the audit. In a word, *the service rendered by the defendant in Glanzer v. Shepard was primarily for the information of a third person*, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. *In the case at hand, the service was primarily for the benefit of the Stern Company*, a convenient instrumentality for use in the development of the business, and *only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter*. Foresight of these possibilities may charge with liability for fraud. The conclusion does not follow that it will charge with liability for negligence." (Emphasis added)

In thus limiting the liability of accountants to third parties for mere negligence, the court indicated how negligence might of itself be evidence from which an inference of fraud could be drawn. In this connection, the court stated:

"Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that, if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more."

In dealing with the question of the possible liability of the accoun-

tants on the second cause of action, for fraud, the court concluded that in this case the certificate of the accountants involved both the representation of fact and the expression of opinion. Thus it found that the accountants "certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account." As to this, *it was held, as a matter of law, that if their statement of fact was false, they were not to be exonerated because they believed it to be true.* The court further concluded that there was ample evidence from which the jury might hold such a statement to be false. The court discussed this point further, stating:

"Correspondence between the balance sheet and the books imports something more, or so the triers of the facts might say, than correspondence between the balance sheet and the general ledger, unsupported or even contradicted by every other record. The correspondence to be of any moment may not unreasonably be held to signify a correspondence between the statement and the books of original entry, the books taken as a whole. If that is what the certificate means, a jury could find that the correspondence did not exist, and that the defendants signed the certificates without knowing it to exist and even without reasonable grounds for belief in its existence."

In reviewing the facts in the record concerning the audit that was made, the court dwelt upon the grounds for suspicion which existed, as reflected in the working papers of the accountants, and felt that a jury might have held that in the circumstances the limited testing and sampling employed was entirely inadequate. The following quotation from the court's opinion indicates how *neglect to follow through with the most searching inquiry when suspicions are aroused may readily present a question for the jury as to whether there was a sincere belief in the opinion expressed:*

"How far books of account fair upon their face are to be probed by accountants, in an effort to ascertain whether the transactions back of them are in accordance with the entries, involves to some extent the exercise of judgment and discretion. Not so, however, the inquiry whether the entries certified as there, are there in very truth, there in the form and in the places where men of business training would expect them to be. The defendants were put on their guard by the circumstances touching the December accounts receivable to scrutinize with special care. A jury might find that, with suspicions thus awakened, they closed their eyes to the obvious, and blindly gave assent."

On the whole record the Court of Appeals concluded that *a jury might find* that the accountants, in certifying to the correspondence between the balance sheet and the accounts, made a statement of fact as true to their own knowledge when they had no knowledge on the subject; also that *a jury might find* that the accountants acted "without information leading to a sincere or genuine belief when they certified to an opinion that the balance sheet faithfully reflected the condition of the business." Accordingly the dismissal of the cause of action in fraud was reversed and a new trial was granted.

The State Street Trust Company Case

The principles enunciated in the *Ultramares* case were soon to be applied in two other cases now to be discussed. The action in the *State Street Trust Company* case⁸⁵ was commenced in December 1932, subsequent to Judge Cardozo's opinion in the *Ultramares* case. Accordingly the complaint was based on allegations of fraud although the evidence from which the jury was asked to find fraud involved gross negligence for the most part.

The audit covered the operations of Pelz-Greenstein Co. for the year 1928 and their financial position as at December 31, 1928. This company was engaged in the factoring business, a form of commercial financing. They loaned money to firms who were manufacturers and merchants and made a profit from charging interest, commissions, deducting interest, discounts, et cetera, in connection with the loans which they made to others and the collection of the accounts receivable assigned to them by their customers. Pelz-Greenstein Co. in turn obtained most of their own working capital from some seventeen banks to whom they were indebted in the aggregate amount of \$4,275,000 on December 31, 1928. The plaintiff in this action was one of the said bank creditors who claimed that they had made loans in reliance upon the financial statements certified to by the defendant-accountants, which were here attacked as fraudulent misrepresentations.

The basic factual issues were different from those in the *Ultramares* case. Here it was claimed that the reserves set up for bad and doubtful accounts were grossly inadequate. Furthermore, it was contended that, in a long-form report which the accountants later submitted to their client only, material facts were revealed which indicated that the accountants knew that the financial position was not fairly presented in the condensed report which they had issued for distribution to the banks. It was further claimed that the long-form report to the client was qualified by making it subject to comments which were omitted from the condensed statement, whereas the condensed statement carried with it the unqualified certificate of the accountants. The certificate which was attached to the short-form report (described as "condensed statement") read as follows:

"We hereby certify that we examined the books of account and record (sic) pertaining to the assets and liabilities of Pelz-Greenstein Co., Inc., New York City, as of the close of business December 31, 1928, and, based on the records examined, information submitted to us, and subject to the foregoing notes [not here material], it is our opinion that the above condensed statement shows the financial condition of the company at the date stated and that the related income and surplus account is correct."

In comparison with the accountants' certificate involved in the *Ultramares* case, it is interesting to note (a) there was no reference to the statement being in accordance with the books, (b) the certificate em-

braced the "related income and surplus account," as well as the balance sheet.

The case was tried in March 1936 before a judge and jury in the Supreme Court of New York County. At the close of plaintiff's case, defendants moved to dismiss the complaint. The trial judge reserved decision. The defendants thereupon rested without calling any witnesses, renewed their motion to dismiss and also moved for a directed verdict. The trial judge reserved decision again and submitted the case to the jury. The jury rendered a verdict for plaintiffs in the amount of \$246,000. Thereupon the trial judge granted a motion to set aside the verdict and directed a verdict for defendants on the ground that the jury's verdict was not supported by the evidence. The Appellate Division unanimously affirmed the directed verdict for defendants, making it necessary for the plaintiffs to obtain permission from the Court of Appeals to carry the case to that court. The Court of Appeals by a vote of four to two reversed the judgments below and granted a new trial.

The Court of Appeals reiterated the principles laid down in the *Ultramares* case, which it summarized as follows:

"We have held that in the absence of a contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit. (*Ultramares Corp. v. Touche*, 255 N.Y. 170). Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

In *Ultramares Corp. v. Touche* (255 N.Y. 170) we said with no uncertainty that *negligence, if gross, or blindness, even though not equivalent to fraud, was sufficient to sustain an inference of fraud*. Our exact words were: 'In this connection we are to bear in mind the principle already stated in the course of this opinion that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross.' (Emphasis added)

It would seem that the apparent inconsistency between the long-form report later submitted to the client and the short-form report upon which the plaintiff had relied was of itself the crucial evidence which the Court of Appeals felt supported the jury verdict of fraud. In the following discussion the court refers to this long-form report as "a letter of explanation." In the absence of an affirmative defense by the accountants the court seemed to attach sinister significance to the fact that a certified report should be supplemented by a more detailed document which

went only to the client and that the detailed report was not released until after a delay of thirty days. This view is indicated in the following quotation from the opinion:

"The record is, indeed, replete with evidence, both oral and documentary, to make a prima facie case against the defendants. In the first place, we have these accountants guilty of an act which is the equivalent of active misrepresentation. On April 2, 1929, they sent to Pelz-Greenstein the certified balance sheet, with ten additional copies, knowing that it was to be used to obtain credit. 'Nothing was said as to the persons to whom these counterparts would be shown, or the extent or number of the transactions in which they would be used. . . . The range of the transactions in which a certificate of audit might be expected to play a part was as indefinite and wide as the possibilities of the business that was mirrored in the summary.' (*Ultramares Corp. v. Touche*, 255 N.Y. 170, 174.) Not until thirty days later did the accountants send to Pelz-Greenstein a letter of explanation of this balance sheet, and then apparently only one copy. So important was this covering letter in the minds of defendants that, although the balance sheet attached to the covering letter was in other respects substantially identical with the original balance sheet, it contained the following notation, which did not appear at all on the original balance sheet released thirty days earlier: 'This balance sheet is subject to the comments contained in the letter attached to and made a part of this report.' One of the copartners, testifying before trial, said: 'We wanted to try to prevent anyone using this balance sheet, without knowing the scope of the examination which we made, which is set forth in paragraph 2 of the full report. . . . We have had cases where our entire covering letter had been deleted from these reports and just the balance sheet used.' Yet, in effect, these defendants themselves did just this. They held back this covering letter for thirty days and issued the balance sheet alone to the world of possible lenders. The loan by the plaintiff was made long before this important covering letter was even sent.

The above act of the accountants, in placing in circulation a certified balance sheet which they practically conceded should not be used without knowing the scope of the examination set forth in the covering letter, and then allowing a period of thirty days to elapse before sending the covering letter, and then only one copy, whereas there had been ten copies of the certified balance sheet issued, was itself gross negligence and an important piece of evidence raising an inference of fraud."

There was considerable additional evidence before the jury indicating that the accountants accepted the assurances of their client concerning the collectibility of accounts when the records before them should have aroused their suspicion to a point where independent inquiry was mandatory. From this evidence to support the allegation of gross negligence, the jury might have inferred that the expression of opinion concerning financial position (embracing the adequacy of reserves for bad and doubtful accounts) was a mere fraudulent pretense and that the accountants did not entertain a sincere and honest belief in the opinion which they expressed. On this phase of the case the court stated:

"The defendants urge that these defendants were excused from investigation because of a letter from Leon S. Pelz, treasurer of Pelz-Greenstein, in which

he stated that Pelz-Greenstein had in its possession 'sufficient saleable merchandise to completely liquidate' these accounts. In other words, defendants were content to certify a balance sheet knowing it would be used to secure bank credit which contained an item of over \$125,000* of apparently dead accounts on the uninvestigated and unsupported statement of the party seeking the credit that these accounts were amply secured, although it appeared on the face of the books that there had been no realization upon this security for years. Where the books indicate the likelihood of a substantial loss, a failure to indicate this on the balance sheet can be justified only by an actual check-up. It does not suffice to rely instead upon the statement of an officer of the firm the books of which are being examined. If an accountant may disregard a situation which indicates substantial losses because he is informed by the person whose books are being examined that there is adequate security, the balance sheet issued by the accountant, by its failure to point this out, contains a misrepresentation. The very purpose of the bank in seeking the balance sheet prepared by the accountant is to check any possible fraud on the part of the person seeking the loan. Yet these accountants contend that they may accept as true a statement by the party whose books are being examined, make no check-up or investigation on their own part, and issue a statement omitting entirely any mention of the reason why investigation of the security was omitted.

We have explicit expert testimony, uncontradicted, that under these circumstances it was improper accounting practice for defendants to accept a letter from Pelz-Greenstein, and that they should have investigated these accounts very fully to ascertain whether the companies were still in business and to ascertain definitely and independently what security, if any, Pelz-Greenstein held for the payment of these accounts."

The opinion of the Court of Appeals also indicates that they were unfavorably impressed with the fact that the defendants rested without calling any witness, "although there would naturally be available the men who made the audit, those who prepared or supervised the preparation of the working papers or the certified balance sheet and experts to refute the testimony offered by the experts called by plaintiff." The conclusion to reverse the judgments below and grant a new trial was thus expressed:

"The foregoing presents abundant evidence from which a jury could find that defendants knew facts which vitally affected the financial worth of Pelz-Greenstein, and which defendants totally suppressed on the certified balance sheet but disclosed to Pelz-Greenstein alone in the one copy of the covering letter sent thirty days later. The jury further could have found that the computation of reserves on the certified balance sheet was a misrepresentation which did not reflect the facts as known to defendants, and which they in good faith should have revealed. Where the record shows acts on the part of the accountants, as outlined above, we cannot say, as a matter of law, that plaintiff has failed to make out a case for the jury."

There was an interesting dissenting opinion representing the views of two of the six judges who sat on this appeal. They stressed the fact that *the only representation of fact here involved was the statement by the accountants that they had examined the books of account, which was*

* Sic. Should clearly be \$215,000. (Ed.)

undisputed. It also was pointed out that the defendants did not warrant or certify the accuracy of the balance sheet; they represented only that the balance sheet was "in their opinion" correct. With respect to the expression of such an opinion, the minority of the court went on to state:

"The defendants are not liable for error of judgment; they are not liable even for lack of care in arriving at their opinion. They are liable only if the opinion expressed was not only erroneous, but was fraudulently expressed. Actual bad faith and intent to deceive is not always, it is true, an essential element in a cause of action for deceit. Such a cause of action may be established against the defendants without proof that they expressed an opinion which they knew was incorrect; at least, however, there must be evidence of a ruthless disregard of whether the opinion was correct or not — the expression of an opinion where 'the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it.' (*Ultramares Corp. v. Touche*, *supra*, page 186.)"

The discussion in this dissenting opinion of the inadequacy of reserves particularly warrants quotation:

"Judge FINCH [who wrote the majority opinion] has, in his opinion, referred to the evidence upon which he bases his conclusion that it establishes fraud. I shall try to avoid repetition of that evidence. The most important of the alleged errors in the balance sheet is the failure to provide sufficient reserves for the collection of 'commission accounts receivable.' The amount of reserves which should be set aside to take care of loss that may be suffered by reason of inability to collect such accounts is a matter of judgment. The defendants knew of circumstances which it is said pointed clearly to the conclusion that a reserve of \$21,000 is insufficient to take care of these accounts of over \$2,043,337.81. Perhaps the defendants here showed a lack of caution. Their letter sent thirty days after the certified balance sheet was sent, shows that they knew that the reserve *might* prove insufficient. None the less, the amount of probable loss even with these circumstances known remained uncertain; the estimate of one per cent loss was doubtless over-optimistic, yet the estimate was based on facts which were not 'so flimsy as to lead to the conclusion that there was no genuine belief back of it' (page 186).

The next error which, it is argued, shows negligence so gross as to indicate a lack of honest belief based on substantial grounds is that no allowance was made for 'commission account advances.' Many of these accounts were old. Again there are circumstances which perhaps should have acted as a warning signal to a cautious accountant. The defendants saw the signal — that is shown by the supplementary letter — but decided, nevertheless, to make no allowance. Again it would, doubtless, have been better if the defendants had given to those who might rely upon the balance sheet, the warning signal they had seen. They did, however, give notice on the balance sheet that accounts were 'inactive and in liquidation' and they removed them from the current assets of the business and placed them 'below the line.' The owners of the business, men who at that time had a fine reputation, assured the defendants that they had sufficient security to liquidate these dead accounts. I can find here no justification for any argument that a balance sheet which shows that no allowance or reserve has been made for inactive accounts in liquidation may be held to be a fraudulent representation that no allowance or reserve is necessary."

The minority concluded:

"The jury might find that the defendants' judgment was bad, but the court pointed out in the *Ultramares* case that liability cannot be predicated upon error however great in the exercise of judgment. The error of judgment does not indicate a willful expression of a false opinion, or an expression of opinion based on grounds so flimsy that the jury might conclude that the opinion was not based on genuine belief. To permit recovery in a case where the evidence does not sustain such a conclusion is to wipe out the distinction which this court has always drawn and which it reiterated in the *Ultramares* case."

When one considers the views expressed in the minority opinion together with the fact that six judges in the courts below all felt the evidence did not support the jury's verdict of fraud, it would seem that the adverse decision in this litigation may have turned upon the existence of a long-form report which made the condensed statement seem misleading by comparison, coupled with the fact that the accountants chose not to defend their own work. This thought emphasizes the inherent danger, from an evidentiary standpoint, of the coexistence of a condensed and a detailed report.

The O'Connor Case

This case³⁶ involved an action by a group of persons who had purchased shares of the preferred stock of G. L. Miller & Company, Inc., during 1925 and 1926, in alleged reliance upon a balance sheet dated August 31, 1925, which was stated to present the financial position after giving effect to proposed new financing, namely, the sale of thirty thousand shares of preferred stock at par, an aggregate offering to the public of \$3,000,000. The balance sheet was published on the letterhead of defendant-accountants and was reprinted and incorporated in the prospectus which was used in the sale of the stock. At the bottom of the balance sheet, over the signature of the accountants, appeared the following certificate:

"Our audit of the books and accounts of the G. L. Miller & Company, Incorporated, discloses that the net earnings of the Company for the year ended December 31, 1924, were in excess of $2\frac{1}{2}$ times the dividend requirements of the contemplated issue of 30,000 shares of 8% cumulative preferred stock, and that the net earnings for the eight months ended August 31, 1925, were in excess of 3 times the dividend requirements of said stock for the said eight months."

The corporation was adjudicated bankrupt in 1926. Its assets were insufficient to pay the allowed claims of creditors and therefore the plaintiff-stockholders lost their entire investment. The action against the accountants was begun in 1928; it did not come to trial until 1934. During this period of time, the final decision in the *Ultramares* case was handed down. Shortly thereafter, the complaint in this case was amended

so as to state a cause of action in fraud against the accountants, instead of negligence. Owing to the diversity of citizenship of the plaintiffs, the action was brought in the Federal District Court for the Southern District of New York. After a 13-week trial before a judge and jury, the jury brought in a verdict for the defendants, in May 1934. Several of the plaintiffs carried the case on appeal to the Circuit Court of Appeals where, in August 1937, by the unanimous decision of the court of three judges, the judgment for the defendants entered upon the jury verdict in the Court of Appeals was affirmed. Plaintiffs' petition to the Supreme Court of the United States for a writ of certiorari, requesting that body to review the decision of the Circuit Court of Appeals, was denied.

The business of G. L. Miller & Company, Inc. consisted in underwriting mortgage bonds on real estate, usually on buildings to be constructed, acting as trustees under the mortgage indentures, and selling the bonds to the public. The criticism of the audit and the "certified" balance sheet involved a great many very complicated transactions and technical legal relationships growing out of the manifold functions of the client as underwriter, trustee, and disbursing agent in connection with the business which it conducted.

The main issues which emerged were the contentions of the plaintiffs that:

1. The audit and balance sheet were claimed to be "intentionally fraudulent in not adequately disclosing the amount of cash held in trust."
2. Payments made by Miller & Company to complete the construction of mortgaged buildings were falsely shown in the balance sheet to be "Secured."
3. Miller & Company itself guaranteed to bondholders the completion of buildings under construction, and the balance sheet made no mention of such contingent liabilities.
4. The defendants made a false certificate as to the net earnings of Miller & Company.

The defendants and members of their staff who worked on the audit testified at great length as to the work done. Voluminous working papers supplied further evidence of the audit procedures followed and the accounting evidence upon the basis of which their opinion was expressed. The testimony of experts was offered both on behalf of plaintiffs and defendants. There was a sharp conflict on the basic issue as to whether the audit was so conducted that a jury might infer that the accountants did not entertain a sincere and honest belief in the opinion which they expressed.

Accordingly, the judge carefully explained the applicable law and submitted the entire case to the jury. The Circuit Court commented as follows upon the charge to the jury:

"The charge which Judge Patterson delivered to the jury was an exceptionally clear exposition of the applicable law. Since there was no contractual relationship between the plaintiffs and the defendants, liability could be imposed only for fraud; a mistake in the balance sheet, even if it were the result

of negligence, could not be the basis of a recovery. *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441, 74, A.L.R. 1139. Fraud presupposes not only an untrue statement but also a fraudulent intent. On the question of falsity of the representations the jury was told that the issue was whether the defendants' representations, 'in the sense to be taken by an ordinary reasonable man,' were, in fact, true or untrue — whether a true or a false impression was created. On the question of intent, the jury was told that fraud may be established by showing that a false representation has been made, either knowingly, or without belief in its truth, or in reckless disregard of whether it be true or false; and that the issue was whether the defendants had an honest belief that the statements made by them were true. 'If they did have that honest belief, whether reasonably or unreasonably, they are not liable. If they did not have an honest belief in the truth of their statements, then they are liable, so far as this third element [scienter] is concerned.' The jury was also told that an intent to deceive may be inferred from a lack of honest representation; and that, so far as alleged concealments or omissions were concerned, the issue was whether the omission to state certain matters was deliberate and intended to conceal. It was further charged that, if the audit made 'was so superficial as to be only a pretended audit and not a real audit, then the element of knowledge of falsity of their representations is present, and they may be held liable.' Reading the charge as a whole, it seems to be in strict conformity with the established law."

Upon this appeal the issue relating to the item "Notes and Accounts Receivable and Accrued Interest — Secured," was particularly crucial. The trial judge stated that these assets were not secured as a matter of law. The plaintiffs contended that the defendants knew they were not secured. The defense maintained that they honestly, if erroneously, believe them to be secured. With respect to this issue the trial judge charged:

"As matter of law it is my opinion, and I charge you, that these advances to complete unfinished buildings are not the kind of advances that are secured under the trust deeds. The point, however, is not so clear that persons reading such parts of the deed might not, in good faith, entertain different opinions; and the good faith of the defendants in representing these advances as secured is one of the questions of fact for you to determine under all the evidence applicable to these notes, and under the rules which I will later explain to you."

The plaintiffs requested the trial judge to charge the jury that if they should find that the statement as to security was false and "that the defendants represented to the plaintiffs that this was true to their own knowledge, as distinguished from belief or opinion, they were guilty of making a false balance sheet, even if they believed it to be true." This request to charge was denied, and the denial became one of the important grounds for appeal. The Circuit Court supported the position of the trial judge, dealing with the question in the following language:

"Accountants profess to speak with knowledge when certifying to an agreement between the audit and the entries in books audited, but there is no suggestion in the cases relied upon that a statement by an auditor that notes are secured by the provisions of a trust deed is an assertion of knowledge

rather than an expression of opinion. To suggest that a title examiner was guilty of fraud if he erroneously certified a title because he had honestly misconceived the legal significance of a provision in a deed would doubtless horrify counsel for the appellants no less than other members of the legal profession. There is no reason to hold accountants to a higher standard, when they deal with legal documents. The issue of the defendants' good faith was rightly left to the jury."

As to the alleged omission of contingent liabilities, it was stated:

"The charge called attention to the conflicting testimony and instructed the jury to weigh it. The refused requests were to the effect that omission of the contingent liabilities made the balance sheet false. In view of the conflicting testimony, such a charge was properly refused. *Even if it were an abuse of good accounting practice to omit them, such an abuse was not fraud unless accompanied by an intent to conceal. The issue of fraudulent concealment was fairly put to the jury in the general charge.*" (Emphasis added)

The Circuit Court concluded that a full and fair trial had been had; that the instructions given to the jury as to the applicable law were correct; that the factual issues had been properly submitted to the jury and that the verdict of the jury for the accountants should not be disturbed.

General Comments

A comparative study of the foregoing three leading cases dealing with accountants' legal responsibility to third parties supports the following general conclusions.

In the absence of special statutory rules (such as the Federal Securities Act soon to be discussed) there is no liability for mere negligence. However, the *Ultramares* case did not reverse such authorities as *Glanzer v. Shepard*³⁴ and *Doyle v. Chatham & Phenix National Bank*,³⁷ where it had been held that there would be such liability if there was a sufficiently intimate relationship between the third party and the defendant. Thus, we still have the possibility of liability for mere negligence if the particular third party, or a limited group of which he was a member, was known to the accountant with sufficient definiteness as a party for whom the certified statement of the accountant was intended.*

The *Ultramares* case held that a false representation of fact as of knowledge creates liability even if believed to be true. This rule em-

* It should be noted, however, that the Court of Appeal in England, early in 1951, dealt with just such a situation and on the authority of a line of earlier English cases held that the accountant was not liable for mere negligence to a plaintiff, other than his client, even though the accountant knew definitely that his report was intended for the use of and reliance upon by that specific plaintiff. The court divided two to one on the result, but the majority felt that the English precedents dictated a result in favor of the defendant accountant. The provisions of the English Companies Act were not involved. *Candler v. Crane, Christmas & Co.* (1951) 2 K.B. 164, (1951) 1 The Times L.R. 371.³⁸ This case is discussed at length in *The Law Quarterly Review* (London) by Warren A. Seavey, "Candler v. Crane, Christmas & Co., Negligent Misrepresentation by Accountants,"³⁹

phasizes the vital distinction between representations of fact and expressions of opinion. It was a major issue in the *Ultramares* case in relation to the alleged representation that the balance sheet was in accordance with the books, and it was one of the major issues resulting in the reversal which sent the case back for a new trial. Plaintiffs in the *O'Connor* case sought unsuccessfully to have the court submit to the jury the question of whether or not the characterization "Secured" in relation to assets in the balance sheet was a representation of fact as of knowledge. However, it was there held that the use of this term involved only the expression of opinion concerning what was essentially a legal concept.

The principles that there is liability for fraud to persons outside the privity of contract, that gross negligence may be evidence of fraud, that even the expression of opinion may be a fraudulent representation if there is not a sincere and honest belief in that opinion — are all long established in the law. Only the application of such principles to the accountants' situation is novel. It has shifted the strategy of third party plaintiffs from the battleground of negligence to that of fraud. However, it has not eliminated the legal distinction between fraud and negligence, nor has it eliminated that distinction as a practical matter. But for the ruling in the *Ultramares* case, the *O'Connor* case would have been fought out on the issue of negligence and the jury would not have had to rest its decision upon the basic issue of the good faith of the accountants and their sincere belief in their opinion, even if erroneously held.

These cases highlight the decisive role of the jury in determining the legal responsibility of accountants. In *Ultramares* it was held that the case on fraud should have gone to the jury. In the *State Street Trust* case it was held that the verdict of the jury for plaintiff should not have been set aside. In the *O'Connor* case it was held that the jury verdict for defendants should prevail. Not only do the questions of negligence and fraud present factual issues to be passed upon by the jury, but so does the question of the reliance of plaintiff upon the work of the accountants, as well as the question of damage to plaintiff, if any, resulting from the fault of the accountants.

In the absence of a defense of his work, the jury is likely to assume a consciousness of fault on the part of the accountant. This may have been an important factor in the *State Street Trust* case. Similarly, if the testimony of plaintiffs' experts is uncontradicted, it carries maximum weight with both court and jury.

Questions of auditing standards and accounting principles are matters of fact and not of law. If there is conflicting expert testimony, it is for the jury to decide which testimony it should follow. In this connection, where the cause of action is in fraud, the jury, in order to render a verdict for the accountants, does not have to do more than conclude that

the accountant had an honest belief in his expressed opinion on these technical matters, even if such belief might have been erroneous. On the other hand, in areas where standards and principles have not been clearly defined, the lay jury may be misled and reach a conclusion disastrous to the defendants. Hindsight wisdom * lends plausibility to the arguments of plaintiff and is always a serious threat to the defense.

LIABILITY TO THIRD PARTIES — BY STATUTE

The common law liability of accountants to third parties has been substantially affected by the enactment of the Federal Securities Act of 1933 and the Federal Securities Exchange Act of 1934. Insofar as the work of the accountant falls within the jurisdiction of the 1933 Act there can be liability for mere negligence as well as for fraud, to certain large classes of third parties, namely, the purchasers and owners of securities. As was said of the 1933 Act shortly after its enactment:

"To say the least the Act goes as far in protection of purchasers of securities as plaintiff in *Ultramares Corp. v. Touche* unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor. The change which that court thought so 'revolutionary' as to be 'wrought by legislation' has been made. And the duty placed on experts such as accountants has not been measured by the expert's relation to his employer but by his service to investors." ⁴⁰

The Federal Securities Act of 1933 regulates the offering of securities for sale to the public through the use of the mails or in interstate commerce. It provides for the prior filing of a so-called Registration Statement with the Securities and Exchange Commission, in which there is disclosure of all material facts concerning the securities to be offered. Included in the Registration Statements are the relevant financial statements of the issuer of the securities. These statements are required to be certified by independent public accountants who are usually certified public accountants. Section 11 (a) of this statute in part provides:

"In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue — . . .

(4) every accountant engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;"

* As Mr. Justice Brewer observed in *United States v. Bell Telephone Co.*, 167 U.S. 224, 261: "Anybody could have discovered America after 1492."

It is further provided that no person, other than the issuer, shall be liable who shall sustain the burden of proof that:

"(B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert;"

With respect to the amount of damages which the plaintiff may recover under the statute, it is stated:

"Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable."

The effect of the statute, as indicated by the above quotations, insofar as it relates to financial statements prepared or certified to by an independent public accountant and included with his consent in the Registration Statement, may be summarized as follows:

1. Any person acquiring securities described in the Registration Statement may sue the accountant, regardless of the fact that he is not the client of the accountant.

2. His claim may be based upon an alleged false statement or misleading omission in the financial statements, which constitutes his prima facie case. The plaintiff does not have the further burden of proving that the accountants were negligent or fraudulent in certifying to the financial statements involved.

3. The plaintiff does not have to prove that he relied upon the statement or that the loss which he suffered was the proximate result of the falsity or misleading character of the financial statement.

4. The accountant has thrust upon him the burden of establishing his freedom from negligence and fraud by proving that he had, after reasonable investigation, reasonable ground to believe and did believe that the financial statements to which he certified, were true not only as of the date of the financial statements, but beyond that, *as of the time when the Registration Statement became effective.*

5. The accountant has the burden of establishing by way of defense or in reduction of alleged damages, that the loss of the plaintiff resulted in whole or in part from causes other than the false statements or the misleading omissions in the financial statements. Under the common law it would have been part of the plaintiff's affirmative case to prove that the damages which he claims he sustained were proximately caused by the negligence or fraud of the accountant.

It should be noted that Section 13 of the 1933 Act bars any action under its provisions unless brought "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." In no event can such an action be brought "more than three years after the security was bona fide offered to the public."

No court cases against accountants have been reported under this Act since 1933 based upon alleged falsity or misleading omission as of financial statement dates. It would seem clear, however, that proof of compliance with generally accepted auditing standards would be an adequate and effective defense insofar as the statements speak as of their purported dates. It is the vague extension of responsibility beyond the financial dates and down to the "effective date" of the Registration Statement (which may be months later) which poses a difficult and unresolved problem. What constitutes the "reasonable investigation," within the meaning of the statute, that the accountant should undertake, covering the period from the completion of his audit down to the subsequent effective date, is still relatively an open question. Whereas generally accepted auditing standards have been promulgated with reasonable clarity, such standards are not applicable to the "reasonable investigation" covering this post-audit period. There is considerable difference of opinion as to what work the accountant should perform after the completion of his audit, to assure himself that the statements which are a fair presentation upon the completion of his audit work are also a fair presentation upon the subsequent effective date of the Registration Statement. It is generally considered essential to take the following steps:

1. Inspect the minutes down to a date reasonably close to the effective date.
2. Address inquiries to the management as to whether there have been significant events down to that date.
3. Inspect available unaudited financial statements dated subsequent to the audited statement dates.

The "reasonable investigation" outlined above is far less than an audit, falls far short of compliance with generally accepted auditing standards and is not intended to afford a basis for the expression of an opinion as to any period or any transaction subsequent to the audited statement dates. It does serve, however, as a reasonable inquiry by the accountant, within the practical limits of the situation, to place him in a position where he feels justified in relying upon a presumption of continuance as to the fairness of presentation to which he certified as of the audited statement dates. On the other hand, if the accountant does have actual knowledge, however obtained, of material subsequent events, it is generally considered to be his responsibility to insist that such facts of which he has actual knowledge are adequately disclosed.

The only recorded court case involving a claim against accountants under the Federal Securities Acts dealt with the failure to disclose a con-

tingent liability which had developed between the date of certification and the effective date. The case ⁴¹ was dismissed against the accountants as well as against the other defendants. The case arose in 1939 and is inconclusive for a number of reasons. The opinion of the court seemed to ignore any responsibility on the part of the accountants for events subsequent to the date when they certified the financial statements. The peculiar situation existed where the Registration Statement became effective on a given date but as of a prior date, which prior date coincided with the date on the accountants' report. Furthermore, the action was dismissed on the additional grounds of a failure by the plaintiff to prove damages. The statute of limitations was also invoked. The decision was criticized in law reviews ⁴² on varying grounds and contributed very little toward the clarification of accountants' responsibility under the statute. This case was recently discussed at some length in *The New York Certified Public Accountant*.⁴³

The Securities Exchange Act of 1934 relates in general to the regulation of securities exchanges and the securities there traded in and listed. It provides, among other things, for the filing of annual reports with the Securities and Exchange Commission, including financial statements certified by independent public accountants. Section 18 of the 1934 Act deals with the liability for misleading statements and is applicable to accountants involved in the certification of such statements. This Section provides as follows:

"Sec. 18. (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant."

The Statute of Limitations relating to actions under the 1934 Act contains 1-year and 3-year provisions which are substantially similar to those under the 1933 Act.

It will thus be seen that the provisions of Section 18 of the 1934 Act differ in the following significant respects from the comparable provisions of Section 11 of the 1933 Act:

1. There is no provision similar to the "effective date" requirement of a Registration Statement. In contrast, it is provided in the

1934 Act that to be actionable, the statement must be false or misleading "at the time and in the light of the circumstances under which it was made." It would seem from this that the accountant is not obligated to extend his examination or inquiry beyond the completion of his audit work, even though the filing with the Securities and Exchange Commission may take place at some subsequent date. In the case of the 10-K report covering a calendar year, this is required to be filed on or before April 30th following the close of the year. It usually includes financial statements, the audit work on which may have been completed two or three months earlier. The accountant's report usually bears the date of the completion of his audit and it would seem that his responsibility would be limited to his compliance with generally accepted auditing standards applied down to the date of the completion of the audit. However, if the accountant has actual knowledge of the occurrence of subsequent events which are of material significance, it would be incumbent upon him to insist upon adequate disclosure in the report.

A similar view was expressed in a paper read at the 1951 annual meeting of the American Institute of Accountants by the present chairman of its committee on auditing procedure, from which the following is quoted:

"It should be recognized as entirely proper that there are situations in connection with which we may acquire no knowledge of what has occurred after the date of our examination and, in the absence of any such knowledge, are able to release a standard form certificate within a reasonable period after the completion of our field work with no fear of responsibility for what might have happened in the interim period concerning which we had no contact with the client or his affairs. It would appear that this should apply in the case of an annual report filed with the Securities and Exchange Commission or any similar body. If, for instance, the field work for a printed annual report is completed and the report is certified on February 14, and the working papers then contained necessary data for checking the company's report to be rendered in April to the Commission, the independent accountant should check such report in April and furnish his certificate to accompany it with no responsibility for events which had occurred between February 15 and April unknown to him." ⁴⁴

2. The plaintiff must prove his reliance upon the financial statement and prove damages that were caused by such reliance.

3. While the plaintiff does not have the burden of proving negligence or fraud on the part of the accountant, the accountant is given the statutory defense "that he acted in good faith and had no knowledge that such statement was false or misleading." This quoted language is consistent with freedom from fraud rather than freedom from negligence. It would seem, therefore, that the rule of the *Ultramares* case has been here enacted and that there would not be liability to third parties for mere negligence where the good faith of the accountant is established.

The civil remedies under the Federal Securities Acts apply only to purchasers and owners of securities and do not include claims of creditors who are not bondholders or the owners of similar securities. Securities transactions which are strictly intrastate matters would not be covered.

Most of the states have their own so-called Blue Sky laws which regulate the issuance of securities and which do not contain specific provisions modifying the legal responsibility of the accountant under the common law. However, in the case of the State of Florida, the remedies of the Federal Securities Acts have been incorporated into their own state law by the following statutory enactment:

"The same civil remedies provided by laws of the United States now or hereafter in force, for the purchasers of securities under any such laws, in interstate commerce, shall extend also to purchasers of securities under this chapter." (Comp. Gen. Laws Supp. 1936, § 6002 (26). Laws 1933, c. 16174, § 5.)

DISCIPLINARY PROCEEDINGS

Situations may occasionally arise where the work of the accountant may be subjected to serious critical attack which nevertheless does not involve legal responsibility or civil liability. Though the claim may be made that an audit was performed or reported upon fraudulently or incompetently, the claimant may be unable to prove that he sustained damages. Therefore he cannot maintain any action, either at common law or under the Federal Securities Acts. He may be a third party who cannot even sue for the recovery of a fee. In such circumstances, he may resort to the filing of a complaint seeking disciplinary action against the accountant involved. Though such a complaint may not include the threat of a judgment for money damages, it may place in jeopardy the reputation of the accountant, or even the retention of his CPA certificate. From this latter viewpoint it would seem relevant to include in this chapter some mention of disciplinary proceedings.

Disciplinary powers over accounting practitioners are vested in:

1. Professional societies such as the American Institute of Accountants and the various state societies. These organizations have established codes of professional conduct for the breach of which a member may be expelled or suspended from membership, or censured.

2. Under the authority of state statutes regulating certified public accountants there is generally provision for the revocation or suspension of the CPA certificate or the censure of the CPA where, after due notice and a proper hearing, the constituted authorities find evidence of specified professional misconduct.

3. The Securities and Exchange Commission in Rule II(e) of its Rules of Practice has provided:

"(e) The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

- (1) Not to possess the requisite qualifications to represent others; or
- (2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

It is significant to note that fraud and gross negligence in the practice

of public accountancy have been included in the broad concept of professional misconduct subject to disciplinary action. By way of illustration it is pertinent to quote Rule 5 of the Rules of Professional Conduct of the American Institute of Accountants:

"5. In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

- (a) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
- (b) he fails to report any material misstatement known to him to appear in the financial statement; or
- (c) he is materially negligent in the conduct of his examination or in making his report thereon; or
- (d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
- (e) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

WORKING PAPERS

Relevancy From an Evidentiary Viewpoint

In any case brought against an accountant on the ground that negligence or fraud was involved in his work, it is altogether likely that the working papers relating to the audit will be offered in evidence in whole or in part. The evidence may be offered by the plaintiff to support his allegations of fraud or negligence. On the other hand, it may be the accountant who may introduce his working papers to establish the adequacy of his audit and the fairness of the opinion which he expressed in his report thereon.

To be more specific, the working papers may be relevant on one or more of the following issues which may arise in the case:

1. The working papers will constitute a record of the audit work performed, both from a qualitative and quantitative standpoint. That is to say they will constitute proof of what records were examined, what inquiries were made, what confirmations were undertaken, etc. At the same time they may constitute a record of the amount of testing and sampling that was performed, which, in the judgment of the accountant, was adequate in the circumstances.
2. The extent to which the audit work was properly planned and supervised may be evident from the working papers.
3. The nature and extent of the review of the client's system of internal control and its effective operation may appear in the working papers, and therefore the extent to which the accountant relied upon his appraisal of internal control in planning and carrying out his audit program.
4. The scope of his inquiries addressed to the client and the extent to which

the accountant relied upon the client's representations may be recorded in the working papers.

5. Working papers may contain information which the plaintiff claims should have aroused the suspicion of the accountant and resulted in an extension of his audit procedures beyond the work which was done.
6. The working papers in their entirety may be offered by the accountant as evidence of his compliance with generally accepted auditing standards in support of the opinion expressed in his report.
7. The working papers may contain information which the plaintiff claims should have been disclosed and the omission of which, it is claimed, makes the report of the accountant misleading.
8. Where the genuineness of the accountant's belief in the opinion which he has expressed is put in issue, the working papers may offer persuasive evidence of the thinking of the accountant in the development and formulation of his opinion.

Even where the working papers themselves are not put in evidence, they may be used to refresh the recollection of the accountant as to significant occurrences during the course of the audit and as to the circumstances existing in connection with his work which influenced his judgment in many important ways. On the other hand, an inspection of the working papers by the plaintiff's representatives may supply leads for inquiry and material for the cross-examination of the accountant.

Ownership of Working Papers – The Ipswich Mills Case

In view of the potential importance of the accountant's working papers, many states have confirmed their ownership by the accountant through specific statutory enactment.* Even in the absence of such statutory provisions, however, the courts have recognized and upheld such ownership by the accountant.

The leading case on this point is *Ipswich Mills v. Dillon, et al.*,⁴⁵ decided in 1927 in the Massachusetts Supreme Judicial Court. That was a case brought by a corporation against certified public accountants, the corporation seeking to gain possession of certain documents held by the accountants, who had theretofore been employed by the corporation to

* The states of California, Florida, Kentucky, Missouri, New Hampshire, Oregon, Pennsylvania, Virginia and Washington, and Puerto Rico, have included such provision in their statute regulating the practice of public accountancy. In some instances the provision relates only to certified public accountants. In other instances, it relates to certified public accountants and public accountants. In all other respects, these provisions are substantially identical. The Virginia statute is quoted by way of illustration:

"All statements, records, schedules and memoranda made by a certified public accountant or a public accountant, or by an employee or employees of a certified public accountant, or public accountant, incident to or in the course of professional service to clients by such certified public accountant, or public accountant, except reports submitted by a certified public accountant, or public accountant, to a client shall be and remain the property of such certified public accountant, or public accountant, in the absence of a written agreement between the certified public accountant, or public accountant, and the client, to the contrary."

(1928, p. 1154; Michie Code 1942, § 572a; Virginia Code of 1950: Title 54, Ch. 5, § 54-101.)

make annual audits, prepare tax returns and statements for banks, and to represent the corporation in a Federal tax matter before the Bureau of Internal Revenue. There had been no special agreement between the client and the accountants as to the ownership of the documents. The papers were divided into the following categories for purposes of this litigation:

Group A consisted of papers that originated in the client's offices or in the offices of its selling agents or of someone associated with them. The accountants conceded that the client was the owner of these papers.

Group B included a copy of the amended Federal tax returns of the plaintiff for the year 1918 and certain papers (not work sheets) relating thereto.

Group C included copies of the client's tentative and amended tax return for 1919 with work sheets and correspondence in connection therewith.

Group D consisted of papers and work sheets of revaluation of the client's plant assets.

Group E consisted of the accountants' work sheets of their July 1922 report.

Group F included papers, reports, returns, copies, work sheets, data, correspondence and memoranda respecting the tax case, together with some letters originating in the client's office.

The trial judge had ruled that the client was the owner of all of the above enumerated papers, except those in Group F, and entitled to their immediate possession. As to Group F, he ruled that the client and the accountants were jointly interested in those papers, with the right in the client to take them temporarily from the accountants.

On appeal, this decision was reversed and it was held that except for group A (which the accountants conceded belonged to the client) *all enumerated papers and documents belonged to the accountants*. The appellate court stressed the fact that the accountants were not mere employees of the client but were independent contractors functioning in a professional capacity. The court also was impressed with the necessity for the accountants retaining possession of all of these documents "if the accuracy of their work was questioned." The following quotations from the court's opinion further explain the decision reached:

"The carbon copies of the defendants' letters to the collector of internal revenue did not belong to the plaintiff. Whatever right it may have to examine these copies, or take copies of them, which point we are not called upon to decide, the defendants' copies did not belong to the plaintiff; they were owned by the defendants. The fact that the copies of these letters concern the plaintiff is not a sufficient reason for depriving the defendants of their property. In writing the letters the defendants were not the plaintiff's servants.

In group C there are copies of Federal tax returns. These, as we understand from the record, were the defendants' office copies. The record shows that copies of all returns and schedules prepared by the defendants for the plaintiff were sent to the plaintiff. Even if the plaintiff has a right to require further copies, a question not involved in this suit, it has no right to demand of the defendants the surrender of these office copies. They were the property of the defendants.

The work sheets, as defined by the trial judge, were the defendants' property. They were made by them while engaged in their own business. The paper on which the computations were made belonged to them. They were not employed to make these sheets. The sheets were merely the means by which the work for which the defendants were employed might be accomplished. The title to the work sheets remained in the defendants after the computations were made. In the absence of an agreement that these sheets were to belong to the plaintiff, or were to be held for it, they were owned by the defendants. It may be that these papers contained information confidential in its nature and of importance to the plaintiff; but the defendants did not receive this information as the plaintiff's servants. . . . The interest of the plaintiff in the information collected and copied by the defendants and the confidential nature of this information do not give title to the plaintiff of the defendants' working papers. They were made by the defendants solely for their own assistance in preparing the tax returns.

With reference to group F, the letters addressed to the defendants, copies of letters written by the defendants, copies of returns furnished to the plaintiff, and work sheets relating to the tax case, are the sole property of the defendants, and this is true of the papers and reports collected by the defendants in the preparation of the tax case. The plaintiff is not jointly interested with the defendants in these documents. We do not understand that any of these reports, papers and returns were property of the plaintiff which had been placed in the defendants' custody by the plaintiff or merely delivered to the defendants. If there are any papers belonging to the plaintiff which were lent to the defendants, the plaintiff is entitled to them; but as we construe the record, the papers referred to in group F were gathered and collected by the defendants in the course of their business, and were not papers of the plaintiff placed by it in the defendants' possession."

The New York Surrogate's Court Case

A case arising in the New York Surrogate's Court in 1936 ⁴⁶ indicated that the property rights of the accountant in his working papers may be qualified or limited in certain circumstances. A certified public accountant, who had been an individual practitioner for a number of years prior to his death in 1933, in his will bequeathed to his secretary "all of my office files and records." Upon the proceeding to settle the accounts of the executrix, the Surrogate's Court was called upon to decide whether the language in the will included working papers and if it did, whether or not the testator had a legal right to dispose of them by will. The Surrogate held that no such right existed, but in so holding, it did not differ with the Ipswich Mills case.

The Ipswich case did not deprive the client of the right to prevent the accountant from disclosing to other persons the confidential information in his working papers. In other words, the title of the accountant to his working papers was always subject to his obligation to deal with the information there contained in compliance with the confidential relationship of client and accountant. This legal principle was not abrogated by the Ipswich Mills case, nor could it have been, without doing violence to the rights of the client implied in the client-accountant relationship.

If the deceased accountant had been a member of a partnership and had bequeathed his interest in the partnership papers to any one or all of his surviving partners, the question presented in this case would not have arisen. The confidential nature of the working papers would have been safeguarded despite the transfer of ownership of the interest in them possessed by the decedent. But this was the case of an individual practitioner who had no surviving partners. If the court had recognized an unqualified right in the testator to deal with his working papers as he would with other assets of his estate, then his legatee in turn could dispose of them to anyone else, even to a competitor of the client. Similarly, if the ownership of these working papers was to be regarded in the same category as the ownership of other assets, it would have been necessary to recognize the paramount right of creditors who might assert their claims against the working papers and dispose of them by sale for the satisfaction of the debts of the decedent.

The Surrogate wisely held that after the executrix had assured herself that there was no basis for claims against the estate which would require the retention and preservation of the working papers for the protection of the accountant's estate, she was ordered to return to the respective clients all working papers which had originated in their offices and to destroy all working papers which the deceased accountant himself had prepared.

This important case, which bristles with undecided and unresolved implications, is not recorded in the official reports. It has been rescued from obscurity, so far as accountants are concerned, through the very comprehensive discussion of it which appeared contemporaneously in *The Journal of Accountancy*. The comments on the case in this chapter are based upon the foregoing discussion in *The Journal of Accountancy*.⁴⁶

The Frye Case

This case⁴⁷ was decided by the Supreme Court of Ohio in May 1951. It is of special interest to practicing accountants for at least three reasons:

1. It is an illustration of the uncomfortable predicament of an accountant who is not a party to a litigation brought against his client, but who, nevertheless, is compelled by legal process to testify against his client's interests by divulging the contents of his working papers.
2. While reaffirming the Ipswich Mills case, it holds that the mere possession of legal title to his working papers does not give the accountant the legal right to refuse to disclose their contents to parties other than his client, where such disclosure is ordered by the courts incidental to litigation or for other reasons.
3. It clarifies the legal limitations affecting the confidential nature of his working papers and the qualified obligation of the accountant to refrain from disclosing the contents thereof.

The client in this case was being sued by a sales agent who had been

in its employ, who claimed commissions to be computed on a percentage basis. The accountant, who had audited the books of the client, was served with a *subpoena duces tecum* requiring the production by the accountant of "all records or copies of records in your possession relating to the financial condition or operation of [the client] from the date of its organization to the present day; including copies of all . . . tax returns, state or federal . . ."

The accountant appeared for examination, testified that she had been the client's auditor since its organization, and presented and identified some thirty separate exhibits consisting of audit reports, financial statements, and commission statements. At a subsequent hearing the accountant appeared with counsel who objected to the introduction in evidence of the accountant's working papers previously identified or of "photostatic replicas" thereof. To lay a foundation for such objection, she testified that she did work for the defendants as an independent contractor in the capacity of auditor; that she had no records which belonged to the defendant; that the records which she had previously identified were her own personal records; that when she made out the tax returns for the client, she gave it the originals and copies for its files and that the client did the filing of the tax returns. Upon her persistent refusal, she was cited for contempt and put under technical arrest. The legal issues thus raised finally came before the Ohio Supreme Court on appeal.

The court held against the accountant and ruled that she was lawfully obligated to produce the documents for use in evidence. It was held that the Ipswich Mills case did not apply to this situation, the court stating:

"In that case the papers were not under subpoena in the hands of the accountants to produce them in court. Doubtless they were subject to subpoena but this question was in no way before the court. The sole question determined was the ownership of the papers. Doubtless in a proper case a court will protect the owner of papers and documents so far as their custody is concerned by requiring the party calling for them for evidential purposes to make photostatic or other proper copies of the same so that the owner may retain the originals. Such an offer was made to Frye by the plaintiff in the instant case but the offer was rejected."

The accountant also contended that the documents sought in evidence related to the income tax returns of the client and that their production by the accountant would be in violation of the United States Internal Revenue Code which provided:

"It shall be unlawful . . . for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return. . . ."

The court disposed of this contention in the following ruling:

"Furthermore, there is no infraction of the statute involved in this proceeding.

The latter part of the statute above quoted prohibits any person from printing or publishing *tax returns* or sources of income, profit, losses or expenditures *appearing in any income tax return*, in any manner 'not provided by law.' This statute does not and could not legally inhibit the disclosure, as evidence in a proper judicial inquiry or where required by law, of the operative financial data relating to the business of a taxpayer, even though such data comprehends the elemental facts and information from which his income tax return is necessarily made up. The law could never sanction such a sweeping prohibition of disclosure of the essential facts of the business world. **It must be evident that the statute in question has no such purpose or intent."**

The broad question of the duty of the accountant not to disclose the information involved because of its confidential nature, was dealt with by the court in the following terms:

"In the absence of a privilege created by constitution or statute not to disclose available information, a witness may not refuse to testify to pertinent facts in a judicial proceeding merely because such testimony comprehends a communication or report from himself as agent to his principal or as independent contractor to his employer, no matter how confidential may be the character of the communication itself or the relationship between the parties thereto. See *Robertson v. Com.*, 181 Va. 520, 25 S.E.2d 352, 146 A.L.R. 966. And where one possesses knowledge of facts which are pertinent to a judicial inquiry, he may be required to testify or to produce papers and documents as to such facts.

In discussing this subject, 58 *American Jurisprudence*, 40, Section 32, states the rule as follows: 'It is a general rule that a witness possessing knowledge of facts material to the vindication of the rights of another may be compelled by judicial process to appear and give evidence in behalf of that other party, notwithstanding the evidence thus coerced may uncover the witness's private business. This rule is also generally held applicable when the information sought is contained in books and papers. Accordingly, it has been held that it is no ground for the refusal of a witness to produce books and papers, when required by lawful authority, that they are private. The duty of witnesses to disclose the details of their private business for the benefit of third persons when required in the administration of justice, is one devolving on them as members of a civilized community.'"

The above quoted language of the court defines and limits not only the legal obligation but the ethical duty of the accountant concerning the confidential relationship existing between himself and his client, a relationship which has been set forth in the Institute's Rule 16 of the Rules of Professional Conduct (See Appendix B of Chapter 5). The legal position of the accountant with respect to the question of privileged communication status (which will be dealt with in the following pages) was only indirectly involved in the *Frye* case.

PRIVILEGED COMMUNICATIONS

In the *Frye* case it was emphasized that neither the confidential nature of an accountant's working papers nor the personal ownership of them by the accountant was sufficient legal reason for a refusal by the accountant to divulge their contents in a judicial proceeding to which they

were relevant. A different result might have been reached by the court had the relationship of accountant and client conferred upon these documents the status of privileged communications.

Such a status of privilege has been recognized under the common law as to confidential communications between attorney and client, and between husband and wife, and by statute generally as to confidential communications between physician and patient and between priest and penitent. Statutes have also codified and to some extent limited the common law privilege accorded to the attorney-client and the husband-wife relationship. With special reference to the accountant-client relationship, however, it has been held that no such privilege ever existed under the common law and that none will be recognized in the absence of a statute specifically creating such a status.

The leading case which so held was that of *In re Fisher*,⁴⁸ decided in 1931 in the Federal District Court of the Southern District of New York (a state which has no accountant privilege statute). The question arose during the course of bankruptcy proceedings. The witness involved was both a certified public accountant and a lawyer. He had acted as the bankrupt's accountant for a number of years and, after his later admission to the bar, also acted as the bankrupt's attorney. He refused to answer questions relating to the bankrupt's books of account or to produce working papers prepared by members of his accounting staff in the course of auditing the bankrupt's books. It would appear that he relied upon the privilege arising from the attorney-client relationship with the bankrupt, but the court, in directing the witness to testify, gave consideration as well to the fact that the evidence involved was obtained by the witness in his capacity as accountant. In support of its conclusion, the court stated:

"There is no privilege with regard to communications made to accountants. The information given to the witness and to the accountants in his employ for the purpose of making financial statements and doing other work characteristically performed by accountants is not privileged, despite the fact that the witness may also have rendered legal advice on the basis of such data. See *Matter of Robinson*, 140 App. Div. 329, 125 N.Y.S. 193, where it was held that an attorney for a corporation, who was one of its directors, could not refuse to disclose information about corporate affairs by claiming his professional privilege.

Furthermore, the privilege accorded to an attorney is the privilege of the client and not of the attorney. *Baumann v. Steingester*, 213 N.Y. 328, 107 N.E. 578, Ann. Cas. 1916C, 1071. For this reason the attorney cannot claim privilege where the client has already disclosed the substance of the communication. *Baumann v. Steingester supra*. Nor can he claim privilege where the communication was made with the understanding that it was to be imparted to third parties. *Rosseau v. Bleau*, 131 N.Y. 177, 30 N.E. 52, 27 Am. St. Rep. 578.

In the case at bar it appears that the bankrupt has already testified with respect to the matters contained in his books and records. And the income tax

returns and financial statements drawn up from the communications made by bankrupt to the witness were obviously intended to be communicated to others.

For these reasons, the witness should be directed to testify with regard to the bankrupt's books and to produce in evidence the monthly work sheets made by the accountants."

In the case of *Himmelfarb v. United States*,⁴⁹ decided in 1949 in the Federal courts of California (a state which has no accountant privilege statute) it was again held that privileged communications are not recognized as between a client and his accountant. In that case the certified public accountant had been employed by the client's attorney during the pendency of an investigation by the special agents of the Intelligence Unit of the Treasury Department. The accountant attended numerous conferences with the attorney and the client and also examined the client's records. In an effort to work out a settlement, the attorney and the accountant had supplied the Treasury agents with considerable documentary material which the accountant had assembled from the books and records. On the trial which followed, the accountant was subpoenaed and identified the documents, which were then put in evidence over the objection of the client's attorney. The court held that even if the accountant had obtained some of the information by being present at conferences between the client and the attorney, such communications were not privileged. The accountant's "presence was not indispensable in the sense that the presence of an attorney's secretary may be. It was a convenience which, unfortunately for the accused, served to remove the privileged character of whatever communications were made. Of course, communications made by the client to such a third party in the presence of the attorney are not within the privilege."

It was held that, from any viewpoint, the documents prepared by the accountant were properly admissible. To the extent that they were based upon information given to the accountant directly by the client or obtained from the client's records, there was no privilege growing out of the accountant-client relationship. Insofar as the documents were based upon information overheard by the accountant at conferences between the client and the attorney, which would otherwise have been privileged, the presence of the accountant destroyed the privilege.

It was similarly held in the later income tax evasion case of *Gariepy v. United States*⁵⁰ that under the common law there is no accountant-client privilege. In this instance the Michigan statute creating an accountant-client privilege was expressly inapplicable in a criminal case.

The *Himmelfarb* case was specifically cited and followed in 1951, in the Federal courts in Pennsylvania, in the case of *United States v. Stoehr*.⁵¹

Although all of these cases arose in the Federal courts in connection with criminal or bankruptcy matters, they consistently support the proposition that, in the absence of statutory provision, there is no status of

privilege applicable to the confidential communications between client and accountant similar to that which applies to the communications between attorney and client.

Statutes which confer the status of privileged communications upon information obtained by accountants during the course of their work have now been enacted by twelve of our states and by Puerto Rico. These statutes fall roughly into three groups:

1. Arizona, Iowa, Maryland, Michigan and Tennessee specifically provide that the privilege is not applicable in situations involving criminal or bankruptcy laws. All of this group, except Tennessee, apply to certified public accountants and public accountants. The Tennessee statute mentions only certified public accountants. There are other variations within this group, but the Michigan statute may be quoted as a fair example:

"Except by written permission of the client, or person, or firm, or corporation employing him, or the heirs, successors or personal representatives of such employer, a certified public accountant, or a public accountant, or a person employed by a certified public accountant or by a public accountant shall not be required to, and shall not voluntarily, disclose or divulge information of which he or she may have become possessed relative to and in connection with any examination of, audit of, or report on, any books, records, or accounts which he or she may be employed to make. The information derived from or as the result of such professional service shall be deemed confidential and privileged: *Provided, however,* that nothing in this paragraph shall be taken or construed as modifying, changing or affecting the criminal or bankruptcy laws of this State or of the United States." (Compiled Laws, Michigan, 1929: Title XVIII, Ch. 155 § 8659; § 23 of the Accountancy Law.)

2. Florida, Illinois, Kentucky, Louisiana, New Mexico and Puerto Rico do not exclude criminal or bankruptcy matters from the provisions of this statute. The Louisiana statute is quoted as an example of this group:

"No certified public accountant, public accountant, or person employed by certified public accountant or public accountant, shall be required to, or voluntarily disclose or divulge, the contents of any communication made to him by any person employing him to examine, audit, or report on any books, records, or accounts, or divulge any information derived from such books, records or accounts in rendering professional services except by express permission of the person employing him or his heirs, personal representatives or successors." (Acts 1908, No. 125, § 7; Acts 1924, No. 136, § 2; Acts of 1950, No. 497, § 85.)

3. Colorado and Georgia may be considered a third group which, like the second group, does not exclude criminal and bankruptcy matters from the statutes, but mentions certified public accountants only. As these statutes create a status not recognized under the common law, they would be strictly construed and therefore would exclude from their provisions accountants who were not certified public accountants. However, there are very important differences in wording between the Colorado and Georgia statutes, and for this reason it is advisable to quote both.

The Colorado statutes provides:

"Who may not testify without consent. There are particular relations in which it is the policy of the law to encourage confidence and to preserve it inviolate; therefore, a person shall not be examined as a witness in the following cases: . . .

Sixth — A certified public accountant shall not, without the consent of his client, be examined as to any communication made by the client to him in person or through the media of books of account and financial records, or his advice, reports or working papers given or made thereon in the course of professional employment, nor shall a secretary, stenographer, clerk or assistant of a certified public accountant be examined without the consent of the client concerned concerning any fact, the knowledge of which he has acquired in such capacity." (L. 1911, p. 679, § 1, amending R.S. 1908 § 7274; C.L. § 6563; L. 1929, p. 642, § 1.)

The Georgia statutes provides:

"Any communications to any practicing certified public accountant transmitted to such accountant in anticipation of, or pending, the employment of such accountant shall be treated as confidential and not disclosed nor divulged by said accountant in any proceedings of any nature whatsoever. This rule shall not exclude the accountant as a witness to any facts which may transpire in connection with his employment." [As added by Act No. 397, Laws 1943, effective March 19, 1943.]

It should be reiterated that there are other important variations in wording in the statutes within the other groups. This should be kept in mind in considering the legal problems which may arise in any particular engagement.

There is frequently the question as to whether the federal or the state rule will govern in any particular case. This question was raised in a proceeding before the Securities and Exchange Commission, where the Commission held that it was not inhibited by the Illinois statute from admitting in evidence a confidential communication contained in the accountant's working papers. The following is quoted from the Commission's release⁵² in that case:

"47. Registrant also asserts that the Kuiper memorandum was erroneously admitted in evidence because of an Illinois statute which provides that a public accountant is not required to testify as to information obtained by him in his capacity as a public accountant (2 Ill. Stat. Ann. (Jones) Sec. 1.19).

It is clear that the common law never recognized any privilege in the accountant-client relationship (In re FISHER, 51 F. (2) 424 (S.D.N.Y. 1931)). Moreover, state legislation purporting to create such a privilege is given no effect in federal courts outside the state (*Doll v. Equitable Life Assur. Soc.*, 138 Fed. 705 (C.C.A. 3d, 1905)). While, in this case, the Kuiper memorandum was introduced during a session held in Illinois, the hearing was originally ordered to be held in Washington, D.C., and a large portion of the hearing was actually conducted in that city. Since it is clear that such a statutory privilege is not recognized outside the state and that no objection based on such a privilege could have been directed to the introduction of the Kuiper memorandum during that portion of the hearing held in Washington, D.C., it would be

manifestly absurd to hold that the memorandum must be excluded because of the fortuitous circumstance that it was introduced while the hearing was being conducted in Illinois. Moreover, while the question need not be resolved here, we have some doubt whether state limitations on the admissibility of evidence which go beyond the common law rules of evidence can be binding in any case in hearings of a tribunal having no fixed situs analogous to that of the federal district courts. For the underlying basis for the conformity statutes, such as 28 U.S.C. § 631, is to achieve a uniformity of evidentiary rules in forums which are permanently fixed within a single state and has no applicability to the hearings of tribunals which have no fixed situs within that state."

A more recent instance of an apparent conflict between the Illinois statute and Federal court decisions was disposed of in *Petition of Borden Co.*,⁵³ where the Federal court refused to give effect to the state statute because it conflicted with the Federal Rules of Criminal Procedure. In other words, the Federal court in effect attached to the Illinois statute a proviso that it did not apply to a criminal proceeding in the Federal court. The following is quoted from the court's opinion:

"It is contended that the reports made by public accountants for The Borden Company, called for by the subpoena duces tecum in question, are privileged. Section 51, Chapter 110½, Illinois Revised Statutes 1947, provides: 'A public accountant shall not be required by any court to divulge information or evidence which has been obtained by him in his confidential capacity as a public accountant.'

It is doubtful whether the privilege granted by this section to a public accountant extends to his written report after he has released it, but it is unnecessary for the court to decide whether the privilege created by the section does extend to the report after its release for the reason that Rule 26 of the Federal Rules of Criminal Procedure, 18 U.S.C.A. following section 687, provides: 'The admissibility of evidence and the competency and privileges of witnesses shall be governed, except when an act of Congress or these rules otherwise provide, by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience.'

At common law the reports of public accountants are not privileged. No act of Congress and no one of the Federal Rules of Criminal Procedure provides otherwise. Accordingly, the court concludes that the reports of public accountants are not privileged."

The dictum in the *Borden* case also serves to raise the interesting question as to whether the client does not waive the privilege as to accountant's reports which he has released to third parties. It may well be argued that such reports have lost their confidential character, which is the foundation of the privilege. If the accountant's report has lost its character as a privileged communication protected by statute, it would then seem to follow that the working papers of the accountant, which were compiled in connection with the preparation of that report, have similarly been released from the prohibition of the statute.

It has been argued that even though the "accounting statements are designed for exhibition to others generally and would not therefore constitute a communication in confidence . . . , the working papers generally contained confidential matters never revealed in the financial statements."⁵⁴ This is undoubtedly so, yet the relevancy of the working papers to the financial statements which are published is so intimate and important that it is highly doubtful that courts would draw the distinction urged above. It would seem more likely that the courts would hold that the client, by publishing his financial statement, waives his privilege not only with respect to that statement but with respect to the underlying working papers assembled by the accountant in the course of preparing or examining the financial statement in question.

Furthermore, the accountant might have to resort to the working papers to defend himself against critical attack. Certainly if the client himself attacks the work of the accountant, it is inconceivable that the client would not have waived any right he might have previously had to prevent the accountant from putting the working papers in evidence. If a waiver on the part of the client were not implied in such a situation, the result obviously would be unconscionably unjust.

For the same reason, if a third party brings an action against the accountant, based on the accountant's report published by the client, the accountant should not be prevented from offering his working papers in evidence in defense of his work merely because his client's consent thereto cannot be obtained. Under Section 22 of the Federal Securities Act of 1933, state courts and Federal courts have concurrent jurisdiction in all actions brought to enforce any liability created under the statute. Such an action might be brought against an accountant in the courts of the state where there is a statutory accountant privilege. The plaintiff might be a third party security owner who brings an action against the accountant based upon prima facie proof of a false statement in the balance sheet audited and certified to by the accountant. The accountant would have the burden of proof of showing that after reasonable investigation he had reason to believe, and did believe, that the financial statement was true. Without recourse to his working papers, the accountant might not be able to sustain this burden of proof. It is most unlikely that in such a situation the state court would hold that the accountant could not put his working papers in evidence or testify concerning their contents without the consent of his client. The only reasonable and just attitude which the courts could take in such a situation would be that when the client caused the financial statement (based upon these very working papers) to be made available to the public through its inclusion in the Registration Statement filed with the Securities and Exchange Commission, he waived the statutory privilege, and, by implication, consented to the accountant's use of his working papers to defend his work, if need be.

One other case should be noted which dealt with the accountant's privilege under the Colorado statute. This was the case on appeal in

Hopkins v. The People,⁵⁵ which involved the conviction for embezzlement of the administrator of a decedent's estate. On the trial a certified public accountant, employed by the prosecution, testified to certain facts obtained through an examination of the records of the estate. The defendant objected to the testimony because of the Colorado statute providing that a certified public accountant, under certain circumstances, should not be examined as a witness without the consent of his client. The court held that the statute had no application to this situation since the defendant who invoked the statute was not the client of the certified public accountant who testified, and therefore the defendant's consent was not required.

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CHAPTER 7

OFFICE ORGANIZATION AND RECORDS

OFFICE AND EQUIPMENT

Office Location. Office Arrangement (General Layout; Furnishings; Separate Offices; Staff Rooms; Storage Space; Modifications and Practices). Office Space Requirements (Allocation of Space; Number and Kind of Offices; Preservation of Records; Space for Filing; Method of Storage). Equipment (Sources of Information; Electric Typewriters; Duplicating Machines; Experience with Reproduction Equipment; Use of Commercial Reproduction Service; Adding Machines, Calculators and Comptometers; Extent of Machine Use; Kinds of Machines in Use; Bookkeeping Machines; Postage and Sealing Machines; Inter-office Communication; Microfilming; Dictating Equipment; Rental of Equipment).

OFFICE ORGANIZATION AND CONTROL

Selection of Non-staff Employees (Application; Appraisal of Applicants; Contracts and Records). Training Office Employees (Instructions and Manuals; Extent of Use of Manuals; Revisions of Instructions and Manuals; Binders; Contents of Manuals; Examples of Manuals). Correspondence and Reports (Correspondence; Reports). Assignment of Office Management Responsibilities (Duties of Office Manager; Other Arrangements for Office Supervision).

OFFICE PROCEDURES AND RECORDS

Receiving Clients. Telephone Procedures (Records of Calls). Control of Staff. Handling of Incoming Mail. Secretarial Assistance (Equipment for Dictation; Part-Time Stenographic Assistance). Office Hours (Saturday Work; Summary of Working Hours; Traveling Time). Office Conduct by Employees. Filing Systems (Filing Methods; Questionnaire Replies). Supplies and Stationery (Standardization; Practices of Firms). Records of Engagements (Engagement Memoranda; Replies to Questionnaires). Records of Meetings, Conversations and Opinions. Records of Tax Returns (Questionnaire Replies). Tickler Files and Follow-up Files (Examples of Procedures; Examples of Pronounced Variations; Questionnaire Results; Other Suggestions for Work Controls; Minor Variations in Control Procedures; Examples of Control Forms). Records

(Over)

OFFICE ORGANIZATION AND RECORDS (*Continued*)

of Staff Work (Records of Location of Personnel; Time Reports; Frequency of Reports; Posting of Time Reports; Time Unit; Filing Reports; Description of Work; Samples of Other Time Reports; Questionnaire Answers). Time Ledgers (Procedure of a Large Firm; Examples of Time Ledger Sheets; Replies to Questionnaires). Expense Reports. Work Progress Records (Accountants' Service Records; Personnel Records; Work Forecasts; Replies to Questionnaires). Accumulation of Charges to Clients (Examples of Forms Used). Use of Punch-Card Accounting (Replies to Questionnaires). Cost of Operation (Budgeting Personnel and Costs; Methods of Allocating Costs; Replies to Questionnaires). Wage and Hour Problems (various Compensation Plans; Replies to Questionnaires). Other Employment Policies (Traveling Expense and Arrangements; Responses to Questionnaire). Supplies (Control; Questionnaire Replies). Entertainment. Accounting Records of Operations (Fiscal Year; Accounting Basis; Books and Records; Replies to Questionnaires). Other Problems of Operation (Insurance Coverage). Library and Information Services (Replies to Questionnaire). Problems of Branch Office Arrangements (Frequent Meetings Desirable; Reviewing Branch Office Reports; Interchange of Field Workers; Branch Office Records; Inquiry into Laws of State Where Branch Office is Planned; Replies to Questionnaires).

Office Organization and Records

BY LOUIS H. PILIÉ

WITHOUT GOOD OFFICE MANAGEMENT, no practitioner can be sure of giving every client maximum service. Efficient organization and good records are imperative.

Ralph B. Mayo¹ subdivides the accountant's basic functions into two parts: (1) productive problems, that is, serving clients, and (2) administrative problems, or "housekeeping" duties. As to the second, he comments:

"It is a difficult mental adjustment to lay aside work on clients' books for which revenue is collected and devote nonproductive time to one's own books. . . . However, if records are productive for the client, then they must be good medicine for the practitioner."

The CPA should frequently remind himself, as well as his clients, that inadequate records may prove costly. As his work increases in volume and changes in nature, he will probably procure new partners and staff members. New problems will develop. Their solution will be facilitated by the recording of events as they occur.

To aid the accounting practitioner in attaining greater efficiency in his housekeeping duties, this chapter has been designed as a compendium of information about office procedures and records currently employed by certified public accountants.

Most of the information and forms contained in this chapter were obtained by direct contact with a number of representative firms and individual practitioners. Several of these were visited personally, others promptly answered requests for specific data, and the great majority furnished answers to a 31-page questionnaire sent by the American Institute of Accountants to many of its members. In addition, much material of value was obtained from articles in *The Journal of Accountancy* and other professional and business periodicals and from published texts. Representatives of various office machine companies provided other useful information.

The practitioners contacted were located in every part of the country.

¹ See references at end of this chapter.

Their answers to questions, and the forms and equipment and methods used by them, were particularly interesting in one respect: their problems were common ones, as were their solutions. While varying, sometimes to a pronounced degree, according to categories of size, their procedures were not greatly influenced by their particular locations. Medium-sized firms in California solved their problems in more or less the same fashion as firms of corresponding size in Chicago. But very large firms were more exacting in their internal management functions than were their small neighbors.

In order to compare procedures followed by firms in the various size groups, the questionnaire returns were divided into three classifications denoting size of firm replying: small, medium-sized and large. The division into the three groups was arbitrarily constituted as follows, according to size of accounting staff (including partners):

Small firms	1 to 15, inclusive
Medium-sized firm	16 to 35, inclusive
Large firms	Over 35

These categories are used throughout this chapter.

Full coverage of detailed procedures, forms, and methods has been attempted in this chapter in the belief that it is desirable to set forth all variations imposed by size, locality and specialization. The beginner wants to know primarily what established practitioners are doing, because from that he can obtain the maximum help on his own problems. And the largest firm can learn something from the smallest practitioner who has solved a particular problem.

Certain of the forms used were given to the author by accountants whom he visited, others were sent in with answered questionnaires, and still others are reproduced from *The Journal of Accountancy* and textbooks. In many instances forms used were identical. In other cases they were similar. Therefore, it is not feasible to give credit to the designers of forms, except those from textbooks. Where practices are described for illustrative or explanatory purposes in this chapter, the names of firms using them has been omitted.

The names of machines and office equipment are mentioned in the text. With but few exceptions, this occurs only when particular practitioners have had those machines or equipment in use. Because costs of equipment are constantly changing, it is deemed inappropriate to mention prices.

Some of the material in this chapter may also be covered in other sections of the Handbook. For example, Chapter 14 "Planning and Control of Audit Procedures," discusses budgeting and scheduling of working time, and keeping track of work in progress. These matters are also dealt with in this chapter, but only insofar as they pertain to the need for office records.

OFFICE AND EQUIPMENT

Office Location

An interesting discussion of an accountant's choice of office location appears in a recent book by Paul E. Bacas.² It discusses advantages and disadvantages of the various sections of the nation, of town, city and village practices, and even the problem of choosing a neighborhood. The same problems also are treated extensively but along broader lines in Chapter 2 of this Handbook, "Building and Keeping a Clientele."

The accountant's nature, disposition, aspirations and business connections will influence his choice. The need for economy or some other good reason may influence one man to use his own home as his office. Another may decide that his special aptitudes for work with financial institutions require that his office be opened in the financial district of a large city; certainly he would not start in a remote rural area. One who is interested in mining and its industrial peculiarities, who has connections in that field and who has a desire to serve its needs, would probably err gravely to install himself in New York. It seems clear that the selection of an office location is largely a matter of the exercise of good judgment.

Office Arrangement

The small practitioner has a relatively simple problem in this respect. His space is small, his staff is small, and he is not overburdened with clients. What difficulties he faces in arrangement are not complicated. If he has only one small room, he uses it as best he can and concentrates on getting enough clients. They will furnish the best means of providing more extensive facilities.

When he expands, his troubles as to organization and layout really begin. He obtains more space but has to use it for more and increasingly varied purposes. There are perplexing alternatives imposed by gradual specialization and departmentalization.

Bacas² discusses office arrangement in great detail. He suggests the size and type of office to suit the relative needs of organization of various sizes. Many of the firms contacted by the author in preparing this chapter were found to operate largely in accordance with the procedures Bacas suggests, in this and other respects.

General Layout

With certain alternatives noted, the writer's version of an adequate office for medium-sized and larger organizations is predicated on reasonable compactness, with the various private offices, the library or conference room and the working spaces of key men (such as supervisors and reviewers) flanking the main staff room, the tax and filing departments,

and the stenographic room. Of course, circumstances would alter cases. It is usually considered preferable to have the tax department separate, though near the staff room. The head tax man, whether a partner or employed executive, should be located as close as possible to his assistants. The bookkeeper-cashier should be near the partner or office manager whose responsibility it is to manage the office. The waiting room should be sufficiently spacious to afford comfort to visitors. If the switchboard is located in this room, the operator may serve as receptionist. It is desirable to have halls leading to entrances of the various parts of the office in order to overcome confusion and provide for more satisfactory handling of visitors; this of course adds to the cost of space.

Furnishings

The furniture throughout the office, including the reception room, should be attractive but dignified; in other words, of a nature consistent with a professional atmosphere. It should not be gaudy, extravagant or ornate. Those preferring simplicity have plain furniture, well arranged, neat and in good condition; they do not consider that unusually fine furnishings will affect clients or provide a satisfactory substitute for effective service. Of paramount importance, however, is the desirability of indicating to clients and prospects that the office is well equipped to take care of their needs.

Most practitioners do not hang their CPA certificates, certificates of membership in state societies and college fraternities, and similar certificates in the waiting room. But many do display them in their private offices. Most waiting rooms are decorated with a reasonable number of pictures or prints of a type consonant with the profession's nature. This should not be overdone. Some prefer not to display membership certificates and diplomas even in their own private offices. Several firms keep their walls free of adornment.

Separate Offices

The majority of firms visited by the author have private offices enclosed from outside view on four sides, but some of the private offices make extensive use of glass. The argument in favor of glass partitions is that it permits more effective maintenance and review of decorum, and communication with other members of the force without the necessity of telephoning. The argument against this transparency is that it frequently occasions discomfiture of clients or others who would prefer greater privacy.

Private secretaries should have their office locations near to the executives they serve. The ideal for the large establishments is a secretarial office or space immediately adjoining the principal with a direct-entrance

door from one to the other. Or two secretaries may share an office located between the two private offices of the men they serve.

Staff Rooms

In lieu of desks to accommodate staff men, large tables are used frequently. The accountants are not assigned space but utilize such vacancies as they may select to do their work. Of course, there must be sufficient chairs. If a separate stationery room is not provided, the staff room may contain a cabinet for work paper, envelopes and the stationery and supplies appropriate for staff use. The stenographic department should be similarly accommodated.

Some firms subdivide their staff rooms under a plan which separates specialists from the general staff. One large firm, which has approximately seventy-five people at its main office and has eight branch offices, has segregated its accountants into two separate offices: one to accommodate those who are specialists in one or several services, the other to accommodate the general staff. Desks are assigned specifically only to four staff supervisors and certain other key men.

In the staff room should be placed one or several metal drawer cabinets in which the staff men can store their papers. It is inconsistent with the order and decorum that should pervade the professional accounting office that papers be strewn on desks, tables and tops of file cabinets when not in use.

Storage Space

It is desirable that the firm's books and private records and valuable papers belonging to clients be safeguarded by using a metal safe. The minimum protection is a fire-resistant, locked file drawer or cabinet of drawers.

Space for a coat and hat room or lockers is important. Equipment such as duplicating and photostat machines, postage meters and the like is best kept separately, although some firms place them in the file, staff or stenographic rooms. If such equipment is noisy, it should be placed as far from office workers as is feasible.

The file room, to be discussed under its own caption, should preferably be assigned to two persons in order to provide relief. A lock should be provided, and keys should be issued only to those two persons and perhaps one partner. Location of the file room near the staff room and tax department is desirable.

Modifications and Practices

The main objective in arrangement is to save steps and safeguard against lost motion. Small firms must adapt as much of the ideal as is

possible for them under their special circumstances.

The author's views, presented before, are a summary of opinions expressed in reply to the questionnaire item: "What would you consider to be the ideal layout as to rooms for an office with approximately twenty-five staff members?" However, some interesting "asides" are worthy of mention.

The following are quoted from questionnaire returns of five small, six medium-sized and two large firms:

Small Firms

"Even a cubby-hole and desk for every junior has been found a good expenditure for increased productivity."

"We use private cubicles, each to accommodate two men, two tables, two chairs, one telephone, one adding machine."

"Seniors should be two to a room; others not over four to a room."

"We have a large staff room for juniors — small individual rooms for seniors and supervisors."

"We have private offices for partners and supervisors, one staff room with adequate desk or table space for all staff members, receptionist office, clerical office, conference room, library, tax room, storage room, washroom, vault, and sound-proofed equipment room for typing and adding machines."

Medium-Sized Firms

"We built our offices to order three years ago when we bought a building and remodeled it to serve our needs. We have room, light, air conditioning and all the necessary comforts."

"Our space is arranged so that each partner, each supervisor and each senior has his own office. Semi-seniors share offices not more than two to a room, each with his own desk. Juniors share space with not more than six in one room. Secretaries have individual offices, and stenographers and typists are grouped not more than four in one room. We also have a reception room, library, conference rooms, and separate filing and storage rooms."

"We use separate rooms for each partner, supervisor and senior accountant; large separate staff rooms for semi-seniors, juniors and typists; separate rooms for library and tax staff. The filing department is readily accessible to auditing and tax staffs."

"Any layout is satisfactory if all offices are close together with a center or outside hallway."

"We have three members' desks and a work table to each room."

"We provide separate offices for each supervisor and sufficient rooms to accommodate no more than two seniors or two juniors to each room."

Large Firms

"We have separate rooms for two staff members in each room and one large room for juniors."

"We have a central reception room. Partners' offices are beyond the office across hall. Working departments are to left and right of reception room."

Most firms report almost 100% utilization of space they have. Only one reports as low as 70% and two report 80%. One firm of seven partners, each with his private office, reports with terse realism: "All seven partners seldom present." One reports spotty staff room utilization during the week and heaviest use during the weekend. It adds that its policy is to let the offices bulge until it needs more space. Another uses all its office space to an extent of "approximately 120%." One small firm says "Our offices were recently designed after years of putting up with 'must do.' We had an engineer work it out."

Office Space Requirements

The Institute questionnaire asked "What is the approximate floor space covered by your office? _____ square feet." The returns, averaged according to size of firms, showed:

	<i>Average Square Feet Per Firm</i>
Small Firms (1 to 15)	1,273
Medium Firms (16 to 35)	3,971
Large Firms (over 35)	4,500

The smallest and largest areas in square feet occupied by individual firms surveyed in each group are:

	<i>Smallest Area</i>	<i>Largest Area</i>
Small Firms	220	2,700
Medium Firms	2,640	6,600
Large Firms	3,500	Unlimited

The six smallest firms as to size of accounting staff (1-5, inclusive) reported space occupancy averaging 525 square feet. The balance of the small firms (with larger staffs) reported an average of 1,416 square feet.

Average occupancy by various firms is, of course, only partially significant. It would be much more helpful if information were available as to the square-foot area required per person in organizations of various sizes. Such information, however, cannot be too precise because of the many variable factors such as (1) preferences as to number and sizes of private offices; (2) compactness and arrangement of space available; and (3) extent of needs for furniture, files and other items.

The approach used most frequently seems to be to figure the amount of space needed according to the basic requirements of each type of personnel and the essential equipment, and then to adjust this to the space

available. There are a number of published works on office management containing tables and other related material on office space requirements which might be of interest to the accountant beginning practice. These would supply information needed to deal with the variable setups in accounting offices where, for instance, one firm having four office occupants may have one principal and three staff and clerical workers, whereas another firm having four office occupants may have three partners and only one clerical worker.

Appropriate reference works are:

1. **OFFICE MANAGEMENT** edited by Coleman L. Maze for the National Office Management Association, and published by The Ronald Press in New York in 1947. This has a chapter titled, "Use of Office Space," beginning on page 379, which contains a table of allowances of space for different classes of personnel in order to determine the number of square feet required for an office layout, typical requirements for an office of one hundred persons, and so on.
2. **OFFICE MANAGEMENT** by John H. MacDonald, published by Prentice-Hall, Inc., New York, 1947. This has a chapter titled "Making the Office Layout," beginning on page 64. On page 68, certain general standards for footage are given. This shows, for example, that the standard for a clerical worker is "40-45 square feet." There is a discussion on page 71 of the many factors causing variations in the space per clerk; and on page 73, in a study of a typical layout, it is pointed out that a standard of 50 square feet per clerk, if it includes only certain requirements, is difficult to attain except under most favorable circumstances. This means, for example, that it can be attained in large areas of unobstructed space but only infrequently in smaller areas below 500 feet.
3. **OFFICE METHODS, SYSTEMS AND PROCEDURES**, by Irvin A. Herrmann, The Ronald Press, New York, 1950. This has a section titled "Analysis of Space," beginning on page 60, and has on page 61 a helpful list of layout standards and arrangements for equipment to be applied for best utilization of space.

An accountant or accounting firm, with no previous experience and without ready access to such material, could use as a rough rule of thumb a requirement of approximately 250 square feet for each partner and 50 square feet for each staff and clerical worker. This rough formula gives some consideration to the fact that staff men are not expected to be in the office for more than a small portion of their time and that their quarters should be interchangeable.

Allocation of Space

The request: "Please indicate the per cent of this space which is allocated to each of the functions listed below," brought the following replies which, although interesting, should not be taken too literally. Estimated divisions of space are more often than not based on actual floor area rather than separation into rooms or offices. Also, space assigned to some primary function is used frequently to a lesser degree for other non-segregated activities.

Space devoted to:

		<i>Average Per Cent</i>	<i>Range Per Cent</i>	
			<i>Lowest</i>	<i>Highest</i>
(1) Staff Rooms	Small	36	9	55
	Medium	26	13	40
	Large	20	15	23
(2) Partners' Offices	Small	30	15	50
	Medium	30	22	50
	Large	20	15	24
(3) Tax Room	Small	8	5	11
	Medium	8	5	13
	Large	9	5	15
(4) Space for Clerical Help	Small	18	5	25
	Medium	16	7	29
	Large	10	2	15
(5) Conference Rooms	Small	8	4	11
	Medium	6	6	6
	Large	3	3	5
(6) Receptionist's Office*	Small	12	5	20
	Medium	8	2	19
	Large	7	1	20
(7) Washroom†	Small	4	2	7
	Medium	4	1	9
	Large	3	2	4
(8) Storage of Records‡	Small	9	5	15
	Medium	10	3	37
	Large	14	5	20
(9) Library	Small	8	1	15
	Medium	5	3	9
	Large	6	3	12
(10) Others§	One small firm specifies a photostating room			

* One firm states its allocated space also includes "typing department."

† It is to be remembered that in most office buildings washrooms are conveniences supplied by landlords outside the office space rented to tenants.

‡ Must be considered in relation to prevalent practice by many firms of storing records outside the space used for office purposes.

§ The percentages for each classification add to more than 100% in each category, being simple arithmetical averages of all reports, but the individual figures are nevertheless relative.

Number and Kind of Offices

Of the firms replying to a question concerning the number of rooms of each kind, 30% of the small firms, 60% of the medium-sized ones and 85% of the large ones stated that they had two or more staff rooms. Other information was as follows:

<i>Separate Offices</i>	<i>Percentage of the Firms Replying</i>		
	<i>Small</i>	<i>Medium</i>	<i>Large</i>
One Tax Room	19.0	13.3	—
Two or More Tax Rooms	—	13.3	71.4
Partners' Offices	88.5	100.0	100.0
Supervisors' Offices	7.7	26.7	57.1
Seniors' Offices	23.1	40.0	14.3
Conference Rooms	15.4	33.3	57.1
Library Room	30.8	46.7	85.7

A large number of firms specify numerous additions, most of which relate to facilities for clerical, stenographic and typist help and for equipment. Here again should be kept in mind firms with a single undivided office where apportionment is by floor area instead of rooms and firms that use rooms for several purposes. An instance is one firm which uses a corner of its reception room as desk space for part-time assistants.

An unusual form of facility arranged by one firm is a glass-enclosed section for revenue agents visiting the office.

Some practitioners place their top seniors in a room separate from their juniors and other seniors; others put them all together. A few assign two or more accountants to the same desk. Most of them assign desk space to each, even juniors. Answering the query "What portion of your accounting staff will your desk and table space accommodate at one time?" a great majority of small firms say 100%, a few say 90%, and one each reports 80%, 75% and 50%. Most medium firms report 100%, and one each 80%, 75%, 65% and 60%. Only one large firm reports 100%, and one each reports 90%, 66%, 60%, 50% and 25%. These results suggest the larger the staff the smaller amount of table space per person.

Questionnaire replies stressed quiet, privacy and efficiency as major advantages of numerous staff rooms. Some say that such provision makes employees happier and more secure, keeps idle or semi-idle accountants from disturbing busy ones, and causes less confusion. In addition, the ceiling of the room closest to noisy machines can be soundproofed, thus saving the cost of soundproofing the greater area of a large single staff room. Of course, supervision according to type of engagement is facilitated by proper arrangement.

The main disadvantages of numerous staff rooms reported were: added cost, inaccessibility of files and office machines, inconvenience in advising among staff members, less close contact between supervisors and staff, and lost motion. More telephone and buzzer extensions and more lighting fixtures are needed. Supervision over decorum is more difficult.

The preponderant practice is away from the use of large staff rooms and in favor of smaller private working spaces.

Preservation of Records

One of the problems of operating an accounting practice is that of preserving records. This has two aspects—the availability of current records and the retention of records no longer in current use but nevertheless too important to be destroyed.

The questionnaire replies indicate that three years is the period applied most frequently as the time stamping a file as current. Of those who answered the questionnaires, the greatest number of small firms specified three years; others two, four and five years. A few specified holding-periods ranging from two to twenty years. Among the medium-sized firms, the usual term varied from three to five years. Scattered choices range from two to ten years. Among the large firms, three years was favored, with some preferring five or seven years. A few firms indicated that the period is dependent upon whether the client is an active account.

About 55% of those answering questionnaires keep their current and active records under lock, and about 35% protect their inactive records similarly. Sixty per cent file their working papers, reports and correspondence separately. Fifty per cent keep all filed working papers, reports and correspondence under lock, except when in use.

Over 90% of firms of all sizes permit staff members ready access to reports and working papers. Approximately 70% permit this as to correspondence. One large firm states that access to files by staff members is granted to seniors only. Over 75% do not require staff members to sign receipts when moving papers from any files. Seventy per cent place especially confidential documents in a safe or vault.

Space for Filing

Without exception, every firm keeps its current files within the office. Some store inactive records at the home of a principal or partner; some use a vault or other room in a basement or on another floor in their buildings and, in one case, where the principal owns the building his firm occupies, there is a storage house in the back yard. Others use private rooms in public warehouses with the practitioner having the only keys to the store rooms.

Method of Storage

Most firms store inactive records in steel cabinets, a few in wooden boxes, with a fair proportion of the total replying using cardboard boxes stored in fireproof vaults or rooms. Those making packages of records are in the minority. Some stack their folders or packages on shelves in a filing room, within or away from the office.

Three small firms would modify their procedures as follows if it were feasible to do so:

1. One firm would acquire a roomy vault, file all matters on shelves continuously, properly card-indexed so that it would be unnecessary to go through all stacks to find, for instance, a 6-year series of files for one client.
2. One firm would strip files of all except the most important papers. It would destroy accounts receivable confirmations and other bulky material after three or four years, especially where accounts are audited year after year. Separate files of tax returns and related papers would be kept even after examination by tax authorities.
3. One firm observes that it would be more satisfactory to leave all records, including inactive ones, readily accessible in steel files near or adjoining the office. That, they believe, is generally impracticable or too expensive.

Equipment

Investment in office machines and equipment can run high and wrong selections may prove costly. Before deciding on such purchases, the person charged with this responsibility should make thorough reference to catalogues, periodicals and other literature on the subject.

Sources of Information

In preparing this section on office equipment, the author has relied on information from various sources. The publishers of the periodical, *The Office*, were most generous and furnished current and back numbers of their publication. The facilities of the American Institute of Accountants' library also were of great value (not only in relation to this project but on other occasions as well; Institute members should avail themselves of its services more frequently).

The October 1951 issue of *The Office*³ contains a reprint from the new booklet "How to Conserve Stenographic and Typing Skills," which is available from the Government Printing Office, Washington, D.C. This reprint covers two checklists, the first for dictators and the second for transcription supervisors. The booklet is worth obtaining and can be very helpful during a temporary stenographer shortage. One of its aims is improved relations between dictators and transcribers, as well as improved efficiency.

Those who need equipment might also consult The Management Controls Reference Library, 315 Fourth Avenue, New York, New York. They can obtain, free, any information requested on various office forms, machines, et cetera, if specific information is given with the request. Those interested particularly in reproduction and imprinting problems should read Irvin A. Herrmann's article "Office Reproduction and Imprinting Methods," appearing in the April 1951 issue of *The Office*.⁴

Available equipment is constantly improving. Therefore, keeping up with developments requires continual examination of the latest information on the subject.

Electric Typewriters

Electric typewriters are finding favor with more and more accountants. About 70% of the firms contacted use them. By personal visits and advice through correspondence, it was found that the IBM Executive and Electromatic models enjoy the greatest popularity. Remington Rands and Underwoods apparently are giving equally good service. Wide carriage machines predominate, of course.

Electric machines meet the requirements of quality of work, speed and ease of operation. They are less fatiguing. The appearance of the finished audit report is a credit to the firm issuing it. The original has the appearance of printing. Because of the carbon paper ribbon, there is a definite improvement in the sharpness and uniformity of type impressions on carbon copies. It is easier to adjust the pressure of keys for various numbers of carbon copies. Several typists may type different sections of the same long report without that well-known complaint that the ribbon variations spoil the effect. Variable unit spacing which makes it possible to line up the right-hand margin is available only on electric machines. The sharp copies produced are better for planographing.

One small practitioner reports getting an original and eleven copies on 9-pound Esleeck Fidelity Onion Bond paper with his Executive model IBMs. He gets six clear, legible copies on 16-pound bond, but adjusts his underscoring so that it will not cut through.

One manufacturer claims that a 2-pound blow is needed to drive the typebar of a nonelectric typewriter against the platen, as compared with approximately two ounces on the electric machines. If so, a large amount of the energy expended when operating a conventional typewriter is conserved.

Twenty per cent of the small firms using electric machines use no other kind. Among the large firms reporting, a majority use no other type. One medium-sized firm reporting that 60% of its typewriters are electric added the comment that "nonelectric machines are used only for extra typists in busy season."

By means of a "justifier" on the Executive model, it is possible to attain an even, vertical margin on the right side of the paper. One additional typing of the same material is required, however. This can be accomplished without the "justifier" but calls for extreme care on the part of the typist. The process is useful for writing papers and other documents where formality is a prerequisite, but the use of this feature is seldom, if ever, applied to standard audit reports. The greater attractiveness does not compensate for the added time and effort.

As to the disadvantages of electric typewriters, firms stress mainly their cost, frequent and high maintenance charges, and the fact that failure of power puts them out of use. Beginners tend to shy away from them, but their dislike is soon dissipated, as they quickly learn to enjoy the lighter touch. Some owners in smaller cities complain of poor servicing, and that

operators are hard to get. Several firms report these machines to be more difficult to align for typing tax returns and other forms. On the Executive IBM, the absence of decimal tabulating is a distinct disadvantage. The newer Electromatic machine (wide carriage) eliminates this defect.

Duplicating Machines

There are many types of duplicating machines. Demonstrations were secured of the following:

1. Multilith
2. Standard Duplicator (Ditto), either flat bed or rotary models electrically or manually operated. These are processed with the use of gelatine or liquid.
3. Multigraph
4. Mimeograph
5. Photostat

Those mentioned by other accountants are:

1. Bruning BW Copyflex
2. Ozamatic, by Ozalid
3. Varsity
4. Graphotype

Of the firms answering the questionnaire as to ownership of reproduction machines other than typewriters, 50% have such equipment. One-third use multilithing and one-quarter have mimeographing and photostating equipment. Several firms own gelatine Dittos (Standard Duplicators), one owns a Multigraph and two own Varsitys, and one an Ozamatic. Twelve of the firms visited or otherwise personally contacted owned reproduction machines: four Multiliths, two Mimeographs, two photostats, two gelatine Dittos, one direct (liquid) Ditto and one Graphotype.

Literature on the following reproducing equipment was examined. The manufacturers' names and addresses are given below. Readers of the Handbook may get some helpful hints by writing directly to manufacturers of those attracting their interest:

Reproducing Equipment

<i>Trade Name</i>	<i>Process</i>	<i>Manufacturer</i>	<i>Address</i>
Roneo	Stencil, Rotary	Addo Machine Co., Inc.	145 W. 57th Street New York 19, N. Y.
Multilith Multigraph	Lithographic Type	Addressograph-Multigraph Corporation	1200 Babbitt Road Cleveland 17, Ohio
Auto-Typist	Automatic typewriter	American Automatic Typewriter Company	614 N. Carpenter St. Chicago 22, Illinois
Apeco Auto-Stat	Photocopy Spirit	American Photocopy Equipment Company	2849 N. Clark Street Chicago 14, Illinois
Burroughs	Microfilm	Burroughs Adding Machine Co.	6071 Second Boulevard Detroit, Michigan
Copyflex	Photocopy	Charles Bruning Co., Inc.	125 North Street Teterboro, N. J.

<i>Trade Name</i>	<i>Process</i>	<i>Manufacturer</i>	<i>Address</i>
Flexowriter	Automatic typewriter	Commercial Controls Corp.	1 Leighton Avenue Rochester 2, N. Y.
Vari-Typer	Automatic typewriter	Ralph C. Coxhead Corp.	720 Freylinghuysen Ave. Newark, New Jersey
Davidson Dual	Lithographic Type	Davidson Corporation	1020 W. Adams Street Chicago 7, Illinois
Mimeolith	Lithographic Stencil, Rotary	A. B. Dick & Company	5700 W. Touhy Ave. Chicago 31, Illinois
Flofilm	Microfilm	Diebold, Incorporated	1411 — 5th St., S.W., Canton, Ohio
Ditto	Gelatin Spirit	Ditto, Incorporated	2243 W. Harrison St. Chicago 12, Illinois
Kodak	Photocopy	Eastman Kodak Corp.	343 State Street Rochester, N. Y.
Gestetner	Stencil, Rotary	Gestetner Duplicator Corp.	50 McLean Avenue Yonkers 5, N. Y.
Xerox	Photocopy	Haloid Company	43 Haloid Street Rochester 3, N. Y.
Heyer	Gelatin Stencil, Rotary	Heyer Corporation	1850 S. Kostner Ave. Chicago 23, Illinois
Hunter	Photocopy	Hunter Photo Copyist, Inc.	566 Spencer Street Syracuse, N. Y.
Marr	Stencil, Rotary	Marr Duplicator Co., Inc.	53 Park Place New York 7, N. Y.
Thermo-Fax	Similar to photocopy	Minnesota Mining & Mfg. Co.	"Thermo-Fax" Dept. St. Paul 6, Minn.
Niagara	Stencil, Rotary	Niagara Duplicator Co.	Concord, Calif.
Ozamic	Photocopy	Ozalid Corporation	Johnson City, N. Y.
Recordak	Microfilm	Recordak Corporation	444 Madison Avenue New York 22, N. Y.
Portagraph Transcopy	Photocopy Microfilm	Remington Rand Inc.	315 Fourth Avenue New York 10, N. Y.
Robotyper	Automatic typewriter	Robotyper Corporation	125 Allen Street Hendersonville, N. C.
Liberator	Stencil, Rotary	Speed-O-Print Corp.	1801 N. Larchmont St. Chicago, Illinois
Standard Coronet	Spirit	Standard Duplicating Machines Corp.	1935 Revere Beach Blvd. Everett, Mass.
Stenafax	Electronic facsimile	Times Facsimile Corporation	540 W. 58th Street New York 19, N. Y.
Victor	Photocopy	Victor Safe & Equipment Co., Inc.	North Tonawanda, New York
Copy-rite	Spirit	Wolber Duplicator & Supply Co.	1201 Cortland Street Chicago 14, Illinois

Experience with Reproduction Equipment

One accountant states that his office tried photostating tax return schedules (as did the writer's office also). Both had to discontinue this procedure because the larger returns with many schedules were too bulky. Experiments were then made with hectograph reproduction. Both firms started with a gelatine machine and graduated to a spirit-type operation.

In Esenoff's case ⁵ specially printed forms were used as work sheets with special pencils. This was found unsatisfactory. The reproductions were not clear, the line registrations were inaccurate and corrections were difficult to make on the master sheet. There was a small but inadequate improvement when a change was made from gelatine to spirit-type equipment.

Bad registration, messiness due to carbon masters and difficulty of correction were still present.

In the writer's experiments, the chief objection was the color, which was purple. Black was tried but the final product was hazy and therefore disappointing; and the special glazed paper called for was unsatisfactory. Although some audit reports were prepared with it, when ten or more copies were needed its appearance was displeasing.

Both offices then turned to Multilith with excellent results. Special printed masters are used as work sheets. The equipment makes direct copies of these work sheets in clear black line reproduction on plain white paper.

There is no problem of registration and erasures, and corrections are easily made. All copies are clear. The stenographers say that less time is needed to type the master than is required to type a single run of several copies. Some firms have a policy that all audit reports, regardless of number of copies, must be run through Multilith. It is known that end results will be better on the average, and all copies will be uniform, but there is no certainty as to relative cost.

One large firm uses Mimeograph exclusively for its bulletins, letters of confirmation written on clients' stationery, and similar written work. The firm also uses an Apeco photostat machine for minor quick-reproduction jobs. These photostats are never sent out of the office.

One medium-sized organization photostats tax return schedules, certain pencil work papers and its own financial and statistical reports for partners and managers. This is, of course, a proven saver of typing and comparing time as well as a safeguard against errors in transcription. The firm has utilized this equipment for reproducing minutes, corporate charters and amendments, and other permanent file "work papers."

Use of Commercial Reproduction Service

To the question "Do you send work outside to be reproduced?" the affirmative answers were:

	<i>Per Cent</i>
Small Firms	61
Medium Firms	72
Large Firms	73
All Firms	<u>66½</u>

Preponderantly, the work sent out is of a type requiring many copies. It includes confirmation letters, court report schedules, clients' bulletins, questionnaires, special letters, time reports and other forms, and special schedules to be submitted with audit reports, especially during rush periods. Several practitioners also send out audit reports, one of them stating that he does so with clients' permission or when report is to be published. Most firms frown on this practice. One small firm has "Depreciation" schedules and "Capital Gain" schedules blueprinted.

Adding Machines, Calculators and Comptometers

The profession uses almost every type of adding machine made. Among the popular brands are Burroughs, Remington Rand and Victor. One accountant visited uses a Swift, another a Clary. In one case, only Comptometers and Monroe calculating machines (without tape) were employed. Electrically operated adding machines predominate. Many of them are portable and are used not only in the office but in the field. Adding machine stands seem to be disappearing, although some offices still use them.

Extent of Machine Use

Questionnaire replies to the request "Please indicate the number of each type machine listed below which you have in your office" were as follows:

	<i>Firms Reporting</i>	<i>Range in Numbers of Machines</i>		<i>Average Number of Machines</i>
		<i>Lowest</i>	<i>Highest</i>	
Adding Machines	Small	1	9	4
	Medium	1	16	7
	Large	2	7	4
Calculators	Small	1	5	1½
	Medium	2	7	3
	Large	1	8	3
Comptometers	Small	1	3	1½
	Medium	2	3	2½
	Large	1	2	1½

Kinds of Machines in Use

Names of calculating machines used were not reported, but personal observation indicates that Monroes, Marchants and Fridens are widely used. Olivetti and Allen machines also were seen.

Some firms use the combination rapid calculating features of adding machines and do not invest in special calculating units. A few object to the rapid calculators on the ground that no tape is available. One accountant prefers the combination feature because he cannot easily transport two machines to field engagements. There are in use several brands of foreign adding machines and calculators produced in Germany and Italy and apparently regularly advertised in the United States.

Bookkeeping Machines

Not many CPA firms use bookkeeping machines for their general bookkeeping; but Burroughs, Remington Rand and National Cash Register machines are found in use, the latter particularly for payroll and time recording purposes. One firm reports it has an Elliott Fisher, and two firms report that they have Remington Rand machines. Comptometer operators, considered part of the audit staff, go into the field and foot books of original entry, inventory calculations, and other records.

Two firms are known to have experimented with "punch card" accounting for their accumulation of hour, day and dollar amounts of staff time; their objective is speed. The author's firm obtains weekly tabulation of data on each client by this method. One practitioner reports that he plans to ask the Powers-Samas Accounting Machines (Sales) Ltd. to figure with him on punch-card accounting. He plans to use the machine in his own office. He gave space-saving as one of the reasons for his interest in that particular type of machine. This general subject is discussed in a later section of this chapter entitled "Accumulation of Charges to Clients." In addition, J. Sanford Smith's book ⁶ published by the British Tabulating Machine Company, Ltd., and distributed by the Counting House Publishing Company gives a vast store of information on punched card accounting, but the emphasis is on the needs of the professional accountant's client.

Literature on the following other bookkeeping machines has been noted.

Bookkeeping Machines

<i>Manufacturer</i>	<i>Address</i>
R. C. Allen Business Machines, Inc.	678 Front Street, N.W. Grand Rapids 4, Michigan
Burroughs Adding Machine Company	6071 Second Boulevard Detroit, Michigan

<i>Manufacturer</i>	<i>Address</i>
International Business Machines Corp.	590 Madison Avenue New York, N. Y.
Monroe Calculating Machine Co., Inc.	555 Mitchell Street Orange, New Jersey
National Cash Register Company	Dayton 9, Ohio
Remington Rand Inc.	315 Fourth Avenue New York 10, N. Y.
Underwood Corporation	1 Park Avenue New York, N. Y.

Postage and Sealing Machines

Postage meter and envelope sealing machines are gaining in popularity. Seen most frequently is the Pitney-Bowes, both in its larger, cabinet stand model and the smaller portable model. Next in favor seems to be the product of the Commercial Controls Corporation. Both companies manufacture other mail room units such as mail openers, precision scales, postage charts, stamp affixers and all-electric multisealers. The individual practitioners and small firms would probably find little use for, and would not profit by, postage meter machines with their high-speed automatic sealing and postage printing equipment, or the protective features afforded by metered mail machines. The larger offices can hardly do without this type of equipment, particularly when numerous confirmation circulars are mailed.

The detachable postage meter is taken to the Post Office periodically where it is opened (no outsider can possess a key) and, upon advance payment of postage, it is set to deliver the postage paid for. It automatically computes and imprints, whether the need is for one 3-cent stamp or for \$3.00 for a package. The outstanding protective feature is that the possibility of unauthorized use of stamps is eliminated.

Interoffice Communication

Quite a few medium-sized firms use interoffice communication systems. RCA (loud-speaker type) and Dictaphone were the only ones seen; one accountant reported a "Talk-a-phone" installation. Another large firm is experimenting with a "Steno" wire recorder, manufactured by Crescent Industries, Inc. It is a combination dictation, transcription and inter-office communication device, featuring wire recording.

Microfilming

Microfilming work papers and records of special significance which are to be destroyed now prevails in a few of the larger firms. One small firm does this also. A few other large and medium firms report their interest in and proposed study of the equipment.

Dictating Equipment

Among dictating machines, those seen or reported in use were:

1. Edison (old models)
2. Dictaphones (old models)
3. Dictaphones (Time-Master)
4. Soundscribe
5. Edison Televoicewriter
6. Voice Master (disc)
7. Gray Audograph
8. "Steno" Wire Recorder

Another firm has a wire recorder but seldom uses it.

Details as to operation of some of these machines are given later under "Secretarial" in the section on "Office Procedures and Records."

Rental of Equipment

Not all firms can or find it necessary to buy special items. Rental is their solution, particularly when the need is only temporary or occasional. Asked "If you rent special machines or equipment, is this customary only in peak seasons or when needed on out-of-town engagements?" the firms queried reported as follows:

<i>Type of Firms Replying</i>	<i>% Yes</i>
Small	66%
Medium-sized	80

OFFICE ORGANIZATION AND CONTROL**Selection of Employees (Other than Staff)**

A person not suited by inclination and qualification for the work assigned to him or her will always be a square peg in a round hole. The CPA's work is specialized work. Each employee's talents should be fitted to that part of the office work for which he is most suited. A typist who hates tabulating and columnar transcription is headed for dismal failure in a public accountant's office. The time to discover any such failings is when investigating the application. The employer must be resolute in making choices based on an intelligent hiring policy.

In a small office, the stenographer is frequently the only nonstaff employee. Under those circumstances, she is called upon to do bookkeeping work, but very seldom handles the general books of the firm. In several cases the stenographer enters receipts and disbursements in the cash book and posts time to the time ledger. It is not good practice to permit staff members to post time records.

Sometimes the duties of the one office assistant encompass several phases of activity. Besides receiving visitors and answering the telephone, she

must file literature, pamphlets and tax service reports for the library; file audit work papers, audit reports, tax returns and letters; keep track of the stationery needs; maintain the accounts receivable and other ledgers, as well as cash records; and keep records on staff location. All this leaves little time for comparing and checking typed reports against original manuscripts, and taking care of personal matters for her employer, to say nothing of running errands.

Most firms employ only female stenographers. One employs male secretaries and typists only. Several of the large and medium firms report a preference for college trained or partly college-trained stenographers and typists, especially those doing secretarial work. Smaller firms indicate preference for at least high school graduates, very few of them employing secretaries or even typists who have less than high school training.

In view of the variety of work required of an office assistant in a small organization, the importance of having an unusually competent person is increased. Care must be exercised in selection of such an assistant.

Some of the medium-sized and large firms place the responsibility of hiring and firing, regardless of type of employee, upon one personnel manager who may or may not be a partner. Other firms permit the staff supervisor to employ staff accountants, but that person has nothing to do with other applicants. Under those circumstances either the managing partner or office manager selects nonstaff employees.

Application

The natural starting point in the selection of employees is the filing by them of an application. Most application forms ask the same questions. Examples are given as Figures 2, 3, 2(a) and 3(a) in Appendix B of this chapter. Figure 2(a) is designed to be used for both staff applicants and nonaccountant applicants. Figures 3 and 3(a) are used only for nonaccountants. Figure 2 is used for staff applicants only. Other examples of interview and application blanks can be found in books dealing with office organization and management (see list of books in the Bibliography). Chapter 9 also contains extensive suggestions on selection of personnel, some of which are applicable to nonstaff personnel.

Appraisal of Applicants

It has been stated by some that too great confidence is not placed in letters of recommendation. One personnel official prides himself on his record of successful choices, and a factor to which he gives credit is his policy of *telephoning references*, long distance if necessary, instead of writing to them. He makes the point that people will be less candid in a letter than in conversation.

In larger cities, employment agencies and psychological organizations offer services intended to assist employers in selecting suitable employees. There is reason to believe that these organizations vary in quality. Chap-

ter 9 describes one approach to finding a reputable psychologist.

One organization (Worthington Associates, Incorporated, Chicago) through the use of information submitted by the prospective employee on an application form, develops a psychological report under the general heading of "Personal Characteristics, Working Relationships and Placement," which is amazingly complete. Figure 2(b) is a reproduction of the Personal History blank used by this firm as its source of data. This confidential report is somewhat expensive for general office personnel but is an example of what can be obtained from such a service.

There are a number of standardized tests available for use as aids in employing clerical and office personnel. Examples are:

1. Minnesota Clerical Test
2. Blackstone Stenographic Proficiency Test
3. Thurstone Examination in Typing
4. Thurstone Test of Mental Alertness
5. Bengé Clerical Test D
6. DAT Clerical Speed and Accuracy Test
7. Purdue Clerical Adaptability Test
8. SRA Tests of Clerical Aptitude
9. Seashore-Bennett Stenographic Proficiency Test
10. Otis Self-Administering Test of Mental Ability

These tests vary as to time required and difficulty of administration and interpretation. Some, such as the Otis Test and the Minnesota Test, are relatively easy to administer. However, all tests require experience to assure sound evaluation. A reference book on personnel such as the *Personnel Handbook*⁷ may aid in the selection of suitable tests. Tests may be purchased from the publisher and a wide range of tests may be purchased from The Psychological Corporation, 522 Fifth Avenue, New York, N.Y. Tests and scoring services may be obtained from the Educational Records Bureau, 21 Audubon Avenue, New York, N.Y. The Educational Records Bureau does not sell tests to institutions planning to score their own tests unless these institutions hold membership in the Bureau.

One large firm operating many branches places great emphasis on the importance of a comprehensive application blank and a most thorough investigation of every detail of the applicant's general education, technical training and experience. Applicants file triplicate application blanks, two of them remaining as carefully guarded parts of the firm's permanent records, one at the main office, the other at the branch at which the applicant applied. The third copy is utilized as a current document pending completion of investigation, and is placed in a general file if the applicant is employed; otherwise, it is destroyed. Using a type of large "scrapbook" for the purpose, both offices will keep a photograph of the employee, and a narrative record of all pertinent information.

Some firms insist on at least two interviews with each applicant. The last conference is usually with one or sometimes two senior partners of

the firm. This, however, applies particularly to key executives and staff accountants.

Accounting firms are frequently asked by their clients for assistance in locating personnel. One firm, through its staff-personnel manager, prepares a monthly report for all partners showing applications for positions as well as openings with clients as of the close of each month. These reports show (1) jobs available, (2) applicants available, and (3) jobs filled. A follow-up is maintained for the benefit of the applicants, as well as the clients. This procedure is reported to have developed the goodwill of clients.

Contracts and Records

A common incident of employment is the signing by both parties of an "employment letter" or contract which covers matters relating to starting salary, annual vacation, notices of termination, et cetera. Some firms also require that a "deed of secrecy" be signed by the employee, who pledges to keep inviolate during and after his incumbency any and all knowledge of clients' affairs. Examples of employment contracts used by a large firm are reproduced as Figures 5 and 6 of Appendix B to this chapter. Further information as to employment contracts and their terms appears in Chapter 9.

It seems desirable that a careful classification for filing of applications be maintained and that none be destroyed immediately, unless it is certain that the applicant cannot be used by the firm or by a client. The file should be kept current. After one year, all applications of unsuccessful applicants should be destroyed, unless there is a good reason for further retention.

Application forms of personnel employed should be transferred to the employment files and retained permanently.

Training Office Employees

It is tragic when the carelessness of office employees, say in the review department or in comparing and checking, destroys the confidence and goodwill of clients developed by good work in the field and by able services on the part of partners and key department heads. The sole safeguard against such a hazard is persistent and systematic control of office routine. Such control is much easier if the employees possess the capabilities to do the work properly and if they have been adequately trained in their jobs. For a comprehensive discussion on training employees, readers are referred to the many books on personnel and on office management.

Where there are several office employees, higher employees must be trained to delegate reasonable authority to subordinates. A chief employee who does not utilize his or her assistants' time and services to the greatest possible advantage is clearly inefficient.

In the review of working papers, reports and tax returns, reviewers cannot delegate all authority or responsibility. But they can train their aides in strict adherence to proper procedures and so pass on their own experience for the benefit of the firm and to the advantage of those instructed.

Instructions and Manuals

As an aid in training employees, as a means of maintaining employee morale, and as a means of obtaining more uniform and consistent office work, a manual (or series of manuals) on procedure is desirable. While such manuals are difficult to prepare and require revision from time to time, they can be of great help in the operation of an accounting practice.

In a recent talk Norman H. S. Vincent⁸ had this to say on manuals, bulletins and written memoranda:

"As the size of the staff increases, the desirability of written manuals and office bulletins also increases. These manuals and bulletins might cover the following topics:

1. Personal conduct and professional ethics.
2. Hours, compensation, time and expense diaries, and reports.
3. General office instructions, equipment, telephone, correspondence, file room.
4. Library (pamphlets, books and tax services).
5. Audit manual.
6. Preparation, processing, distributing and filing of reports and tax returns. It is most desirable that members of the staff inform themselves quickly on the ways of the firm, its techniques, and grow into harmony with its ideals and traditions. The formal manuals and bulletins assist in this endeavor. Supplementing these from time to time can be written memoranda on special topics."

A checklist of indoctrination procedures for use with new employees is reproduced as Figure 4 of Appendix B.

Extent of Use of Manuals

Firms to which questionnaires were sent were asked to indicate whether they used general or special manuals on the following subjects: (1) general staff regulations, (2) audit procedures instructions, (3) instructions for statement forms, (4) report preparation instructions, (5) stenographic instructions, (6) review instructions, (7) instructions on preparation of tax returns and (8) filing instructions.

Almost half reported use of manuals for items (1) and (2), about one-third for items (3), (4), and (5), about one-fifth on item (6), and about one-fourth for items (7) and (8).

Accounting firms using manuals are divided equally between those using general and those using special manuals, but the large firms naturally tend more toward special manuals for separate purposes rather

than a general one for all. Also there is a greater tendency in all groups to use generalized manuals for staff regulations and review instructions, while the preference is definitely for specific manuals covering instructions on audit procedures and preparation of tax returns.

Most firms furnish a copy of relevant manuals to every employee, and those that do not make an office copy available to all. Manuals are usually compiled in loose-leaf form and are reviewed and revised periodically. Practice is about equally divided on general instructions and detailed instructions.

Revisions of Instructions and Manuals

Where a firm prepares a manual covering any area of its operations, it should make provision for revisions. By using the loose-leaf form, pages can be revised and a manual kept up to date without revising it completely. Some firms send out instructions to their personnel in the form of memoranda rather than manuals. These instructions may be revised readily by issuance of a new memorandum on the same matter.

Binders

Some firms use leather-bound books or other attractive bindings for their loose-leaf instruction sheets. Others use 8½ x 11 or legal-sized paper.

A medium-sized organization also reports the use of binders, one for each partner and staff member, in which are filed pertinent office memoranda on audit procedures, taxes, government regulations as to prices, wages, renegotiation, and other subjects.

Contents of Manuals

One large firm divides its tax department manual into two sections. One section deals with the review of tax returns and the other with the handling of tax cases. The first section contains tax checklists on income and deductions, special rulings and decisions. The second section covers generally accepted methods of preparing protests and conduct in dealing with internal revenue agents and conferees.

Several firms of medium and large size have office procedure manuals or sections on office procedures in comprehensive manuals. They deal with such matters as office hours, salaries, overtime, night and weekend work, vacations, notice of termination of employment, and policy on sick leave and fringe compensation. An example of an administrative policy manual on personnel appears as a supplement to Chapter 9.

One large firm's office manager no longer believes in formal staff and office manuals. His firm tries to be flexible even on office hours and vacations. Its policy is to issue brief informal regulations to employees with revisions as the occasion demands. They are mimeographed and delivered to each person.

Examples of Manuals

A comprehensive stenographic style manual is presented as an appendix to Chapter 8, and an example of a staff manual is included as an appendix to Chapter 9. Examples of review questionnaires are included as an appendix to Chapter 11, and audit procedure outlines will be found as appendixes to Chapter 14. Instructions for preparation of financial statements and instruction data on tax procedures are contained in the appendix to Chapter 18 and in Chapter 21, respectively. Filing manuals may be prepared from the information in Appendix A to this chapter.

Correspondence and Reports

Other aspects of this subject are covered in Chapter 8. Here, in Chapter 7, reference to it relates primarily to some of the alternative practices found in use.

Correspondence

A reading file, or extra copies of letters and other documents, for partners and key executives is normal procedure in many offices. One large firm places copies, latest on top, in a loose-leaf binder in the firm's library. The readers initial each as read, until all proper parties have read them. The last of the designated readers destroys the copy.

Some firms send out tax returns only when accompanied by a transmittal letter. In one case this is a multigraphed form forwarded in duplicate which reads: "*Please sign and return the duplicate to us in the enclosed envelope, acknowledging that the returns have been received and will be filed on time.*" Other large firms never forward any report or return unaccompanied by letter of transmittal. In one instance, copies of all such letters are placed in a post binder, the latest on top, and are destroyed when four months old.

Reports

Quite a few accountants use preprinted report and work paper schedules. These are available commercially. Others prepare them in advance of the audits either on the typewriter or by hand. One accountant uses "ditto pencil" on the appropriate paper for all adjusting entries. With the use of a gelatine duplicating machine, he provides the client with a ditto copy of these entries without the necessity of typing. All working sheet trial balances and other work sheets to be used monthly are prepared on the typewriter, many copies at a time. An extra copy of the audit report of the current period is prepared, omitting figures and dates as an aid in preparing the next report. The time saved is substantial. This CPA prepares the audit program for the next period before leaving the scene of the engagement.

One firm has pretyped models of standard report paragraphs, pre-numbered, to which the senior refers when writing his pencil comments. For example, under Accounts Receivable he may instruct the typist to "copy paragraphs 1, 6 and 8, after which type the following. . ." He then inserts the appropriate additional material. Another applies similar treatment to writing semiannual reports of audit of homestead associations, of which he has many as clients, since the audit requirements are largely standardized by the Federal and state examining authorities. In the opinion of his firm the pretyped material is easily woven into the pencil draft.

One time-saving device calls for typing in advance copies of the skeleton statements and exhibits and some of the work papers for all regular clients. The pencil figures and changes can be inserted easily, if the pretyped sheets are prepared intelligently.

In an article in the *New York Certified Public Accountant*⁹ Chan recommends that during the slow seasons it is helpful to prepare proforma outlines of the lengthier reports and schedules, inserting prior year's comparative figures and putting these outlines in the work paper folders so that at the time of the next audit valuable time is saved. He also states that a little busy-season time can be saved on corporate tax returns by filling in during slack times the names, addresses, prior year balance sheet figures and answers to questions.

Assignment of Office Management Responsibilities

Questionnaire returns reveal that only about one-third of the small firms have designated office managers in charge of office organization and control. However, about 80% of medium-sized and large firms indicate they possess such an administrator.

In three out of four small firms, the office manager is a partner, but in the two larger groups this is true in only 50% of the firms. When the office manager is not a partner, in four cases out of five he is an accountant and his administrative duties tend to be limited in scope in definite relation to his knowledge and experience. One firm reports its office manager is a woman who is not on the accounting staff.

Duties of Office Manager

The duty assigned most frequently to the office manager is to engage and discharge nonaccounting personnel. Other duties often assigned are, in the order of their relative frequency, the administration of all non-accounting phases of operation, the engagement and discharge of temporary staff personnel, the engagement and discharge of juniors, the billing of clients, the handling of staff pay records, the engagement and discharge of seniors, the collection of accounts, and the assignment of juniors and seniors to work responsibilities.

With decreasing frequency the following duties also are assigned:

direction of staff training programs, review of untyped reports, handling of firm's correspondence, review of working papers, review of final typed and corrected reports, assignment of supervisors, supervision of proofreading and proof of computations, reviewing of tax returns, reception of clients and visitors, and employment of supervisors. Numerous miscellaneous added duties are reported by various firms. Typical are purchasing of supplies, keeping of firm books, control of stationery, preparation of office procedures and systems, and preparation of weekly staff location reports.

Other Arrangements for Office Supervision

Where there is no designated office manager, the returns indicate that office organization and control are usually handled by a partner or all the partners acting collectively as to all matters or individually as to specific phases. It is not uncommon for tax departments to have as their managers partners who are attorneys as well as CPAs. Very often, they are former Bureau of Internal Revenue employees.

Whenever possible, top positions should be filled from the ranks, regardless of department. Recognition of this custom by employees sustains morale.

OFFICE PROCEDURES AND RECORDS

Receiving Clients

The usual procedure for receiving clients is to have the telephone operator stationed in the waiting room or outer office as a receptionist. She is the first to greet clients and other visitors. It is important that she be polite, intelligent, well-groomed, well-mannered and well-spoken. Poise, patience and a good "telephone voice" are imperative, as well as a maturity which insures the thoughtful handling of messages and a real awareness of their significance. A telephone call may be a firm's first contact with a prospective client. Unless the telephone operator is courteous, efficient and understanding, it may be the last. For this reason, many firms have definite rules for proper handling of all telephone communications and for the reception of clients and other visitors.

About 80% of the firms answering the Institute's questionnaire have receptionists. All are women. Approximately three-quarters of the receptionists are provided with pertinent information concerning clients, such as names of executives. Over 95% of receptionists are given some additional duties to perform. Those mentioned, listed by types of firms, are:

Small firms — answering the telephone, taking dictation, typing, filing, bookkeeping, handling monthly write-ups and mimeographing. One receptionist acts as a semi-senior, one as a junior.

Medium firms — answering the telephone, taking dictation, typing, filing and bookkeeping.

Large firms — answering the telephone, mailing, typing, filing, keeping record of daily staff attendance, and doing other clerical work.

About 75% of the firms try to have a partner available at all times to talk with clients who visit their office. About 15% provide for the presence of a responsible staff member.

Telephone Procedures

Switchboards are used by about 11% of small, 70% of medium and 100% of large firms.

All firms which do not have a switchboard have a person designated to answer the telephone. In every case, either the board operator or the person designated to answer the telephone is kept informed as to the exact location of all staff members at all times. Only 6% of firms answering said they make use of telephone-answering services. A little over one-half the firms place a phone on each senior's desk; about 24% have one "on each desk or table in the staff room."

Records of Calls

Figure 30 shows a record of long distance calls, the particular objective of which is to charge the amount to the right client or expense account. This record is built up by having the office operator ask the telephone company toll operator to state the amount (including tax) after completion of each call. If the reports are prepared weekly, it is well to have a report prepared as to the last day of the month to the end that billings to clients are complete.

Control of Staff

Mentioned more completely later under "Records of Location of Personnel," a large firm in the Middle West keeps a record of the location of each staff accountant by having the switchboard operator post each day to a 3 x 5 Kardex file the location of partners, tax men and audit staff. The firm's policy is to have the men go immediately to the scene of the engagement, when appropriate, instead of reporting in person at the office, to which they report daily before 9 a.m. by telephone. This is common practice among accounting firms.

Handling of Incoming Mail

One large firm includes in its correspondence procedure a *mail received report*. An example of this report will be found as Figure 26. After the incoming mail is opened, it is placed on the office manager's desk and he glances over its contents, indicating the distribution of it to partners and employees. The *mail received report* shows to whom each item was distributed and whether or not an answer is required. It also reports the checks received in the day's mail.

The mail is distributed by direction of the office manager and is entered in the "distributed to" column of the *mail received report*. Copies of the *mail received report* are routed to the partners for their information.

Audit confirmations, all received in preaddressed envelopes, go directly to the filing department in this firm and do not pass through the regular incoming mail procedures. The filing department routes the contents to the seniors concerned.

Secretarial Assistance

Among the firms which replied to questionnaires, it appears that in partnerships in the small and medium-sized groups no partner has a secretary assigned solely to him. However, about half the large partnerships report they have a secretary for each partner. One large firm that does not do so indicates that as many as five partners share the services of one secretary.

In the small and medium-sized groups, secretaries are rarely assigned to supervisors but 50% of the large firms have such arrangements.

Some firms, of course, have some secretaries assigned to specific partners and supervisors, and others have no definite assignments but stenographers are made available to partners and staff members as need arises. In practically all cases, whether they have specific assignments or not, secretaries, when not engaged in secretarial duties, are used for filing, miscellaneous, typing, proofreading, and other routine activities.

In addition to secretaries classified as such, medium-sized and large firms have other typists. However, one-third of the small firms reporting do not have such typists. The reason, of course, is that the secretaries do this work too.

Equipment for Dictation

Roughly one-third of all the firms responding have mechanical equipment for dictation. Such equipment, when available, is used by all partners. But in only 70% of the small and medium firms which have such equipment is its use extended to supervisors and seniors. In all the large firms it is used by supervisors but in only one reported instance by seniors.

One great advantage of dictating equipment is that the flow of work in the typing department can be leveled. The equipment can be utilized, of course, at nights, over week-ends and during rush periods.

An individual practitioner who finds it practical to dictate all his reports on a portable dictaphone machine, having the trade name *Time-Master*, demonstrated its use for the author's benefit. He uses it at the scene of the engagement and often takes it out of town. The machine weighs approximately fourteen pounds and fits within a special, larger-sized brief case. It is made of magnesium, not steel, and has a universal (all currents) motor. Since the recording medium is a lightweight, flex-

ible, plastic belt which can be fitted in an envelope of normal size, he can forward it by mail. As much as fifteen minutes continuous dictation will go on one *Memobelt*. A special white chalky "pencil" is used for notations.

Some of the larger firms are partial to *Edison* and *Dictaphone* machines. Several medium-sized concerns report satisfactory results with Sound Scriber's *Tycoon*. These portable machines weigh only fifteen pounds, are easily transported home and to hotel rooms and may be used at clients' offices away from town. Dictation goes on discs which can be sent through the mails. A client of one accountant interviewed claims to save one man's time in taking inventory by using only one person with a portable microphone connected to a late model machine. As with the dictaphone *Time-Master*, the shaving of records is done away with.

Three other dictating machines were mentioned to the author by other accountants:

Edison TeleVoicewriter, having the appearance of a French telephone. One to twenty telephone stations can be connected to an *Edison TeleVoicewriter* located at a secretary's desk. Remote control push-button arrangements govern all start, stop and playback, as well as length and correction functions.

Voice Master Disc Machine. It is claimed that the records can be used up to one thousand times. The machine weighs ten pounds.

Gray Audograph. Weight is sixteen pounds. One flexible, plastic disc will take an hour's dictation, it is claimed. The disc can be resurfaced for reuse up to fifty times.

Part-Time Stenographic Assistance

Some organizations find it desirable to supplement their other facilities by part-time or outside assistants. One firm visited is served by an extra stenographer-typist on a part-time basis. She is available for from three to five days per week during rush season and can be called on short notice during the entire year. Other firms indicate the advantage of acquaintance with someone upon whom they can call for special work. Several use public stenographers but emphasize that discretion must be used in selecting persons to work on material of a confidential nature. Public stenographers should be used mainly for emergency work, and it is desirable to obtain the clients' permission for any confidential material.

Office Hours

An analysis of the information as to office hours shows that accounting firms are generally changing their policies to conform to developments in industry and private business. It is evident that the trend is definitely away from night work. Reasons given are, in order of emphasis: (1) over-work impedes efficiency, is likely to dull keenness of perception and places a severe physical strain upon staff members; (2) professions should

abide by the changing times which call for a greater share of relaxation for employees; (3) a reasonable work schedule tends toward better employer-employee relationships. Those favoring the increasingly common practice of Saturdays off say most of their clients cannot be reached anyway.

Following is a cross-section of reported office hours maintained by the reporting firms:

Small Firms

Firm 1. Officially 8:30 a.m. to 5:00 p.m. — six days each week. At least $\frac{1}{2}$ day on Saturday all year. No night work unless unavoidable. Maintain clients' hours unless impractical. One hour for lunch. Two coffee breaks permitted daily, but only two persons at a time.

Firm 2. As much work as intelligent procedure dictates. Liberal, but not regular, office hours. Assignments are expected to be finished on schedule. Coffee optional.

Medium-Sized Firms

Firm 1. 8:30 a.m. to 6:00 p.m. — Monday through Friday. 8:30 a.m. to 5:00 p.m. — Saturdays (busy season only.) Night work depends on urgency, and staff men decide what nights. Night work is from 7:00 p.m. to 10:00 p.m. Coffee time twice daily (fifteen minutes).

Firm 2. 8:45 a.m. to 5:15 p.m. No work on Saturdays, except during busy season, when the schedule is 8:45 a.m. to 7:00 p.m. on Monday, Tuesday, Thursday, Friday, and 8:45 a.m. to 5:30 p.m. on Wednesday and Saturday.

Firm 3. No regular starting or finishing hours. Forty-two hour work week urged and maintained, except under unusual circumstances. Coffee-time custom tolerated but not encouraged and partners never participate. Prefer no work Saturdays or night, unless conditions demand it.

Large Firms

Firm 1. Strictly 40-hour week, five days. If necessary for night work, time off is given to hold down week to forty hours. Believes in getting all extensions needed for tax returns to avoid overtime work.

Firm 2. 8:30 a.m. to 5:30 p.m. One hour for lunch. During busy season the schedule is 8:00 a.m. to 6:00 p.m. with forty-five minutes for lunch; and on Saturday 8:00 a.m. to 12:30 p.m. This applies to partners and employees, including stenographic department. Night work is discouraged; men must get their supervisors' permission to work at night. This schedule is popular with the staff members. Voted on it when previous program of three nights per week was abandoned. Coffee time twice daily (twenty minutes).

Firm 3. 9:00 a.m. to 5:30 p.m., all personnel except switchboard operator who arrives at 8:30 a.m., five days each week, one hour for lunch. On Saturdays, hours are 9:00 a.m. to 12:00 noon, but seldom keep these except in busy season. Night work optional; staff accountants on their own responsibility.

Firm 4. 9:00 a.m. to 5:00 p.m., five days each week, forty-five minutes for lunch; Saturday 9:00 a.m. to 12:45 p.m., no lunch period. Required that staff members report punctually. When not assigned to work, attendance at the

office is required unless definitely excused. Not required to report on Saturdays or to work that day unless circumstances of an engagement require it. Observe clients' hours, within reason, when engaged at their offices. Must obtain approval of the senior in charge to work overtime.

Firm 5. Follow clients' hours as much as possible. Keep men out of office as much as possible. Office is on five and a half day week — if client is open on Saturday, one-half day is worked; if not, men come to office if there is work. Each engagement is treated separately as to hour requirements.

Saturday Work

A large firm's records show the following interesting trend as to a full day's work on Saturday:

1948 — starting third week in February through April
1949 — starting last week in February through April
1950 — starting last week in February through April
1951 — one full Saturday only
1952 — two full Saturdays only

All other Saturdays, 1948 through 1951: January 1 through April 30, one half day; balance of year no Saturday work. Beginning with 1952 the plan is not to work on Saturdays unless unavoidable.

A Southern, medium-sized firm's staff instructions propose utilization of Saturday mornings during the rush season to call in clients to the firm's office to procure information for tax and other projects.

Summary of Working Hours

On the average, smaller firms are much more flexible in their working hours than large firms, usually regulating the time of staff men to meet the varying work load. In the larger firms, effort is made to adhere to an 8-hour day and a 40-hour week; most require permission of a supervisor or a partner before a staff man may work overtime.

Saturday work is on the decline, despite heavy volumes of work. Very few accountants work a full day on Saturday and then at irregular intervals. Some firms require a half-day on Saturday during the busy times only. Practices are trending rapidly toward the elimination of all Saturday work.

Traveling Time

Traveling time consumed during the working day is usually charged to the client and need not be done on the employees' time, but some firms recommend to their staffs that they do as much traveling as possible in "off-hours," so as not to require billing to clients.

Office Conduct by Employees

Naturally, rules prescribed as to the conduct of employees vary. Accountants are made aware of the professional nature of their services.

Of paramount importance among the items of conduct is the need for the client's confidence that his private affairs will be kept with utmost secrecy. Nothing can affect that confidence more quickly than when a firm's employee makes statements or drops hints on confidential matters of others when speaking to a client. The "deed of secrecy" used by one of the large firms, and mentioned previously, is part of desirable employee training in that respect.

Some organizations even detail in their manuals suggestions to their employees regarding decorum, low tone conversation at the office and over the telephone, and acceptable dress. One goes so far as to discuss manicured finger nails and shined shoes.

The majority of firms answering the questionnaires have rules in effect on the following:

1. Exact office hours.
2. Personal conversations while in clients' offices.
3. Use of idle time.
4. Keeping staff desks and tables clear of papers and file folders when not in use.

Less than a majority have rules on dress of employees and on use of telephones by staff members.

One small firm covers all six of these items and others in its general staff manual. Two others add that demeanor while at clients' offices must conform to stated practices. A medium-sized firm says "gum chewing is out."

One large firm has some interesting special practices. For example, as a means of placing men on their own responsibility, it never complains about employees arriving late. It considers that, more often than not, those who are tardy are frequently the same employees who work nights when it is necessary. However, the record of habitual late comers is carefully kept and promotions are measured in the light of conscientiousness. Staff members are assigned certain work and from then on they are expected to produce.

Filing Systems

In filing, knowing what is wanted is half the battle. Knowing how to do it is the other half. One accountant states that, regardless of the method of filing, a system will stand or fall depending on the person in charge. The mistake is too often made of entrusting files to too young and inexperienced a person. Perhaps the ideal is to have an active but mature former accountant, male or female, as chief of the filing department. This person's knowledge of accounting will be of definite advantage in supervising the arrangement or the checking of work papers as to proper filing position and dates.

It is not uncommon to find retired clerical employees of the Federal or municipal governments in charge of files of accounting firms. This is

now more prevalent in larger firms. Resultant tangible advantages are constancy and good judgment. Some firms employ retired policemen or firemen to help deliver files and requisitions and to run errands. One large firm uses the services of a middle-aged woman as chief and other middle-aged women as helpers in the filing and mail rooms.

Filing Methods

The majority of the firms use an alphabetical arrangement for general filing. Those who file numerically may lose some time through indexing and placing the numbers on the file jackets and folders, and must refer to index cards when a file is needed; but demonstrations in two large offices employing alphabetical and numerical systems, respectively, suggested to the writer that the numerical system affords greater speed in locating desired material, as well as greater security against loss or misplacement. It seems that the person doing the actual filing has an added safeguard against error when the name of the client is tied in with that client's file number. Other advantages claimed by the number system adherents are (1) it is not necessary to retain as much space on shelves or in cabinets when it is known that the next file will carry the next number, as when space must be provided for more jackets under the same letter; (2) the field men, most of whom seem to have the inclination to want to pick jackets of their "own" clients out of the files themselves instead of going through prescribed channels do not find it as easy to violate the rules if they are not well acquainted with the file numbers of their clients.

The numbers are usually in locked index boxes. The index is usually recorded on 4 x 6 cards, or slightly larger. Sometimes the cards are of varied colors, a separate color being utilized, say, for (1) copies of audit reports; (2) working papers; (3) copies of income tax returns; (4) correspondence — general; (5) correspondence — private (confidential or special); and (6) interoffice communications.

A large proportion of the accountants who file alphabetically use no index. The only safeguard against loss of a jacket is usually found to be reference to the records kept by the partner or principal or supervisor in the master tickler file.

Some concerns file their intraoffice communications within their private correspondence section of the file room and never permit them to leave the office.

As to disposition of old working papers, there is wide variation in period retained and method of disposition. Two devices to protect the confidential nature of contents, are (1) to mutilate papers before casting them into a waste paper basket and (2) to afford firm supervision over destruction of records by warehouses. The important point to remember is the auditor's responsibility to his client never to run the hazard of the latter's private business getting into outsiders' possession.

Inasmuch as so many practitioners report difficulty, indecision and dis-

satisfaction with their general filing, Appendix A is devoted to descriptions of filing systems in use by firms. Included are:

1. A description of the major steps from the general filing system of a large firm which files numerically and which is identified as Firm No. 1.
2. A description of steps from the system of a medium-sized firm which files alphabetically and which is identified as Firm No. 2.
3. Pronounced variations in the general filing systems of seven other firms.

Questionnaire Replies

In addition to the information contained in Appendix A, other information as to firm practices was obtained from replies to questionnaires. In the following tabulation, the questionnaire item is stated and the replies are given in percentages, according to size of firm.

Classification of Files, Indexing, Cross Filing of Working Papers

Question. Please check any of the following classifications into which your general files are subdivided:

	% of Firms	
1. Correspondence	S	75
	M	100
	L	90
2. Working papers	S	66%
	M	90
	L	90
3. Reports	S	60
	M	90
	L	80
4. Tax returns	S	62
	M	72
	L	80

Note: One firm combines (1), (2), and (3)), several combine (2) and (3), one combines (2), (3), and (4), and two (2) and (4).

5. Others (specify)

Among the small firms, one files individual client's material all together, one has a separate classification for "examination in suspense," and one for confidential data. One medium-sized firm has separate folders for (1), (2), (3) and (4), places them in a master file for each client, and has a general alphabetical correspondence file for non-clients. A large firm files all classifications in one folder under name of client.

Question. Is each of the above subdivisions kept in a separate file which is arranged by names of clients?

% Yes	
S	61
M	62
L	62

If not, is your major classification by client with each client's file being subdivided as to type of material being filed (that is, correspondence, working papers, reports, et cetera)?

% Yes

S 30

M 24

L 24

Question. Are your general files, as subdivided, also maintained in separate sections according to whether the material is:

% Yes

1. Current or noncurrent?

S 74

M 94

L 90

2. Active or inactive?

S 75

M 87

L 70

Question. How many years' work do you classify as current?

	Years					
	2	3	4	5	6	7
Small (%).....	23	41	9	23	4	0
Medium (%)	15	39	8	31	0	7
Large (%)	11	67	0	11	0	11
All (%)	18	45	7	23	2	5

Question. Aside from the permanent filing system, are temporary files maintained for:

% Yes

1. Material ready for filing?

S 58

M 63

L 50

2. Uncompleted work in staff rooms?

S 25

M 53

L 70

3. Completed work which is not yet ready to be filed?

S 40

M 67

L 40

Question. Are your files by clients arranged alphabetically?

% Yes

S 77

M 53

L 56

If not, are they arranged numerically?

S 23

M 47

L 44

One medium-sized firm files correspondence alphabetically and working papers numerically. A second files correspondence alphabetically,

working papers and tax returns numerically. One large firm arranges files both alphabetically and numerically.

If arranged numerically, how do you assign numbers?

	%
By client	S 45
	M 72
	L 80
By each individual engagement	S 55
	M 28
	L 20

Question. Do you maintain an index of your files?

% Yes
S 50
M 73
L 100

Question. Where correspondence with a client relates specifically to a particular point in an engagement, is that correspondence filed:

	% Yes
1. With the working papers involved?	S 89
	M 86
	L 30
2. In the general correspondence file?	S 7
	M 7
	L 10
3. In both files?	S 4
	M 7
	L 60
4. When it is filed in either place but not in both, is a notation made in the other for the purpose of cross referencing?	S 24
	M 20
	L 40

Controls of Withdrawals

Question. When audit work papers and reports and tax returns are removed from the file, is a written memorandum put in their place?

% Yes
S 43
M 53
L 55

One medium-sized firm has a written memo made only when papers leave the office.

Question. Do you have any established rules as to which staff members may withdraw material from the files?

% Yes
S 17
M 24
L 40

Retention and Transfer of Papers, Reports and Tax Return Records

Question. What disposition do you make of old working papers and reports?

	% Yes
1. Retained indefinitely in storage	S 70
	M 50
	L 50
	% Yes
2. Destroyed periodically	S 30
	M 50
	L 50

Two small firms retain for existing clients and destroy for inactive. One medium-sized firm comments that it recently resurrected 1923 material for a client. Another destroys old working papers periodically but retains old reports indefinitely. A third never destroys reports, and destroys working papers only in cases of clients who have been out of business for at least five years. One large firm keeps typed reports permanently. Another retains "basic" papers and destroys "recurring" papers.

a. If you destroy them, how long do you keep them before they are destroyed?

There is considerable variation ranging from five years to fifteen, with ten years as the generally favored period. The period may also be shorter if the client goes out of business; some firms destroy after a client has been inactive for a specified period, some destroy according to statutory limitations as to liability, and some retain as long as the client is retained. Some vary the period according to the importance of engagements or papers. Some retain tax papers longer than other records.

b. What method of destruction do you use?

Most small firms burn and some destroy by mutilating (usually tearing into bits). Most medium-sized firms burn records, and one follows the unusual procedure of having the warehouse where records are stored destroy by mutilation and issue a certificate to the firm as to the papers destroyed. Another states they are "sent to box factory where we watch them ground into pulp." All but one of the large firms burns the papers, and the exception reports disposition as "waste paper."

c. Do you make microfilm duplicates of papers and reports which are to be destroyed?

% Yes
S 0
M 14
L 14

d. Before destroying old working papers and reports, do you first offer them to the client?

% Yes
S 44
M 0
L 14

- e. If you do not destroy audit working papers, or if you retain them for some years, do you immediately destroy the pencil manuscript of the report and accompanying exhibits?*

% Yes	
S	0
M	19
L	10

If not destroyed immediately, how long do you retain them, assuming the typed copies are also retained permanently?

Period of retention is variable from one to ten years, with an appreciable number of firms retaining them indefinitely, and a few permanently, with most of the others keeping them for ten years.

3. *Which of the following factors influence the period for which you hold records before destroying them?*

	% of Firms
a. Available storage space	S 38 M 55 L 70
b. Governmental regulations	S 50 M 22 L 40
c. Statutes of limitations as to legal liability relating to engagements represented by records	S 44 M 17 L 60

Binders for Working Papers

Question. At the completion of an engagement, do you place your working papers in permanent binders?

	% Yes
1. If so, are they bound at the top?	S 60 M 44 L 60

Several firms use fibroid envelopes instead of permanent binders. One uses heavy red rope envelopes.

2. Please check any of the following items of information which you record on the front of working-paper binders:

	% of Firms
a. Name and address of client	S 88 M 94 L 90
b. Specific nature of engagement	S 10 M 60 L 100

c. Period covered by papers

S 100
M 100
L 100

d. Other (specify)

Among the small firms, one each reports (1) principal offices and phone number, (2) year covered, (3) senior in charge, assistant, if any, and partner reviewing, (4) index, and (5) reviewer, date of review and details as to delivery. A medium-sized firm adds the name of the staff members who made and supervised the audit; another notes the personnel on the assignment; a third records the nature of the papers; a fourth adds file number, persons to receive reports, number of copies of report, and accountant in charge.

In addition to the material on filing contained here and in Appendix A, readers will find sections in many books on office management which contain sections on filing. Several books on office management are listed in the Bibliography (Appendix D).

Supplies and Stationery

An accountant should give careful thought to his policy in selecting supplies and stationery. Not only is this an important item of expense, but the right selection will aid in the handling of his practice.

Standardization

There are numerous concerns supplying standardized audit working papers. Some of these concerns are operated or managed by certified public accountants. Sizes, colors, rulings, punching, binding edges and so forth, conform to the preferences of members of the profession. A book by Frederic Staples entitled "Standardized Audit Working Papers" ¹⁰ is valuable on this subject.

Several firms never use a sheet larger than 8½ x 11 in the formal audit report. For exhibits such as balance sheets, two sheets are utilized with the assets appearing at left of binding edge and the liabilities at right. The objection to this is that no typing appears on the reverse side of either the assets or liabilities sheets, and the reader may be surprised when first introduced to this procedure. In order to utilize to the fullest advantage this comparatively small size paper, some firms now are omitting the two penny columns and the decimal point that precedes them.

Instead of stereotyped preprinted work sheet forms, one large firm uses models that it prepares in advance by the Multilith process. Its argument is that preferences of the principals are better met by this process than to force the use of forms which, in part, do not meet their tastes. Certain model sheets are Multilithed in greater number than others. The forms are prepared on the firm's own stock of blank work paper. The senior

going out on an engagement takes along the number of sheets which he estimates will be needed in each case, based upon reference to the previous year's file. Loose forms soil and spoil and this may be a slight offset to the saving in accountants' time, but not a material one.

As stated earlier under Correspondence and Reports, one firm uses pretyped models of standard report paragraphs, prenumbered, which the senior includes by reference when writing his basic comments.

It is well for the new practitioner to make a complete study of sizes and weights of paper. Finished bond paper that is too heavy reduces the clarity of carbon copies. Some onion skin paper is too thin for use in audit reports. Paper that is too large will not fit in files of bankers, attorneys and the Bureau of Internal Revenue.

Practices of Firms

The following answers were given to the items about stationery and supplies in the questionnaire. They should be representative of practices of accounting firms of various sizes and in various locations.

Supplies and Stationery

Question. Please indicate below the color of your working paper.

	<i>Color of Paper</i>				
	<i>Yellow</i>	<i>Buff</i>	<i>Green</i>	<i>White</i>	<i>Varied</i>
Small Firms (%)	50	38	25	9	6
Medium Firms (%)	45	40	17	0	11
Large Firms (%)	60	20	10	10	0
All Firms (%)	<u>50</u>	<u>34</u>	<u>20</u>	<u>7</u>	<u>7</u>

Note: Excessive percentages reflect the fact that some firms specified two colors.

	<i>Color of Lines</i>						
	<i>Green</i>	<i>Blue</i>	<i>Red</i>	<i>Pink</i>	<i>Brown</i>	<i>Tan</i>	<i>Black</i>
Small Firms (%)	50	50	17	0	33	3	3
Medium Firms (%)	60	6	12	6	40	0	0
Large Firms (%)	40	40	10	0	30	0	0
All Firms (%)	<u>50</u>	<u>34</u>	<u>13</u>	<u>2</u>	<u>34</u>	<u>2</u>	<u>2</u>

Note: When two colors are used, results show green most favored as one and blue or brown as the second.

Width, Length and Number of Columns

Among the small firms, seventeen different sizes are used. Of these seventeen, one size is used in ten different columnar arrangements, one is used in eight different columnar styles and one in seven. The form of paper most used, reported on one-third of the returns, is $8\frac{1}{4} \times 14$ with four columns. Next in frequency is 17×14 with fourteen columns, and third is $8\frac{1}{2} \times 14$ with seven columns.

Among the medium firms, fifteen different sizes are used. Of these sizes, one is used in five different columnar arrangements, one in four

and one in three. No particular form is used by many firms, no particular size and columnar arrangement being favored.

Among the large firms, fourteen different sizes are used. Of these fourteen, two are used in three different columnar arrangements. No particular size is favored.

In general, and particularly among the small firms, there would seem to be a possibility for advantageous standardization. There is some evidence of increased use of $8\frac{1}{2} \times 11$ worksheets, following the trend toward that same size of report paper.

Question. Do you make use of preprinted working paper?

% Yes	
S	12½
M	9
L	3

Main items preprinted are (a) headings for analysis sheets, (b) working trial balances (account names), and (c) usual column headings for work sheets. In addition, one small firm having a large agricultural clientele mimeographs forms for depreciation schedules.

Question. Do you pretype periodic working papers and skeleton financial reports for use in filling in monthly or other periods' statements of clients?

% Yes	
S	78
M	67
L	60

Records of Engagements

The practices of accounting firms vary as to the type and detail of records, memoranda and procedures they use in their offices. This variation extends to the handling of memos of engagements, records of conferences and conversations, and follow-up systems for engagements. Procedures for each of the various features of office procedure will be considered separately.

Engagement Memoranda

Most firms do not have signed contracts with clients. Many of them simply confirm understandings by letter. Several of them write the letters in duplicate summarizing the proposed scope and fee arrangement. In one case, the client is asked to sign the duplicate and return it to the accountant.

A large New York firm, with no branch offices, follows several steps as a matter of course when a new client is obtained. To assure the punctual application of these steps, a checklist, printed in advance on 8×14 paper, records the following:

1. New client's name, address, and phone number.
2. Business organization (such as corporation or partnership).
3. Type of business including products handled, wholesale or retail, price range.
4. Date of end of fiscal year.
5. Names of officers, bookkeepers and other key persons.
6. Affiliated companies.
7. Frequency of audit (such as monthly and annual).
8. General remarks.

Then follows a list of various Federal, state and city tax returns which the business must file, with space to check those returns that the accounting firm is to prepare. At the bottom of the sheet is a small tabulation headed "Date noted in office records." This is followed by spaces for entering the date on which the foregoing information was entered on the accounting firm's client phone list, staff assignment sheet, billing book and other records. It also would seem to be desirable that each client's Federal social security number and state unemployment insurance and sales tax registration numbers be entered on this form, so that these data are readily available if and when required.

A medium-sized firm in the south enters its initial information on one of two printed forms, depending on whether or not the engagement is to be done monthly. These forms are shown in Appendix B. Figure 18 (c) is a control form of engagement program for audits or engagements other than monthly. Figure 18 (d) shows the first page of a form for bookkeeping and special monthly examinations. In each case, the first page of the series (balance of series is a detailed program) is followed by the internal control questionnaire sheet(s). The firm also fills in the notice of contract form, Figure 10 (d), which is filed in the office manager's office. No new form is made for succeeding work, as it is easy to record any minor changes on the original.

One large firm sends out a letter giving a brief statement of the scope of the work to be done on all new assignments. (Many other firms of all sizes also do this.) Only on rare occasions does the first request a signed copy to be returned. The next step is to prepare a notice of contract, Figure 10 (c).

Everything pertaining to the client from that point on clears through the office personnel manager. He is the one who co-ordinates all office activities and is the central clearing point of office procedure on all matters relating to all clients. He is the first person through whom the notice of contract passes and as a final step, usually, all billings against clients pass through him.

A small sole practitioner maintains a record he calls "Client Data Sheet" which he completes as the information becomes available. (See Figure 10 (b) for illustration). A large firm uses the engagement memorandum blank reproduced as Figure 11.

Replies to Questionnaires

The questionnaires sent out to collect information for this chapter included detail on records of engagement. Questionnaire answers follow:

Engagement Memoranda

Question. Upon completion of negotiations for an engagement, do you prepare a written memorandum of the engagements?

% Yes

S 58

M 83

L 100

Note: One small firm says "when necessary" another "on new engagements only." Two other small ones say they do not do this but admit they should.

1. If so, please check any of the following items which the memorandum includes:

% of Firms

- | | |
|---|-------|
| a. Name of client, including names of subsidiaries and affiliates | S 100 |
| | M 100 |
| | L 100 |
| b. Addresses where records are kept | S 83 |
| | M 100 |
| | L 82 |
| c. General nature of business | S 23 |
| | M 100 |
| | L 82 |
| d. Nature of work to be done | S 94 |
| | M 100 |
| | L 100 |
| e. Type of reports required | S 100 |
| | M 100 |
| | L 73 |
| f. Period to be covered | S 100 |
| | M 100 |
| | L 90 |
| g. When work is to begin and be completed | S 72 |
| | M 80 |
| | L 90 |
| h. Names of staff members who will do the work | S 17 |
| | M 33 |
| | L 25 |

i. Basis of charges to client	S	50
	M	73
	L	90
j. Treatment of travel and other expenses on the job	S	28
	M	60
	L	37
k. Who is to receive the report	S	50
	M	80
	L	50
l. Who is to be billed and where	S	45
	M	67
	L	45
m. Client, if different from organization which is to be examined	S	45
	M	74
	L	55
n. Other (specify)		
A small firm includes extent of accountants' responsibilities and whether opinion is to be expressed or disclaimed. Another small firm points out that there is usually some information it does not want to make available to staff, so only the partner in charge has a copy. A third includes some confidential comment on the peculiarities of certain individuals in the organization. A medium firm adds source of engagement (how obtained).		
	% Yes	
2. Is a copy of the memorandum sent to the client	S	17
	M	0
	L	20
3. Are copies sent to the staff members and departments concerned?	S	55
	M	54
	L	54

Records of Meetings, Conversations and Opinions

One New York firm requires dictation of memos of all conversations and meetings, which are then filed with the intraoffice communications in a special private folder which never leaves the office. This requirement also is applicable to tax engagements. All opinions of importance are addressed in writing to the client, and a copy is retained in the appropriate file.

One medium-sized firm in the south keeps "minutes," in a looseleaf book arranged in chronological order, of all meetings with clients and discussions held by the partners on important matters.

Following are the related questionnaire answers on this subject:

Question. Do you make a record of all meetings and conversations with or on behalf of a client?

% Yes
S 50
M 50
L 70

A medium firm records this in time reports and makes specific memoranda only if felt necessary. Another records meetings only, not conversations.

Question. Do you maintain a record of all formal opinions given to each client?

% Yes
S 82
M 78
L 80

If so, please check below any items included in such a record:

	%
1. Point upon which opinion was rendered	S 91
	M 80
	L 70
2. Date of opinion	S 91
	M 80
	L 70
3. How opinion communicated (that is, letter or report)	S 91
	M 85
	L 60
4. By whom opinion expressed	S 87
	M 71
	L 70
5. To whom opinion given	S 87
	M 71
	L 70

Question. Do you maintain the same records of informal opinions given to clients?

% Yes
S 14
M 13
L 40

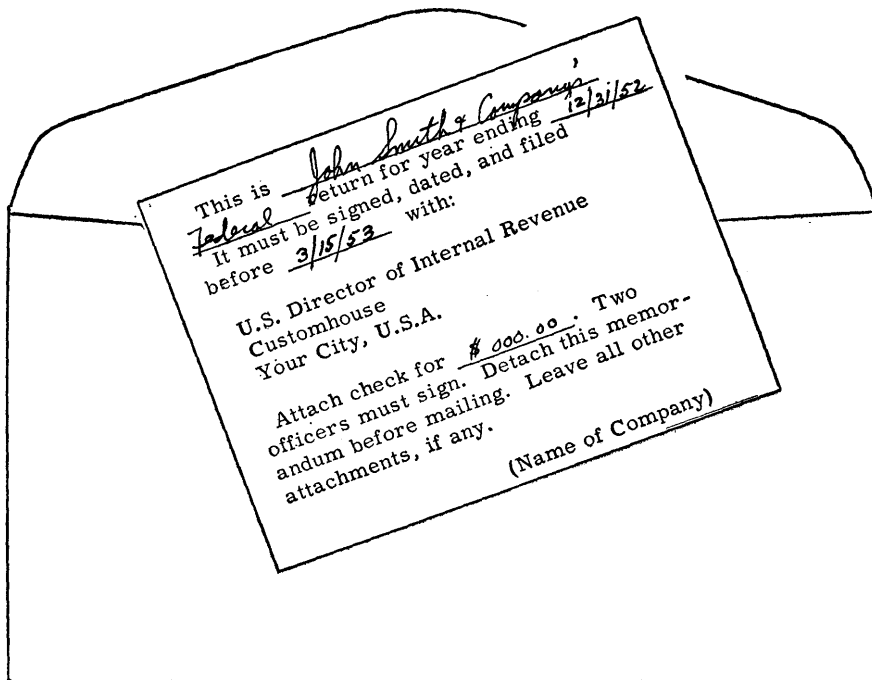
Records of Tax Returns

Much is said on this topic under the next subcaption "Tickler Files and Follow-Up Files." It also was mentioned under "Engagement Memoranda."

A single small practitioner in the South uses a "tax calendar," Figure 11 (a), for businesses and individuals. He sends the client a copy with the return. Other firms do the same. On the first of every month this sole practitioner sends income tax reminder forms to his clients. Figure 11 (b), shows a form used for all tax clients. It is called a "Reminder on taxes and reports—other than income taxes."

In sending clients their returns, he also includes a memo of instructions and a prestamped envelope addressed to the Director of Internal Revenue or the state collector of revenue. He has a rubber stamp for the name and

address of each collector of taxes, which saves stenographic time in addressing. The envelope return name and address are his own. If delivery is not made, the envelope is returned to him which places him on notice.



Questionnaire Replies

The replies to questionnaires provided the following information:

Question. Do you keep a written record, by client, of tax work performed?

% Yes
S 83
M 83
L 100

If so, please check below the items included in the record:

% of Firms

- | | |
|---|------------------------|
| 1. Nature of tax return (that is, income, franchise, et cetera) | S 100
M 87
L 100 |
| 2. Kind of tax (state or Federal) | S 100
M 93
L 100 |
| 3. Calendar of dates when returns are due | S 88
M 93
L 100 |

4. Who performed work	S	88
	M	87
	L	100
5. Tax returns audited by Bureau of Internal Revenue	S	52
	M	67
	L	70
6. Delivery dates and other pertinent data on returns delivered to clients	S	92
	M	73
	L	100
7. Special information of confidential nature on tax matters of clients	S	56
	M	40
	L	40
% Yes		
a. If yes, do you maintain a "special-confidential" file folder on these?	S	33
	M	43
	L	0
b. If yes, does the folder also contain other special information, such as embezzlements?	S	85
	M	83
	L	0

A small firm keeps such a "special-confidential" file on special colored paper which is placed in the working papers and can be removed when the occasion demands.

Tickler Files and Follow-Up Files

It is found that tickler files and follow-up files generally are maintained under two main divisions: (1) those having to do with auditing and accounting engagements or special services to be performed by the accounting staff, and (2) those having to do with income tax returns, advice, and tax controversies with revenue agents and conferees. In some instances, the same file records are used for engagements of the accounting staff and those of the tax staff. When separated, there is usually some cross control.

Generally, the routine follow-up is handled by the supervisor in charge of the staff. In the smaller firms this is usually one of the partners. In the larger firms it may be the office manager.

Examples of Procedures

As in the case of general filing, it is believed that a clearer presentation of tickler files and follow-up files is accomplished by giving two examples, followed by examples of pronounced variations from the first two. Chosen for illustration are systems employed by (1) a large firm with main office in the Middle West and many branches elsewhere, designated for con-

venience as Firm A and (2) by an individual practitioner, designated as Firm B, located in the South, doing much of his work personally and having four staff assistants and one office secretary-typist-bookkeeper.

FIRM A

**(A Large Firm with Main Office in the
Middle West and Many Branch Offices)**

STEPS FROM SYSTEM OF TICKLER FILES AND FOLLOW-UP FILES

1. Purpose of Tickler or Follow-up System

To control the flow of audit, accounting and tax engagements. To safeguard against errors of commission and omission in contacting proper persons, in meeting deadlines and in keeping promises.

2. Party, or Parties, Having Top Responsibility

Final responsibility rests with the staff manager. His background training on the firm's staff, his intimate knowledge of problems of the field and of report reviewing, and his thorough working knowledge of tax affairs, together with his long experience with the firm, fit him for the post. The partners have delegated to him full authority consonant with his responsibility. He shares responsibility for tax controls with the head of tax department. His many years of experience with the firm in the tax department has provided a deep-rooted recognition of the need for protection through an adequate follow-up system.

3. Initial Step in Opening of Follow-Up Record

New engagements are always closed by one of the partners who writes an office memo and, as in the case of all outgoing correspondence, the pink copy goes to the personnel staff manager. The latter's secretary immediately prepares the following control cards:

- a. Client master card, in white, measuring 6 x 8 inches, reproduced as Figure 10.
- b. Five operation cards of different colors, each measuring 4 x 6 inches.

Figure 16 shows the card for controlling progress of auditing or other accounting engagements, and Figure 17 shows one of the cards for controlling progress of tax returns. The other three tax cards have the same wording as the one reproduced.

4. Follow-Up Procedure

Tickler cards. The larger, client master card is immediately filed alphabetically in a Kardex cabinet in the private office of the staff manager. This arrangement provides an index of all clients, the type of work to be done, and the pertinent information necessary for each.

Only one white operations card, controlling the progress of auditing or other accounting engagements, is prepared. The others, all having to do with the preparation of income tax returns, are made out in duplicate, one each for the staff manager, the others for the tax department. A blue card is for Form 1120, Federal corporation income tax returns; a pink for Form 1120 EP (Federal excess

profits tax returns). An orange color is for trusts, partnerships and individuals. A yellow is for state income tax returns. The duplicate tax cards are first examined by the staff manager, then sent to the tax department. The original white operations card is returned to his secretary for current filing near her desk. She is located in a small office immediately adjoining his.

The card for audit control is filed according to fiscal closing date of the client in a small cabinet. When work begins on the engagement, the name of the in-charge accountant is placed on line 2 "In Charge" (Figure 16). The card is then sent by the secretary to the staff manager who retains it during the progress of the work. Line 3, "Preliminary Started," is to cover the starting date of such advance work as inventory observation, surprise count of cash, mailing of accounts receivable confirmations, et cetera. The fourth line, "Preliminary — Finished," receives the entry of the date the preliminary work is completed. The starting and ending dates are placed at appropriate times on lines 5, "Final — Started," and 6, "Final — Finished," and have to do with final major stages of the audit. The date the report is turned in for review is entered on line 7 "In Review," mailing date goes on line 8 "Mailed," and the card is then returned to the secretary after the total "Field Hours" has been entered on line 9. The card is used only on one side, and has four columns to cover four separate accounting periods.

All cards for each particular month are placed on the staff manager's desk weekly whether or not the job is started. He retains only those he wishes and sends back the others. By this method, he is fully aware of the progress of each engagement. This follow-up system is used for audit clients, for those whose financial statements are prepared from the books without audit, and for every other type of accounting engagement.

As stated before, the staff manager also watches the progress of tax returns preparation, as a precaution against failure to have a client's return in his hands on time for filing.

The tax control cards (originals) are filed by the secretary according to the due date of each return. As shown by Figure 17, line 2 provides for the in-charge man's name, as soon as he has been assigned. The staff manager, with the card before him, makes a note of the assignment. Line 3, "Completed by Accountant," receives the date the return was completed and was placed in the office for processing. When the return is given to the review department with the audit work papers, and/or the financial statements, that date is entered on the fourth line "Received — Review Department." When the return goes to the tax department for review, the fifth line "Received — Tax Department" receives the date, and when the review is completed the date goes in the sixth line "Review Completed." When the return goes to the Comparing and Proving staff before typing, that date is entered in the seventh line "Received-Comparing and Proving," and the date the return is mailed is entered on the eighth, "Mailed." After the return is mailed, the card is again filed alphabetically by due date in the secretary's special cabinet.

The duplicate cards in the tax department are entered by the secretary of the head tax man and are filed according to due dates of returns in the same manner as are the originals.

The staff manager receives monthly a form termed master tax calendar on all returns due for filing the following month. It has five columns, as follows:

<i>Taxpayer</i>	<i>Returns (No. of form)</i>	<i>Assigned</i>	<i>Due</i>	<i>Mailed</i>
-----------------	------------------------------	-----------------	------------	---------------

At the same time, each senior to whom the preparation of returns has been assigned receives a similar record covering his assignments.

Work forecasts. Although forecasts are a part of follow-up procedure, since they provide a current desk record of work planned and work completed, it is deemed better to discuss them hereafter under the subcaption "Work Progress Records" which is part of the main subject "Records of Staff Work."

FIRM B

(A Small, Individual Practitioner in the South)

STEPS FROM SYSTEM OF TICKLER FILES AND FOLLOW-UP FILES

1. Purpose of Tickler or Follow-Up System

To use Practitioner B's own words, "when your active policy is to have your clients dependent upon you for every move, you must have at all times up-to-date records on their every need." He claims never to have forgotten to give timely notice on tax deadlines, and never to have failed to keep a promise.

2. Party, or Parties, Having Top Responsibility

He handles everything personally. By temperament, he is extremely meticulous.

3. Initial Step in Opening Follow-Up Record

No later than twenty-four hours after an agreement is made, he transcribes from his own notes in ink on to a Kardex double insert card, all pertinent data on a new engagement, or a change in an old one.

4. Follow-Up Procedure

Tickler Kardex Cards. Into one side of the Kardex "jacket" goes the permanent card, clipped to the jacket, one for each client. The information recorded on this card is given in Figure 16 (a). Into the opposite side of the jacket is inserted, without permanent fastening, but held in with sufficient strength, the same client's current requirements, with later record as these are met. This is the visible index side.

When the file is closed, the following can be seen in the visible index:

- Name, type of organization, street address, post office box number and telephone number.
- Fiscal year close (red ink line drawn vertically immediately after month number — in this case 10, for October).
- Scheduled date for starting next work — November 8th (in this case, 8th per stopping point of orange transparent slide indicator; November, per 11 showing through small hole in blue indicator).
- Two reports per year (as shown by number 2, printed on orange indicator at left).
- Identification of in-charge accountant (as shown by number 4 printed on orange indicator at right).

The meaning of the three orange and the blue flag signals is easily identified by their relative positions. All signals are of transparent plastic material.

As noted in Figure 16(a), the removable, current requirement card shows the function to be performed next (the first listed one appearing without a check mark (✓) at left). When the time comes to perform that function, the card is taken out and placed in an active file to which the practitioner refers daily for a quick perusal of every job then in process. As soon as that duty is performed the card is checked off, the next function is written on it, and it is again placed

in its proper insert, the signal flags being adjusted to suit. The permanent card is not removed except when changes in the data it carries are needed.

Practitioner B displayed three separate unit-files of these cards, which he keeps in his desk. The units are subdivided for

Unit 1 — Louisiana corporations

Unit 2 — All partnerships and other than Louisiana clients

Unit 3 — All individuals

Each unit, which is Kardex #14854, fiber, can hold sixty-six cards.

Work forecasts. Practitioner B sees no advantage in work forecasts, under the circumstances of his practice. He insists on punctuality, regularity and methodical pursuit of every service. Frequent contact with his clients and his assistants, accompanied by the care with which he records his clients' needs, makes for ease in budgeting time.

Examples of Pronounced Variations

A few examples of systems which incorporate marked variations from those systems described above follow, identified as those of Firms C, D, E and F.

FIRM C

It is natural that there should be some overlapping of certain phases of the topics Tickler Files and Follow-Up Files and Work Progress Records. The progress of work is something which must be followed and recorded by using tickler files, even though independent records may also be kept. The topics "Location of Personnel" and "Time and Overtime Records" also overflow into the follow-up system in some offices.

Firm C's "Service Calendar," its "Diary" and its "Day Book" are examples. These three records are used in conjunction with each other. Besides their value as follow-up records, the firm claims they help to make possible the use of lower salaried personnel on the lower grades of work. It is so easy, most will agree, for a senior to be veered off into doing junior work.

The "Service Calendar" keeps track of inventory of work to which attention must be given each particular month. It is rewritten each month, whether the work is commenced or not. It consists of an 11 x 13¾ inch page with headings for "Finished," "Name of Client," "Location," "Started," "Type of Service and Fiscal Year Close" and "Account." The office-staff manager reports that he is constantly referring to this record. If he sees, for instance, that the typing department has reported that an audit report has been typed, but sees nothing about the tax return having been typed, he knows from this, and from his "Diary," that one is due and follows up. The senior in charge of each engagement is responsible for seeing that all tax returns for his clients reach the tax department on time. No record of time spent or cost is entered on this "Service Calendar." It is said that this record eases the idle time problem somewhat. The record is built up or double-checked from several sources: (1) the unfinished work from the previous month's Service Calendar, (2) the "Diary"

discussed below, and (3) the "ready date" in the "Record of Charges to Clients," rear side, discussed under "Time and Overtime Records."

When the work is started, he places a tick mark on the Service Calendar in the *Started* column and does the same in the *Finished* column when notified of its completion.

The "Diary" is a large-size, one-page-to-each-date diary. In it are set forth the commitment dates. The name of the client and the ready date, as well as the name of the in-charge man are placed in the appropriate spots by the office-staff manager. He tick marks to the left, when the engagement is started, and makes proper notation when finished. The Diary furnishes the exact date schedules which the Service Calendar provides by months. But the one-sheet record affords a quicker bird's eye view.

The "Day Book" is shown in Appendix B as Figure 13 (e). The names of the staff accountants according to their classification (such as partners, field accountants, comptometer operators) are entered in the left-hand column. Short sheets, which are bound at the right-hand side are written up, one for each working day. On the short sheet, on the line opposite each accountant's name (the names are written in once each month) are entered the names of the client, or clients, and the amount expected to be earned that day by each staff man. The left edge of that short sheet terminates at a spot which makes the names of the accountants visible without lifting the page. This, of course, is a memorandum and does not tie in with the general books or any other records. A symbol signifying the type of the work, such as "A" for audit and "T" for taxes also is placed on the same line. On these short sheets, entries are made each morning of the clients' names and the expected earnings, figured at standard rates for the type of services to be rendered. The expected earnings are added and a rough estimate of the approximate salary cost is made (using arbitrary salary allowances for partners) and subtracted from the earnings, in order to arrive at a rough gross profit figure for the day. The non-productive partners, the office manager and other nonproductive employees, are listed first. The lines for these do not carry earnings figures, but their daily "salary allowances" are included as part of cost in arriving at the gross profit estimate. Each Day Book daily short sheet acts as a medium for location of personnel.

FIRM D

This small firm, a sole practitioner, has a main office and one small branch a short distance away. His simple record for follow-up of tax returns is illustrated in Figure 17 (a). The sheets are filed alphabetically and by fiscal closings in a ring binder.

FIRM E

A small, individual practitioner in a large city reports the loss of a client because he failed to make a timely recommendation regarding officers' salaries. He says:

"Since then I follow two procedures religiously. I keep in the largest drawer of my desk two files. One is a tickler folder with twelve spaces, one for each month. The other is a loose-leaf, ring binder record of all my clients, giving the usual pertinent information on a page for each one. I file these sheets first according to month of closing, then alphabetically within each closing group. I am familiar with the affairs of practically every client.

As I read my tax services, I try to be conscious of how my clients may benefit through the situations reported. When I perceive such a possibility, no time is lost in dictating into my dictaphone a memorandum for file in duplicate, covering briefly what I wish. One goes into the client's file, the other into the tickler folder in my desk drawer in the month-space preceding by sixty days the close of the particular client's year. I also make an appropriate notation on the client's page in the ring binder.

Shortly after the first of each month, I remove all memos from the tickler file for the current month. I make it my business to examine each situation by:

1. Restudying the memo and related matter.
2. Reading over the last annual and later intermediate reports to see if a benefit can be obtained through that medium or in any other way.
3. Talking to the assistant who serves the client.
4. Talking to the client, if deemed advisable.

All this does not consume as much time as would at first appear, and has paid richly in rewards to me through 'measurable' tax savings to quite a few clients."

FIRM F

A medium-sized partnership with about 30% to 35% of its annual man-hours devoted to clients served monthly or quarterly, operates its staff by teams of supervisors, four or five men to each group, with an independent "pool" of several seniors and assistants not assigned to any team. The office manager, in collaboration with the partners and supervisors, prepares an annual master listing of all clients, by close of fiscal years. There is one sheet for each month of the year, with names in alphabetical order, filed in enough ring binders to provide one for each partner and the office manager. A separate listing by clients under the charge of each supervisor, arranged similarly, is prepared for each supervisor's independent ring binder. The master sheets show opposite each client's name the name of the supervisor in charge. When a corporate engagement, for instance, includes the preparation of the president's income tax return, a separate listing is indicated under the name of the officer (who may file a calendar year return, the company closing with another month). The master and supervisors' loose-leaf sheets record only the names of clients (with notes indicating whether the engagement is regular, on a monthly, quarterly, semiannual or annual basis, or is special), the estimated expected time in hours, and have columns in which to insert dates of forwarding to review department, to typing department and of delivery of reports and tax returns.

The supervisor, having made a record of the date the papers were de-

livered to the reviewer, will await notice from the office manager as to when delivery of report and/or returns has been made to the client, in order to post to his ring binder record. A clerical assistant posts the office manager's records.

Frequent revisions are necessary to take care of the new assignments and to delete sheets of recorded engagements which did not materialize, the latter being accomplished by a red ink ruling off of names, with date this was authorized, and memo "not served" entered in red to distinguish from black ink entries of date report delivered, et cetera. As an adjunct to this record, the firm has a Calendar of Important Tax Dates for each client, which is referred to at stated intervals by the supervisors on behalf of their clients. This type of attention is much appreciated, especially by those who operate small businesses requiring small office forces or having no office forces. This firm has a novel way of protecting against missing a due date of its tax services to clients. It revolves around the "Due Date File" which works as follows:

1. Having received from each supervisor a list of clients by closing dates, the tax department reassembles the data on white 6 x 9 inch file cards to go into a thick loose-leaf binder. For each supervisor and for each month there is a white card or cards, bearing the supervisor's name, the month in which the Federal income tax return is due, and a list of clients to whom such date applies.
2. There also is a blue card of similar size for each month, on which are noted the month, the names of clients on whose behalf some action is to be taken within such month, the final date for such action, and a brief description of such action. For example:

September 1952

George Smith, 11/30/47, Tax		
Deficiency Paid 9/22/50	Brown	22nd
Jones Corp., Application for		
Change to 11/30 Closing	Adams	30th

3. Changes authorized by Due Date Memo are posted to the Due Date File in the tax department.
4. All tax matters must clear through the tax department. Upon tax department processing, a copy of the monthly advance sheet to supervisors, issued at the beginning of the second month preceding that of the due date, is checked off. At the beginning of the due date month, such copy is reviewed for open items, and a final sheet for the month is issued.

To recapitulate, monthly lists of clients, by closing dates and supervisors, to which is added a special list each month of irregular items, is the basis for an advance sheet issued more than two months before necessary action. The tax department checks off, on its copy of the advance sheet, such items as have cleared through it, and at the beginning of the action month, two months after the issuance of the advance sheet, issues a final sheet. The procedures for notification of change, authorization by the supervisor, posting and the requirement that the supervisor receive back and retain initialed Due Date memos, are designed to eliminate slip-ups.

Further clarification is afforded by the office memorandum instructions issued by the tax department to the partners and supervisors on June 10, 1952. These follow:

"In order to avoid the possibility that a due date of any sort will be missed, the following procedure has been set up.

Each partner or supervisor will notify the Due Date File, via a special form, copy of which is attached, of important dates. The originator will number such forms as he issues consecutively. They will be posted to the File, and initialed to indicate such posting, and returned to the originator for retention by him.

The Due Date File will issue monthly, on or about the first day of the second month preceding the month in which action is necessary, a list to each supervisor, setting forth what is required. Such list will include normal closings as well as special matters.

Thus, on July 1, supervisors will be informed as to June 30 closings, and any other tax matters having due dates in September, such as claim for refund, request for change in accounting period to November 30, request for change in accounting method for a year ending June 30 of the succeeding year, et cetera.

On or about the first of the month in which action is required, final notice on open matters will be sent to all supervisors.

The supervisor's counter-initialed serial file will be his evidence that he has notified the Due Date File."

The following is the information contained in the memo form which was attached to the office memorandum sent to the firm's partners and supervisors by the Tax Department. It measures 5½ x 8½ inches.

MEMO

TO: Due Date File

Date

FROM: _____

Supervisor

Serial No.

Client

Year Affected

Please record the final date for action with respect to the change noted below for this client.

Dates

1. Claim for refund (843)
2. Carryback, EP or IT
3. Filing of protest
4. New client
5. Changed taxable year to
6. Paid deficiency on
7. Made a gift on
8. Extension for filing return to
9. Request for change
 - a. Closing on _____
 - b. Bad debt method _____
 - c. Accounting method _____
10. Other

Posted

Questionnaire Results

Questionnaire answers on tickler and follow-up files gave the following information as to current practices:

Question. Do you maintain tickler or follow-up files?

% Yes

S 67

M 69

L 80

1. Please check any of the following items for which you maintain tickler or follow-up files:

*% of Firms Having
Such Files*

- a. Correspondence

S 35

M 55

L 75

- b. Reports

S 75

M 100

L 62

- c. Tax returns

S 100

M 100

L 100

2. Please indicate which of the following items of information you include in your tickler file:

*% of Firms
Having Such
Files*

- a. Date for beginning a particular project
(preparation of return, audit, et cetera)

S 65

M 100

L 100

- b. Names of staff members who are to do the work

S 30

M 73

L 62

- c. Date when work must be turned over for typing
and review

S 35

M 46

L 50

- d. Date when work must be completed for delivery

S 45

M 73

L 75

- e. Date when bills are to be sent out

S 25

M 0

L 25

- f. Date when fees should be collected

S 15

M 0

L 13

3. Do you keep on hand a number of tax return forms for back years for purposes of amended returns, references, et cetera?

% Yes

S 100

M 100

L 100

Other Suggestions for Work Controls

Esenoff relates in *The Journal of Accountancy*⁵ his firm's system of handling the follow-up on tax returns. He says in substance:

1. The firm has approximately five hundred individual income tax clients. It maintains a card file showing, with other data, the accountant responsible for the return.
2. In December each year a letter goes to each client, informing him of January 15th payment, asking if he wishes to file an amended declaration and giving him the name of accountant who will serve him.
3. Also in December, job slips are prepared for each client, as are the 3 x 5 cards and usual job envelopes (part of Esenoff's general accounting system explained later under "Accumulation of charges to clients.")
4. In the envelopes in December 1949, for example, there were placed the 1948 Federal and state tax returns and supporting papers, the 1949 declarations and other data, if any.
5. It becomes the accountant's responsibility to make the appointment, obtain information and prepare the return.
6. As returns are made up, they are placed in a review box and are taken from there in rotation by those assigned to review.
7. After review, the returns are routed to stenographic department and processed.
8. Processed returns are placed in the proof box, proofread and scrutinized in entirety, including recomputations of tax.
9. Forms and schedules are then stapled, and client's copies are then placed in covers.
10. Completed returns are scrutinized again by partner, who also determines amount of bill if case involves a "cash client."
11. Finally, returns are rerouted to the stenographic department where 3 x 5 control cards are transferred to the completed file and the client is called in to sign the returns.
12. As March 15th draws near, 3 x 5 cards in the incomplete file are watched carefully so that no incomplete case is forgotten.
13. Review and proof boxes also are watched carefully, and no undue delay is permitted.
14. Another form of reminder is the weekly report from February 20th on, showing the number of cases which each accountant is holding and each one's state of completion. Each accountant files this weekly report for his own cases.
15. Returns which clients will deliver or mail to the government are so marked.
16. Returns that the firm is to deliver to Collector are arranged in batches with covering letter in duplicate.

Bacas² suggests a system of handling reports expeditiously and to assure

their delivery as promised. He recommends numbering each report in the order of proposed completion, with the understanding that there are always emergency reports which should be given the right of way over others. It is important not to wait until the last minute to check up on this. From time to time, it is desirable that a partner review the record.

In order to control the report from the time of its original pencil draft until it is bound and delivered, a columnar book is used as a report record, with the following being entered in the columns:

1. Draft received.
2. Examined by comparing department.
3. Typing completed.
4. Checking and comparing completed.
5. Corrections made.
6. Corrections checked.
7. Report placed in cover.
8. Cover checked.
9. Letter of transmittal prepared.
10. Report mailed or delivered.
11. If delivered, to whom.

Minor Variations in Control Procedures

In addition to the variations covered by the preceding examples, there are numerous combinations of procedures and many minor variations found in procedures. Interesting examples of these variations are:

1. Many firms have questionnaires and checklists to assure that all steps are taken in reviewing reports, working papers and tax returns. (See Chapter 11 for discussion and examples of these lists.)
2. Many firms utilize rubber stamps on office copies of tax returns that are to be processed. (Care should be taken to see that the various lines of the stamp are promptly filled in regarding person preparing and date, person reviewing and date, et cetera.)
3. In some firms, the partner or authorized supervisor or senior who settles a tax controversy with an agent in the field must notify the firm's tax department immediately. This is done whether or not a revenue agent report has already been issued, and even if a "no change" report is indicated. (Only top level representatives of the firm have the authority to settle clients' matters.)
4. Some firms insist that the head of the tax department review all audit reports, as well as tax returns, before release. This is to determine whether or not the senior on the engagement has made warranted recommendations to the firm, or in some cases to the client (if authorized by the firm to do so), on apparent tax savings and tax hazards.

Examples of Control Forms

Figures 18, 18 (a), and 18 (b) in Appendix B are instruction sheets used by firms of different sizes, as guides for processing reports.

Figure 21 (a), "Weekly Office Report," is used by a medium-sized firm as an additional summary of information from the typing department to the partners and office manager.

The Mailing List, Figure 10 (a), used by a very large firm, is not so much a part of a follow-up procedure in the sense applied in this chapter, as it is a safeguard against mailing finished reports and tax papers to the wrong persons. It affords some assurance that they will reach all of the intended persons. Its purpose is largely historical.

Records of Staff Work

Accounting firms have a dual purpose in keeping records of staff work. Such records afford them a control over the staff itself and usually provide the basis for making charges to clients. Since most staff time in the majority of firms is spent outside of the firm's office, some record of location of personnel and of time worked by each man and by all men on every job is considered essential.

Records of Location of Personnel

All practitioners interviewed maintain a daily location record on all men. Such records range from office blackboard entries made by the men themselves to a comprehensive location sheet prepared for the office manager each morning.

The personnel staff manager of one large firm maintains frequent contact with his field men. They do not always report personally to him, but report to the switchboard-receptionist every morning as to their whereabouts. She keeps a revolving type visible index file next to her switchboard containing a card for each field accountant, each one's name appearing at the bottom of his card. The size is 3 x 5 inches, divided in half by a line down the middle, each half for a separate week. Useable on both sides, one card will serve four weeks. A card covering two weeks for one employee is illustrated below:

Client	Client
10/8 Hardie	10/15 Hardie
10/9 "	10/16 "
10/10 "	10/17 <i>IN</i>
10/11 "	10/18 "
10/12 "	10/19 "
10/13 "	10/20 "
10/14 "	10/21 "
Accountant's Name: <i>Smith, Roger</i>	

The name on the October 8th line is the client at whose place of business Roger Smith was working on that date. The card shows he could be located there every day from the 8th to the 16th, inclusive. The word *IN* indicates his presence in the firm's office on the 17th, 18th and 19th of October.

Every morning at 9:00 a. m., the personnel staff manager makes it a matter of routine to check with the receptionist on personnel location. The same record is kept for the tax men as for the staff accountants. The firm believes it is good to telephone the field men occasionally to check on them. The surprise element is valuable.

A large firm uses a "staff secretary," a man whose office adjoins the office manager. This "staff secretary" is charged with the duty of ascertaining the location of all staff men and keeps a running record for himself and for the office manager. The accountants report to him by telephone each morning upon arrival at clients' premises. He collects time reports periodically and generally acts as assistant to the office manager.

Information as to records kept by firms generally, as given in questionnaires returned, show that in addition to listing basic information such as names of accountants, engagements to which assigned, and location of engagements, many firms add dates on which accountants will be available for other assignments. Often, particularly in medium and large firms, definite personnel reservations for future assignments are indicated.

Time Reports

All firms use time reports. Other names applied are: Time Sheet, Report of Services, and Service Report. With only a very few exceptions (a number of sole practitioners) the time totalled daily, weekly, semi-monthly or monthly is posted formally to a summary sheet for the period as the basis for the charges to clients. The sole practitioners referred to await completion of the engagement, at which time they take adding machine tapes, or machine-add the time on the back of the office copies of invoices sent to clients. One small firm uses an informal summary at the end of each month. Another simply files with the working papers a memo of time spent.

Frequency of Reports

Somewhat less than one-half of firms replying state that they require daily time reports. At least one firm requires a separate daily time report for each employee for each client involved.

There have been several articles written dealing with the subject of time reports. Mayo¹ considers one advantage in daily reporting to be that unassigned time is more quickly noted, and corrective measures can thus be better assured. Schlencker¹¹ recommends a separate time report for each nonproductive or overhead account. He defines an employee's "productivity ratio" for one month as the relationship between (1) the number of hours charged to client and (2) his normal working hours for the month.

Wittman,¹² recommending a 7-hour day for charging clients, considers the tenth, twentieth and last of each month to be convenient dates for time reporting. (One national firm visited agrees.)

Most firms require weekly time reports from staff men, others require semimonthly reports. One large firm with many branches recently changed its method of time reporting from daily to semimonthly. However, the firm still uses daily reports, Figure 22 (g), for its office employees.

Posting of Time Reports

In the latter firm the totals shown on each man's semimonthly time reports are posted to a monthly summary distribution sheet. This sheet shows hours, related dollar amounts for total hours, and hours chargeable to clients and to the various nonproductive accounts. Individual rates are used to cost the time distribution for tax specialists and supervisors. Average group rates are used for all other staff and office employees. Partners' time is not apportioned as between chargeable and nonchargeable. The total dollar amounts shown for each overhead classification are charged to those general ledger expense accounts; the excess of the total monthly payroll over those amounts is considered chargeable salaries. Postings now are made manually. However, the firm contemplates the use of an *N.C.R. 3100* (National Cash Register machine).

The subject of time reports is necessarily bound up with that of time records. Although the latter is discussed generally under the next subcaption, for the sake of continuity in the example of this firm, it is appropriate to call attention here to its time budget form, shown as Figure 15 (a).

It will be noted that the budgeting of audit staff time is broken down into two periods; first from April to October, second from November to March. The total of budget hours for each period is followed by the total actual hours of the corresponding period of the previous year.

Time Unit

Most firms visited use one-quarter hour as their minimum time multiple. The questionnaire answers show this to be predominant practice, with one-half hour the next most popular unit. Of the large firms, only two report the use of a 1-hour unit. The questionnaire also brought in the rather amazing one-twelfth hour used by a small firm, and another that requires that minutes be reported on tax work. Mayo¹ suggests a decimal system of time reporting, in which seven and one-quarter hours would be recorded as 7.25 hours.

Filing Reports

Some firms file time reports by employee names, alphabetically, in groups according to periods filed. Others keep them intact in these

period groups until the time ledgers are posted and balanced, at which time the time sheets are accumulated into one group for each employee. Each group is filed alphabetically by year. The firm previously noted as requiring daily reports, one for each client, files them alphabetically by clients after the separate time summary sheet is prepared for each partner and employee.

Description of Work

Where reports do not provide spaces for description of work performed, some firms furnish their accountants diaries in which these details must be entered. The diaries are the property of the firm, returnable at the close of the year or the termination of employment.

Samples of Other Time Reports

Several samples of time reports are given as figures in Appendix B. Comments about the interesting features of each of these reports are given in subsequent paragraphs.

Figure 22 is a monthly combination time and expense report used by a large firm. The expense report is on the back of the time report.

Figure 22 (d) is a weekly time report with no provision for expenses. Columns for rates and extended dollar amounts and spaces for descriptions of services rendered are provided. Provision is made also for a record of starting and ending time on each day and for an analysis of hours spent at "client's office" and at "other places."

Figure 22 (e) is a semimonthly time report with no provision for expenses, rates or dollar amounts. The nature of work done is indicated by a check mark in one of the three columns: Audit, Taxes and Special. Only one side of the sheet is used.

Figure 22 (f) is a monthly report of time without detail of expenses. It has a column to extend the dollar value of the total hours devoted to each client and to each "overhead" (nonchargeable) expense, as well as one in which to place the total expenses for the same month applicable to the same accounts. No space is provided for a description of work performed. Only one side of the sheet is used.

Figure 22 (g) is a daily time report with no provision for expenses. A separate report is prepared by the accountant for each client for whom he performs work. Provision is made for a description of services performed, for total hours devoted to each type of service, and for an indication of progress made in the engagement.

Figures 22 (h) and 22 (i) are weekly combination time and expense reports. The expense report is on the back of the time report in each case. Figure 22 (i) provides for dollar amounts for time, the other for total hours only.

Figure 8 is an overtime voucher on which no straight time is entered.

It provides for the recording of starting and ending time in three separate categories.

Questionnaire Answers

The replies received to questions about time reports revealed the following information:

Time Reports

Question. How often do you require time reports from staff members?

	Weekly	Daily	Monthly	Bi-Weekly	Semi-monthly
Small firms (%)	52	17	14	3	14
Medium firms (%)	50	14	7	0	29
Large firms (%)	63	0	12	0	25
	—	—	—	—	—
All firms (%)	53	14	12	2	19

Question. Please indicate which of the following items are included in your time report.

The answers to questionnaires indicate that all firms include as basic time report data (a) staff members' names, (b) period covered (inclusive dates), (c) names of clients, (d) number of hours worked daily, and (e) total hours for period covered. Practically all medium-sized and large firms and about 70% of the small firms record the specified types of work done and the nonbillable time for each day. Fewer show the total nonbillable time for the period, or overtime for each day or in full for the period. A small number use code numbers instead of names for clients.

Question. Which of the following forms do you use for time reports?

	% of Firms	
1. Cards	S	6
	M	0
	L	0
2. Sheets	S	73
	M	77
	L	83
3. Slips	S	9
	M	6
	L	0
4. Diaries	S	12
	M	18
	L	17
5. Other (specify)		

A small firm uses sheets for weekly time reports and slips for job time reports. Another uses sheets with tear-off slips. A medium-sized firm uses sheets for staff, and diaries for partners, and diary entries are transcribed to reports by stenographers.

Question. What is the minimum fraction of an hour used in recording time?

	$\frac{1}{4}$ Hour	$\frac{1}{2}$ Hour	1 Hour
Small firms (%)	61	39	0
Medium firms (%)	64	36	0
Large firms (%)	25	50	25
	<hr/>	<hr/>	<hr/>
All firms (%)	56	40	4

One small firm uses 1/12th of an hour; another, on tax work, uses minutes.

Question. Do you require time reports from typists and other clerical personnel showing amount of time spent on each engagement?

% Yes
S 80
M 78
L 86

Question. If not, do you include their salaries in overhead?

% Yes
S 82
M 100
L 100

Time Ledgers

Generally, the first record to which time is posted from the time reports is the Time Ledger. Other names used for this record are work in progress ledger, process ledger, client's ledger, combined time ledger and accounts receivable, unbilled receivables, clients ledger, record of charges to client, individual client's record, and cost sheets. Whatever the name, the time in hours and fractions is posted and, in some instances, the amounts of cost and/or of billing rates also are entered. In the latter cases, entries may represent postings of these dollar amounts from time reports; in other cases the computations are made originally on the sheets in the ledgers.

Procedure of a Large Firm

The Daily Work Analysis Schedule (Figure 14) of a large firm accumulates information on auditing time by major balance sheet and income and expense accounts. This information is transferred to a summary classification of time (Figure 15), maintained by years. This report is tied in with the time budget, Figure 15(a), used by this same firm and discussed earlier under "Posting of Time Reports."

Examples of Time Ledger Sheets

Examples of time ledger sheets and of combination time and amount records used by several firms are reproduced in Appendix B as Figures

23 and 23 (i) through 23 (o). Some of these forms and their use are described in the following paragraphs.

Figure 23 is the ledger sheet (one for each client) of unbilled receivables as used by a large firm operating several branches. Both sides are the same. It forms the basis of a monthly charge (from the five columns indicated) to unbilled receivables with a credit to fees earned, accumulated and posted semimonthly from the time reports. Accumulations are at standard billing rates used by the firm. The "amount of expense" column receives its debits directly from the cash disbursements book. If the actual billing is for an amount in excess of accumulated charges, the actual amount is placed in "amount of bill" column, the difference in "adjustment" column (in black) signifying a credit to income. If adjustment represents a debit to income, the figure is entered in red. At the close of each month the black and red adjustment figures entered that month are added, and the net debit or credit is charged or credited to the "unbilled receivables — clients," control with the contra to billing adjustments.

The firm also uses a salmon colored sheet which is an exact duplicate as to printing and columnar arrangement on both sides. It is used as a reserve against the "unbilled receivables" carried on the preceding sheet whenever the accumulated dollar amounts are deemed to be partly unrealizable from the client.

All billings must be approved by the partner in charge of the client. Each month, lists in triplicate, classified by the partner in charge, are prepared including all "balance unbilled" amounts in the ledger. Each in-charge partner gets his particular list, the duplicates of all lists go to the managing partner, and the triplicates are retained by the business office. Each partner indicates on his copy the clients to be billed that month, and the business office then prepares drafts of bills for his approval. The firm does not use an accounts receivable ledger, utilizing copies of invoices instead. •

The firm sending in the cost sheet, Figure 23 (o), with seven columns for accountant's time, states that the firm is now revising this form to provide eleven columns. The first columns of the present form are for partners, the balance for staff members. Time is posted weekly, with one quarter hour as a minimum multiple, from the time report and the expenses from the reverse side. Dollar cost summaries (cost here is exclusive of overhead) are computed monthly and after entry in columns provided at the bottom of the "cost sheet," these costs are accumulated in general ledger controlling accounts for (1) partners' time in process, (2) staff time in process, and (3) expenses in process. The cost is determined at the close of each month by applying the per-hour salary rate of each employee involved to the hours worked on each engagement, and adding to this amount the expenses incurred. Credits to the individual (inventory) accounts and their controls arise from tabulating the cost of engagements completed and billed during the month. The firm's progressive steps

from this point to the billing stage are described later as one example of accounting records of operation, illustrated by Figures 23 (a) through 23 (h).

Figure 23 (l) is a combination time and accounts receivable ledger sheet. No costing is done, the office manager-partner of the firm holding that costing is theoretical and of limited, if any, value. Posted weekly from the recapitulation on the reverse side of Figure 23 (o), the left side of the form provides a comprehensive history prior to billing. Also, the hours shown on the recapitulation for each accountant are summarized on a separate work sheet. This summary is the main control to prove that all time sheets have been received and posted and serves as a control of the total hours worked each month. It lists the names of staff and contains three columns for each week of the month showing "productive," "office" and "total" time. The right side of the form gives the debits and credits to the receivable part of the record, together with other pertinent information.

Once or twice each month each client's sheet, Figure 23 (l), is scanned and a list of bills is prepared. It is simple to see at a glance which work has been billed and which prior bills have not been collected. In addition to furnishing assurance that all work has been done, this basic record offers rapid comparison of time spent and fee charged. The office manager-partner estimates that for a staff of ten men a little more than one hour each week would be required to post all the time information from weekly time sheets and to control these data with adequate checks and balances. For a staff of fifty men, about one full day of posting time per week should be all that is needed. Of course, the number of clients will affect the posting time.

Replies to Questionnaires

The answers to the questionnaires on this subject are presented in the following summary:

Time Records

Question. Do time reports by employees become your permanent time records?

% Yes	
S	84
M	94
L	89

If so, please indicate how you file these reports:

	% of Firms
1. According to name of employee	S 65
	M 75
	L 62

2. According to engagement	S	12
	M	12
	L	0

5. Other (specify)

It appears from the replies that most firms file time reports by weeks or half-month periods (a few by months), subclassified alphabetically by men within groups. At the close of fiscal year, some then file them by names of employees; a few do not wait until the year's close to arrange them alphabetically, by employees, but do so after posting the information at stated intervals.

Question. If the employees' reports do not become the permanent record, do you consolidate these reports on some type of a payroll record?

% Yes

S	78
M	66
L	86

Question. If the answer to the preceding question above is Yes, how is the payroll record broken down?

% of Firms

1. By time period	S	19
	M	67
	L	45
2. By employee	S	44
	M	33
	L	45
3. By engagement	S	37
	M	0
	L	10

Question. Do your time records include only time units (that is, no dollar amounts)?

% Yes

S	69
M	73
L	44

Question. If your records show dollar amounts, are they arrived at by applying a per hour (or per diem) rate

% Yes

1. For each employee?	S	88
	M	86
	L	75
2. For each class of employee rather than by individual?	S	12
	M	14
	L	25

Question. Do your time records show a cumulative record of productive and nonproductive time for:

	% Yes
1. Each individual?	S 44
	M 75
	* L 67
2. Each classification?	S 11
	M 25
	* L 45

* Some large firms have both.

Question. Do your time records include:

1. Computation of dollar amount of time spent on each engagement?	S 48
	* M 56
	L 50
2. Computation of dollar amount of time of each employee?	S 31
	* M 56
	L 50

* Some medium firms have both.

Overtime Records

Question. Do you maintain a record of overtime for each employee?

S 80
M 88
L 100

Expense Reports

In less than 50% of the firms visited, expense reports are combined with time reports on the same form [See Figures 22, 22 (h) and 22 (i)]. Most firms use separate expense forms which are obtainable from printers' stocks, while others are designed to order. A few firms do not use formal expense reports. Since much has already been said on the subject, it is deemed sufficient here to submit three forms used by practitioners, and which are included in Appendix B as Figures 22 (a), (b) and (c), together with the following questionnaire answers:

Question. How often do you require that expense reports be rendered?

	Weekly	Bi-Weekly	Monthly	Semi-Monthly	End of Eng't
Small firms (%)	35	10	25	15	15
Medium firms (%)	57	0	7	14	21
Large firms (%)	75	0	0	25	0
All firms (%)	47	5	16	16	16

Question. Please check all items below which are included in your expense reports.

The answers show that all firms list name of client, description of

expense, and its amount. Where clients have code numbers, these are used also.

Question. Do you require that any expense items be supported by receipts for the expenditures?

% Yes

S 29

M 33

L 40

Question. How are your permanent records of expense broken down?

Answers show that while the fundamental breakdown is by client, practically all small firms also analyze by type of expense, while only about half of the larger organizations follow this practice. A fair number also break down expense records by employee but this is seldom done by large firms. One medium-sized firm analyzes by client if charged to client, by type of expense if charged to overhead.

Work Progress Records

Many firms keep production records on their staff in order to evaluate their abilities and efficiency. Some base the compensation of their field men on the results shown. This segment of the subject of work progress records, along with facts pertaining to personnel history, is discussed below. Another purpose for which work progress records are maintained by the majority of firms is to determine whether assignment schedules are being met, and if not, the reasons for such failure. These records also help to plan the anticipated work obligations to clients.

Accountants' Service Records

Mayo, in emphasizing the importance of cost records, suggests that "fees produced by each man, as well as the cost of each engagement, should be determined"¹ and states that the first feature "calls for keeping a separate fee-income account for each productive member of the staff and, as bills are written up or down, making adjustments to these fee accounts." He states that records of this character are designed to make the principal, as well as the members of the staff, sensitive to the importance of improving fee production and efficiency, and controlling the cost of separate assignments.

One small firm keeps a monthly record of production of each partner and staff accountant, as well as of each stenographer. This record balances with monthly (and annual) charges to accounts receivable (for fees) and credits to fees account.

A large firm uses an "Accountant's Service Record." These forms, one each for every month, are filled in for the main office and branch offices. The names of the various accountants are written one under the other and the fees produced by each during the specified periods are entered in the columns. The grand total of the fees entered on all forms is the

basis of the debit to "unbilled services" and the credit to "revenue." A summary of these monthly forms is prepared so that annual statistics, controlled by the general ledger, are maintained.

A medium-sized firm prepares a weekly Unassigned Time Summary for each accountant, its purpose being to indicate to what extent the unassigned time is attributable to an oversized staff or any marked falling off of special assignments. This form lists the staff men who had unassigned time during the week and gives comparative totals for the same week last year.

A large firm supplements the usual follow-up data with a written engagement progress report on each job weekly, prepared by the senior in charge to cover his work, as well as that of his assistants, in terms of total time. An example of such a report follows:

Total hours to beginning of this week	104
Total hours during this week	70
	<hr/>
To date	174
Original estimate of total hours to complete	210
	<hr/>
Remaining hours	36
Estimated hours to complete	56
	<hr/>
Variance	20
	<hr/>

Instructions given at the bottom of the form are to the effect that the report must be submitted weekly by the accountant to his supervisor, attached to the weekly time report. Excess of actual time over total allotted time must be shown in red.

It is claimed that considerable time is saved through this means of making the men time-conscious. A conference is held with the in-charge accountant when the "variance" figure is large in the hope that the estimated remaining hours can be reduced. The firm is adamant in its demands that unassigned time be kept at the minimum consistent with performing thorough work, and uses this progress report to accomplish this purpose.

Some firms give incentive bonuses computed on the basis of individual production. Under such circumstances, more consideration is given to flat fees billing, particularly for tax work and special services. However, flat fees based on inadequate estimates produce less revenue than the amount which could have been earned on a per-day or per-hour basis. Staff morale is endangered when earnings of some accountants are affected favorably or adversely by reason of unwise administrative policy.

Personnel Records

Bacas² bewails the neglect by accountants of adequate personnel records. He holds that they will probably find sooner or later that consid-

erable time will be spent trying to obtain some information that would be readily available if a simple card record were maintained. He recommends such a record even to the small organization and insists that its preparation will consume relatively little time. He says: "The personnel card record should have, in addition to the name, address, and telephone number of the member of the organization, his age and a statement about the studies he has completed. It is well to have a list of all immediate relatives — questions will arise as to whether the person is related to a certain individual. The card should have a complete list of former connections. The position for which the person is first engaged, with the rate of pay and date of engagement, should be included. Each change of position or of rate of pay should be noted with the dates thereof. An effort should be made to keep up to date on changes of residence, telephone number, et cetera."

One large firm makes periodic reports of the progress of each employee, recording these in a "scrapbook." This contains a photograph of each employee and a narrative record of all pertinent information regarding him, including his technical development, ability to get along with clients and fellow workers, neatness and personal appearance, attention to duty, facility in grasping information, use of correct English, personality and general demeanor. This regularly-filed report provides a ready and up-to-date history of each member of the organization, past and present.

Several practitioners consider the permanent retention of application blanks an adequate personnel record, provided that they are sufficiently comprehensive. This ignores the value of the history of the employee after employment.

Two examples of personnel record cards are included in Appendix B as Figures 9 and 9 (a).

Accumulations of facts constituting elements of work progress are discussed under other headings. For instance, the date when the audit report is due is discussed under Tickler Files and Follow-up-Procedures; the total accumulated time and cost of an engagement, as well as the names of those doing the work, are dealt with under Time Reports and Time Records. Under the caption, Accumulation of Charges to Clients, the recording of work-in-progress is discussed. The ultimate objective of the procedure is the billing of clients, although the very valuable objective of keeping continuous surveillance on time consumption by engagements is also served.

Work Forecasts

The great majority of firms prepare forecasts or programs of work. Some do so only for short periods, such as for one month at a time; others will spread their predictions over three months to six months; while still others utilize both short-range and long-range programs.

Each month the staff manager of one large firm has two columnar sheets prepared for him. The first, "Estimated Inventory of Work on Closings as of _____, 195____," is maintained in conjunction with the second sheet which is the short-range forecast for the month during which most of the work appearing on the first sheet is to be done. Examples of these two sheets, with fictitious names for clients and accountants, appear as Figures 13 and 13(b) respectively. Each estimated inventory sheet represents one month's closings only and is kept open until that month's work is completed, no matter when that may be. The sheet is prepared from the operations cards (Figures 16 and 17, explained under Firm A, Tickler Files and Follow-up Files) and includes the estimated time to prepare income tax returns as well as to do other work. The work on this sheet is done by hand, but most of it could be done on a typewriter if desired. The headings, including the title of the sheet, could be inserted by some method of reproduction well in advance of the date information is first entered.

Two forecasts are thereby used, one short-range and the other long-range. The short-range forecast will contain many of the same names that appear on the first inventory sheet, but not necessarily all of them. It will also contain names not appearing on the previous month's closing sheet, because of unfinished work coming from previous inventory sheets. A better understanding can be obtained by referring to Figure 13(b) (June 30 closings) and Figure 13 (July). The latter shows, under the names of eleven accountants, the names A.B.C. Company and X.Y.Z. Company covering May 31 engagements (consequently not on the June 30, closing sheet), whereas most of July's short-range forecast covers June 30 closing work or special work listed on the estimated inventory sheet. As jobs are completed, the short-range forecast is changed to show exact dates so that this sheet then begins a history as to dates started and completed.

The long-range forecast is prepared by the staff manager's office. This firm prepares such a forecast for the period beginning October 1 and ending March 31 of the following year, to take in the rush season. As shown in Figure 12, names of the staff men are listed vertically down the left margin of regular columnar audit paper. At the top, running horizontally from left to right, the columns are headed with "Week ending _____." Two lines are utilized for each staff accountant. On the first line to the right of his name are listed in red pencil the names of the clients he served last year. The name is extended, sometimes with the help of a line preceding and another line following the client's name, so as to include the actual time worked on that client the year before. The names of those to whom the accountant is assigned during the current period are entered in black pencil on the second line. These names are made to take up the time spaces based on estimated days required to finish each client's work. Those accountants still on the staff in the current year are listed first, and those who left during the year are

entered next. The red entries covering last year assignments are listed opposite these former staff accountants' names. However, these are crossed out when the assignments for this year have been made to other accountants.

The tax men and the partners are not included in this long-range forecast. In this firm all income tax returns, including those for excess profits tax, are first prepared by members of the audit staff. Simple returns are reviewed by the junior tax men; important ones are reviewed by tax men of a higher level. Two men have full charge of monthly audits, one top senior and one junior. Usually, they are not assigned to other work.

A master tax calendar is prepared by the 15th of each month for the tax returns due in the following month. This calendar is typed in duplicate from the tax operations cards (explained under Firm A, Tickler Files, and Follow-up Files). One copy is given to the tax staff supervisor and the other copy to the audit staff supervisor. After the master tax calendar is completed, it is broken down into individual assignments and a copy of this is given to each man responsible for the preparation of the tax returns. This, also, is done by the 15th of each month. The master tax calendar for the tax season, January 1 to March 15, is always compiled by the preceding December 1, so that a complete check may be made, and so that the individual accountants will know exactly the number and types of tax returns for which they are responsible.

A New York firm has a different approach to the short-range program. It uses a staff assignment program, Figure 13 (c). It lists the staff seniors, juniors and comptometer operators in the left margin, with the names of clients each accountant will probably have to take care of during the current month entered on the right. As soon as the client notifies the office that it is ready for the audit, a red tick mark is placed by the staff supervisor at the top of the client's name. Immediately after an accountant has been assigned to the engagement, a light pencil shading over the client's name is made (indicated in Figure 13 (c) by a line through the clients' names). The staff supervisor maintains continuous contact with the field accountants and is in constant touch with the situation with regard to each client. The office-manager partner stated that no staff accountant knows very long in advance what his next assignment will be.

Another sheet prepared by this firm and titled Staff Assignments Control Sheet, Figure 13 (d) is somewhat similar in nature and in function to the estimated inventory of work, Figure 13 (b). On this sheet appear the names of all, except monthly, clients. It is not essentially a short-range setup, but rather is more in the nature of a continuous record with the names and audit dates of clients entered well in advance of expected starting time. The entries are made in a sequence which will result in the first names having their respective lines completely entered in approximately the order of listing. As soon as the staff supervisor is advised that the audit is started, he enters the name of the accountant in

charge and the date the work was begun. The additional information is entered later as advice is received.

This firm has two tax departments, both headed by former Internal Revenue Agents. One of these departments makes out all tax returns, watches for tax considerations affecting the firm's clients and reviews all tax returns; while the other handles tax cases, estate tax problems and planning, and similar matters. This firm's programming includes two checklists of December 31 income tax returns due not later than March 15 of the following year, Figure 13 (d). The names of all clients are copied from the previous year's list, the new names from the time records. The same tick mark in red is used as under audit follow-up, to indicate clients' readiness to have returns prepared. Each senior is given his own "break down" list of assigned clients, copies being retained by the staff supervisor. Names are crossed off as returns are processed.

One large firm having several branches permits each branch manager to handle his own forecast in his own way. The main office has a quarterly arrangement using a column for each week of the quarter to record the progress of each engagement.

A small firm makes no forecast for its main office, but does have its branch, where approximately three men are regularly employed and two additional men are employed during the busy season, fill in a weekly assignment forecast, Figure 13 (a). This form also serves as a requisition for assistants.

A large firm in the South prepares for the majority of its clients a calendar of important tax dates which is referred to at stated intervals by the supervisors on behalf of their clients. The original of this calendar is sent to the client, a copy remaining in the firm's files. This type of attention is very much appreciated, especially by those who operate small businesses requiring only a small office force.

Another large organization cites the desirability of sending back to the client the same senior who did the interim work on the engagement and, as an aid toward this objective, plots its service obligations carefully between April 1 and October 31, during which period most of the vacations are taken.

One firm writes: "In an organization of our size with two partners in close contact with clients and staff members, it is not difficult to determine the manpower required to complete accounting assignments. As a further check, time reports of staff men are reviewed each week and a summary of unassigned time is prepared each week and accumulated throughout the year. This schedule also shows the unassigned time for the same week in the preceding year on a cumulative basis. This schedule of unassigned time serves as a further check on whether or not the firm is overstaffed; but, as mentioned previously, because of the close connection between partners in charge of assignments and the staff, it is not difficult to estimate manpower requirements on future work."

The most unusual program seen by the author is that maintained by a large practitioner who is always about six months ahead with his tack board and tack heads of several colors. On this board, the clients to be served within the period are listed horizontally at the top and the days of each month listed vertically in the left margin. Each of the twenty or more men is represented by a colored tack head, well indexed. These tacks are moved to the cross spaces for clients and opening dates of engagements. One man, if expected to work in ten places during the period covered, would be symbolized on the board by ten buttons of the same color.

Replies to Questionnaires

Questionnaire answers on work progress records follow:

Question. Do you maintain work progress records?

	% Yes
S	32
M	44
L	78

The responses reveal that where work progress records are kept, all medium and large firms and practically all small ones list the names of clients, and names of staff members on the engagements. Most firms also list the total accumulated time spent on each engagement, and a lesser but still appreciable number show total accumulated cost of work performed and expenses incurred for each engagement. Less frequently recorded, and in order of diminishing frequency, are expected time requirements, dates when reports are due, and expected cost of each engagement.

Accumulation of Charges to Clients

The discussion under "Time Reports, Time and Overtime Records and Work Progress Records" touched upon accumulation of charges to clients. Most of the large and medium-sized firms visited, as well as a few of the small ones, have work-in-progress ledgers in which standard billing rates are applied to accrue work performed but not yet billed. More and more firms are beginning to charge by the hour instead of by the day. Very few maintain records of time accumulation on the basis of salary costs incurred.

Examples of Forms Used

The following is a list of forms used by four firms, in which information preliminary to, or in connection with, billing is accumulated:

1. Figure 24, Memorandum of Billing, prepared in triplicate, together with a sheet of special information prepared at the same time as the Memorandum of Billing.

2. Figure 25, Bill Draft, prepared as a basis for billing.
3. Figure 23 (j), Cost and Billing Card, a data sheet prepared before billing.
4. Figure 23 (i) is a combination time ledger, expense accumulation and final billing data form, including comparison of "ideal" (or, "standard," as termed by some other firms) fee with actual fee, as billed. The explanation of steps taken is provided in the figure.

Features of three of these forms are discussed below, along with a brief description of the steps taken to accumulate the information and to bill the clients. There also is a brief description of the system used by a large firm, under which time records are sent to the I.B.M. electric punch card service and returned weekly.

A good gauge as to fairness in billing is the Memorandum of Billing form Figure 24 which is utilized, with variations, by several firms with which the author conferred. One large establishment uses this form in conjunction with a summary of the client's comparative balance sheets and operating statements. In that form, the memorandum of billing is prepared in triplicate. The white original is retained by the office manager, the yellow duplicate by the bookkeeping department and the pink triplicate by the partner who has supervision over the client. Each copy is filed alphabetically, by client, the latest on top.

More often than not this firm finds there is a deficiency in current fee as previously quoted to a client in comparison with actual accumulated charges at standard rates. The comparative financial and operating figures of the client are then examined, the work program comparison presumably having already disclosed excessive time in certain phases of the engagement. The larger sales volume, or the construction by company labor of a substantial addition to its plant, may represent the chief cause of excess time. This would be revealed by the audit program's section relating to sales or to fixed assets as well as those classifications in the summarized comparative statements. This is an example of the valuable data with which the accountant may arm himself before asking the client for an adjustment in fee.

It may be that the client's current net profit is far below those of the previous years. Despite an inadequate fee, such circumstances may induce the auditor to forego a request for adjustment. On more than one occasion, such a revelation has impelled the suggestion to the client that, pending an increase in the fee, the scope of the engagement be curtailed as an economy measure. However, some accountants feel that an increase in the amount of accounting may frequently be helpful to a client who is experiencing operating difficulties. No general rule can be applicable to such conditions.

One national organization can produce the type of statistics shown on its memorandum of billing in comparative condensed form for each client for more than twenty-five consecutive years.

The firm using the Bill Draft (Figure 25) is a large one, operating several branch offices. This firm's bills, prepared in triplicate, resemble a half-

size letterhead. The wording is selected from the standard, preprinted paragraphs on billing in the consecutively numbered bill draft, as checked; or, if none applies, special wording is inserted under (5). The bill draft thus represents the original and a permanent record of actual charges. The original bill is sent to the client; the duplicate is filed, with the latest data on top, in a binder as a current accounts receivable ledger. This procedure eliminates posting. Payment by the client of his bill in full causes removal of the duplicate from the current to a "paid invoices" binder. Payments on account are recorded on the related duplicates, the reduced amounts being shown. The triplicate invoice constitutes the billing register, and the monthly total is debited to "Accounts Receivable, Control" and credited to "Unbilled Receivables - Clients, Control." The bill draft is numbered with a Bates numbering machine.

Figure 23 (j) is more or less self-explanatory, taking up in the columns and spaces the information called for, in the manner already discussed.

Essenoff⁵ describes the "cost" and billing system used by a firm of seven partners and twenty-four employees. The accrual basis is used, with the chargeable time accumulated by means of a "job cost system" which is a misnomer since it really accrues at billing rates. The numbered job slip for each engagement has spaces provided for various stages of the work, as well as for the dates, hours and the initials of the persons doing the work. The firm uses a guide book with a page for each regular client, showing the scope and detail of work to be done. The request for a job slip usually originates with the partner in charge, on new and unusual work. These job slips are pasted on the outside of a job envelope which is given to the accountant responsible for the engagement.

The job slip, and a 3 x 5 control card as a carbon copy, are prepared simultaneously. The card is filed alphabetically in a file of incomplete jobs. At the same time an entry is made on a "master list," showing in numerical order the client's name and job description. The job slip is pasted to a manila envelope used to accumulate loose papers pertaining to the job. All related jobs done at the same time, such as annual or quarterly returns, have slips showing the same number. These slips are placed on the same envelope.

A summary time report is prepared semimonthly by each staff man and is posted, as to time and accrued amount, to the work progress ledger. Each staff member's chargeable amount is computed on his summary sheet and, in that way, a rough idea of his efficiency is obtained.

The stenographic department transfers the 3 x 5 card from the incomplete to the completed jobs file and sends the job slip to the bookkeeper, who stuffs it in the work progress ledger. Twice each month, a partner goes through the progress ledger and checks the completed jobs. Although the accumulated charge shown in the work progress ledger is the principal factor in determining the bill, there are adjustments, up or down in actual billing.

Clients' ledger sheets have two sets of debit, credit and balance columns.

The first is for work in progress and the second for amounts actually billed. Following is a set of model journal entries with step-by-step explanations of their effect in the records:

Step #1	<i>Dr.</i> Work in progress (an accrual at standard billing rates, posted to subsidiary ledger and control)	\$500	
	<i>Cr.</i> Earnings (details of earnings as desired) Entered when semimonthly time summaries are posted to the work-in-progress ledger.		\$500
Step #2	<i>Dr.</i> Work in progress	75	
	<i>Cr.</i> Pick-up (income) Additional amount deemed a justifiable charge to client because of special service not reflected in time (such as conferences) and because partner rendered a service entitling firm to higher than normal rate for his time.		75
Step #3	<i>Dr.</i> Accounts receivable	575	
	<i>Cr.</i> Work in progress Bill sent to client. The debit is posted to the same ledger sheet which has separate columns for the charges, credits and balances of billed receivables.		575
Step #4	<i>Dr.</i> Allowances (expense)	50	
	<i>Cr.</i> Accounts receivable To record allowance given client who complained that \$575 was excessive.		50

Step #4 is a different type of entry than that which would be made in the work-in-progress columns to record an "allowance" granted before sending the bill. This second type of allowance would be entered:

Dr. Allowances
Cr. Work in progress

Esenoff explains that the firm has succeeded in converting many of its annual clients to a monthly retainer basis. Using its past fees as a guide, the firm suggested a monthly fee that would cover the annual service plus a little extra to be available for consultation and advice throughout the year. This gave rise to a new bookkeeping problem. Following the regular billing procedure, a bill had to be set up as a credit to work-in-progress. However, the advance billing portion of the credit would be lost under that system in the work-in-progress control. To correct this, Esenoff says, "We now credit a new account called 'Retainer Balances' when we bill our clients who have a retainer contact. This new account indicates work to be performed. As services are rendered monthly, we debit Retainer Balances and credit Work-in-progress. A separate detail ledger is maintained showing the individual client's unearned retainer balances."

Use of Punch-Card Accounting

Esenoff reported in 1950 that his firm was experimenting with electric punch-card service to see if clerical work in summarizing semimonthly time reports and accumulating totals for billing could be reduced. In the author's own firm, the International Business Machines Corporation was employed on a monthly, irregular fee basis to accumulate weekly the time devoted to clients, as well as to nonproductive accounts. For various reasons this procedure has not yet been perfected.

Under the system every partner, staff accountant and stenographer fills in, with a sense-marking pencil, the spaces provided on a special I.B.M. job time card, one card being used for each job worked on by each employee each day. These cards are summarized weekly and the weekly totals in hours are run through the punch-card machines. By the use of predetermined symbols, the time consumed by each person is automatically extended at standard rates. On Tuesday morning of every week, a report is received by the office and is subdivided according to clients supervised by each one of six supervisors. There also is a master report combining all clients. Generally speaking, the report shows:

1. The number of the partner or employee.
2. The number of the client.
3. The number of the type of engagement: audit, income tax preparation, special service, et cetera.
4. The name of the client.
5. The hours spent during the week added to the balance through the previous week.
6. The total dollars accumulated during the week, plus the balance at the end of the last week for each client. These extended amounts are at the standard rates of the firm.

The master report and these reports according to supervisors enable the managing partner and each supervisor to maintain an up-to-date control on the engagement. The firm uses this in addition to its engagement progress report, discussed earlier.

Another form of report which can be submitted weekly by I.B.M. is a breakdown by each person of his or her nonproductive, productive and total time, which shows the balance so classified at the close of the previous week, the total consumed during the current week and the total to date. The I.B.M. weekly reports are placed in bound covers, which can be properly labeled and are easy to handle.

This system is designed to assure dispatch in obtaining results because, without timely reports from the partners, staff and others, the entire procedure would collapse. One of the disadvantages is that time reports and, consequently, the end-result tabulations do not show the nature of the work performed covering the time reported. Inasmuch as this is needed only now and then by some practitioners, one way of providing this information is to furnish each person with a diary sufficiently large to accommo-

date such details as are required to record the nature of the work done each day.

Replies to Questionnaires

The questions and a summary of replies to questionnaires are presented in the following pages:

Accumulation of Charges to Clients*

Question. In pricing time charges do you use a standard charge per hour?

	% Yes
1. For each individual employee?	S 56
	M 69
	L 80
2. For each classification of employees (that is, junior, senior)?	S 44
	M 31
	L 20

Question. Does the rate applied in pricing time charges include an element of

	% Yes
1. Profit?	S 96
	M 71
	L 67
2. Overhead costs?	S 92
	M 69
	L 78

From these replies it is evident that most firms price their time accumulations at "selling price" or standard billing rates, a basis which includes all elements of cost and a margin for profit. Only a small proportion accumulate charges in their records under a true "cost system," although many firms use the term "cost" rather loosely to describe the charges to a client's account on the billing rate basis. A majority of the firms use a separate "chargeable" rate for each staff man, although among smaller firms there is a large minority that use merely a rate for each classification.

It is not possible to generalize from the questionnaire replies as to the formulas used in fixing the individual or group billing rates used for time accumulations. However, most firms seem to aim at a billing rate which is at least double each accountant's salary, and some use two-and-a-half times the salary as their objective. Several firms use a formula of 1% of a man's annual salary as his daily billing rate.

Most firms acknowledge that the accumulated charges are merely a basic guide and that actual billings are frequently modified upward or

* The questions here relate to "accumulations" in books, covering accruals, not to billings. Billing figures frequently vary from these.

downward as circumstances dictate. The nature of the work, the responsibilities assumed, the results achieved and other factors are taken into consideration. A thorough and practical discussion of the subject of accounting fees is contained in Chapter 12 of this Handbook.

Question. How often do you accumulate charges to a client's account?

	<i>Weekly</i>	<i>Monthly</i>	<i>Semi-Monthly</i>	<i>End of Engagement</i>
Small firms (%)	24	32	8	28
Medium firms (%)	27	18	18	9
Large firms (%)	66	17	17	0
	<hr/>	<hr/>	<hr/>	<hr/>
All firms (%)	31	26	12	19

Further, one small firm accumulates quarterly, another only when billings are made. A medium firm accumulates daily, one bi-monthly, and one reports "indefinite."

Question. Overtime charged to clients.

	<i>% Yes</i>	
1. In accumulating charges for overtime on client's ledger sheets, such time is included without distinction as between regular time and overtime and priced at regular rates	S	73
	M	82
	L	100
2. Equivalent regular hours are entered and priced at regular rates	S	27
	M	18
	L	0
3. Overtime is priced at overtime rates	S	0
	M	0
	L	0

Several firms have a variable practice on this. If client is responsible for overtime, it is charged to client. If overtime is not directly attributable to clients, firm absorbs it.

Question. Expenses charged to client. Please indicate below which expenses you itemize in accumulating charges on your client's ledger sheet:

	<i>% of Firms</i>	
1. Transportation expense	S	80
	M	88
	L	100
2. Hotel expense	S	73
	M	82
	L	100
3. Food expense	S	67
	M	82
	L	100
4. Postage expense	S	40
	M	53
	L	50

5. Telephone and telegraph	S	50
	M	70
	L	88
6. Supplies used	S	17
	M	35
	L	25
7. Miscellaneous expense	S	23
	M	41
	L	38

Question. Do you show costs of report preparation as a separate item, (for example, do you segregate labor on report preparation from labor in the audit phase)?

% Yes	
S	4
M	28
L	20

Question. Do you segregate costs of partners' time billed?

% Yes	
S	32
M	46
L	40

1. Do partners make out time reports?	S	83
	M	100
	L	100

A small firm has such reports made out only for productive work in clients' offices. Another does not have such reports made, but partners keep diaries.

2. Please indicate how you arrive at a basis for pricing partners' time.

Apparently, some firms price partners' time by the formula used for staff men, applying the standard multiplication factor to the agreed salary or drawing account of each partner. However, most firms seem to price partners' time at arbitrary rates described variously as "going rates" or "competitive rates," with additional consideration given to out-of-town work, difficult assignments and similar factors.

Cost of Operation

Budgeting Personnel and Costs

Of the firms visited and of those who answered the questionnaire, only a small minority use money budgets. The reasons given for not using such a budget are: (1) conditions fluctuate too much to make ordinary budgeting practical, and (2) the benefits derived do not compensate for the time consumed in constructing the budget. Examples of large, unexpected tax fees and special fees distorting the revenue estimates were submitted in support of this argument. Also, it is difficult to predict staff salaries because

the need for additional men cannot be predicted without a better long-term knowledge than is available as to how audit engagements will flow. Previous attempts at budgeting left these firms unconvinced as to the value of so doing. One of them reported a 45% over-estimate in net profits for one year. It is ironical that these same accountants who serve clients in preparing budgets claim that budgeting is more feasible and more beneficial to industrial business than to those engaged in professions. This is especially true with functional budgeting, where each department, even including some of the junior employees, assumes a proportionate responsibility for accuracy in estimating. They hold that, with practicing accountants, there are other ways to watch and control costs and efficiency, such as work forecasts (budgeting of personnel). They feel this is closer to the CPA's needs, gets to the core of his real planning problem and, if done at sufficiently frequent intervals, can be adjusted easily. In actuality, according to this argument, personnel budgets are indirectly money budgets in their significant phases, and they take relatively little time to prepare.

One medium-sized firm, which makes quarterly work forecasts, also prepares a corresponding revenue budget of "repeat business," and measures those computations against the anticipated salaries related to this business. This encompasses the whole or any part of "repeat" annual or semiannual engagements falling within the quarter. It includes no part of known extra audit or tax fees, or related handling charges. Statistics are maintained and studied, the dual objective being to satisfy considerations of financing and economy and also to encourage, first, the conversion of as much business as possible to the "repeat" category, and second, the change-over of as many as possible of clients' closing periods from a calendar year to a natural fiscal year. The firm prepares and studies monthly financial and income statements, which show cumulative revenues and expenses. It deems that this, together with its "repeat business" budget, constitutes adequate surveillance.

In view of this available practical approach, it was not too surprising to find that not one large firm contacted utilizes detailed dollar budgets. However, this must not be interpreted to mean that some firms do not estimate periodically their staff salaries and major expenses in order to forecast costs and profits.

At least one member of the "minority" was emphatic in his praise of a full budget, particularly as applying to expenses. A partner in a medium-sized firm, he labeled as inconsistent the effort to talk up budgeting to clients by those who laugh off its usefulness to themselves. He thinks results are compensatory with the costs and time consumed in preparing them. Reasons for higher than justifiable costs cannot be discerned as easily without the "goals" and "appropriations" which afford intelligent comparisons. Without such comparisons discussion is not engendered and timely correction of unfavorable causes is not likely to occur.

Methods of Allocating Costs

Peterson¹³ provides a method of allocating costs to each job which is not necessarily tied into the firm's general books. He suggests the method of analysis and allocation, and sets up an expense budget and distribution. He recognizes the differences between departments (for example, audit and tax departments) and says that only by doing so can a cost system yield accurate information. These differences may take the form of differences in pay scales, hours chargeable to clients, working space and other overhead costs. The following is a condensation of his recommendations:

Set up predetermined costs and rates annually, semiannually, quarterly or monthly. Because the annual basis is more real than a shorter period and requires less work, he favors the annual basis.

The first step, then, is to estimate the expenses for the ensuing fiscal year (ignoring expenses chargeable to clients). The ultimate goal is to distribute total estimated expenses to each classification of direct workers, such as tax partner, juniors on audit staff and stenographers, to determine the cost rate for each classification. This rate is then applied to hours recorded on each engagement for each classification of direct workers. This will yield costs of jobs.

At least two ways of estimating or budgeting expenses are possible. The first is based on past history. Using last year's expenses, a factor is applied to bring them to what is believed they will amount to during the current year. The second is based on the future and involves estimating the number of hours required in each direct worker classification (partners, seniors and juniors) on each planned engagement. This, together with an estimate of new business, should be consolidated in a "production" budget expressed in terms of hours.

Charts should be set up and a summary made of the procedures to get cost rates and job costs. The charts are of a master budget, a subbudget and a job sheet in a hypothetical case. The charts help materially to understand the procedures quickly. The procedures are:

1. Estimate the expenses for the period.
2. Distribute the expenses to all departments, direct and indirect.
3. Distribute the expenses of the indirect departments to the direct departments.
4. Distribute the expenses of the direct departments to each direct worker classification within each department.
5. Estimate chargeable hours in each direct worker classification for the period.
6. Divide total expenses of each direct worker classification by estimated chargeable hours to get the cost rate.
7. Accumulate the hours in each direct worker classification on job sheets, multiply each total by the cost rate, and add the out-of-pocket expenses to get the costs of the various engagements.

Peterson also says of one illustration:

"The results expressed in the job sheet show that the fee for this engagement was adequate and resulted in a neat profit. But the sheet should be put to

further uses: first, as a means of control of costs; second, as a means of appraisal of individual efficiency; and third, perhaps as a means of a profit-sharing arrangement."

In noting that some of the bases used in prorating the expenses may not be strictly logical, and were chosen because the data were easier to obtain, Peterson observes:

"... using few bases rather than many facilitates the work of distributing the expenses to departments and direct worker classifications. It's perfectly all right to use short cuts provided the resulting error is small. The margin of this error should be determined and kept in mind."

Many firms believe that such refinements of internal accounting provide interesting exercises in costing principles but are unnecessary and not sufficiently beneficial to be worth while. Nevertheless, it is to be hoped that some experimentation will take place in the future along the lines of measuring departmental and job costs and profits for the practitioner. One firm prepares departmental operating figures, with costs and overhead expenses allocated to departments on the basis of relative gross fees. This does not appear to be very meaningful. The author believes that simple but effective departmental statements could be prepared on a basis of charging salary costs directly to departments and allocating other expenses on the basis of productive man-days in each department.

Replies to Questionnaires

The replies to the budget section of the questions show:

Cost of Operations

Question. Do you make use of periodic budgets?

% Yes	
S	16
M	33
L	0

Question. Do you budget the available time of staff personnel?

% Yes	
S	39
M	50
L	50

Question. Please indicate below any items which you consider in preparing your budgets:

Few answers were received on this point. They indicated that estimates of productive working hours of staff constitute the item most frequently considered. Others in their order of frequency were new business expected, expected changes in staff, prior year's expenses, salary adjustments, partners' drawings, and other expected operations changes.

Question. When the budget is completed, is some sort of a standard or budgeted charge per hour of labor established for indirect costs?

% Yes

S 37

M 50

L 0

Wage and Hour Problems

Without dissent, those questioned assert that the source of most of their wage-and-hour problems is Federal legislation. Competition with industry, especially in or near centers where defense projects prevail, is also a troublesome factor. The 40-hour workweek is gaining in popularity. More and more firms are attempting to shorten their workday — by reducing night work where possible. Saturday work is becoming less common.

Compensation Plans

Varying methods of overtime pay to covered employees are in use. Overtime is paid to all “nonexempt” staff members, that is, those who receive less than \$75 a week, and all office employees except those who qualify as “executive” or “administrative”.

The simplest method of payment is straight time-and-one-half, based on a 40-hour week.

Answers indicate the following order of preference as to other overtime payment plans:

The Irregular Workweek

This is known also as the fluctuating or variable workweek. Dividing the employee’s weekly straight time pay by the hours actually worked in that workweek will give his regular rate. This rate will, of course, vary if the number of hours worked varies. The excess over forty hours is the time for which the employee must be paid overtime in a single workweek consisting of seven consecutive days.

The Belo-Type Plan

This is a method in which there is (1) a “regular” hourly rate for the first forty hours, (2) another rate of one-and-a-half times the regular rate for hours beyond forty and (3) a guaranty of a minimum weekly salary regardless of hours.

In this type of overtime pay computation, the regular rate is usually set low, so that regular time plus overtime does not exceed the guaranteed minimum. If the regular rate is set at 1/60th of the weekly minimum, 55½ hours (forty at regular rate and 15½ at time-and-a-half) will produce a wage equal to the guaranteed minimum. A \$60 weekly minimum, there-

fore, would result in \$1.00 per hour regular pay rate for 40 hours and \$1.50 per hour for $13\frac{1}{3}$ hours.

The Time-Off Plan

This involves the allowance of time-off during the duller periods to offset overtime worked. Care must be taken not to violate legislation. Time-off allowances must be within the same pay period as the one when the overtime was earned (The time-off plan is limited to the biweekly, semimonthly, and monthly paid employees; it does not apply to weekly payrolls). If, for instance, the pay period runs for two weeks and overtime is put in by the employee during the first week, offsetting time off is given him during the second week, and thus his pay is a constant amount.

The Long Workweek Plan

This makes it possible to comply with overtime provisions without increasing costs in the case of employees working *regular* workweeks in excess of forty hours. Such employees are placed on a regular workweek of more than forty hours (say forty-eight hours) at a stipulated salary (say \$65.00) that includes overtime. The regular rate of pay is computed by dividing the salary (\$65.00) by the total hours (48) plus half the number of hours in excess of forty. The regular rate is therefore \$1.25 per hour, and total pay is \$50.00 for forty hours plus \$15.00 (at time and a half) for eight hours.

To make this arrangement effective, each such employee must understand clearly that his stated salary includes overtime for the hours in excess of forty, and also that if he works more or less than the stipulated normal long workweek on any occasion his pay will be increased or decreased in relation to overtime covered by his regular salary for the usual period.

Replies to Questionnaires

Questionnaire answers on wage problems follow:

Wage and Hour Problems

Question. What is the source of most of your wage-and-hour problems:

	% Yes
1. Unionization?	S 0
	M 0
	L 0
2. Federal legislation?	S 100
	M 100
	L 100

Question. In complying with Federal legislation, do you attempt to differentiate among any of your activities as to whether or not they come within the definition of interstate commerce?

% Yes

S 8

M 6

L 0

Question. Where employees are to be paid for overtime as required by Federal law, please indicate below what methods of personnel utilization and compensation you have found most satisfactory:

% of Firms

1. The irregular workweek

S 47

M 46

L 17

2. The Belo-type plan

S 16

M 23

L 34

3. The time-off plan

S 11

M 15

L 0

4. The long workweek plan

S 6

M 15

L 34

Other Employment Policies

Employer-employee relationship policies revolve around more factors than length of the workweek and the fairness of compensation. Those gaining more prominent places in the picture are rest periods, "coffee" time, supper allowances, car parking allowances when working at night, extra post-rush-season vacations, considerations for out-of-town work, pension programs, group insurance, and hospitalization insurance plans. A few firms are providing or planning to provide special lounges for women employees. The "little things," such as presenting brief cases to seniors and tax guide books even to juniors, go far to promote good relations. The need for comfortable working conditions is being recognized as a must if the profession is to avoid losing its staff assistants to competing defense industries and others. Pampering is, naturally, not advisable. Practitioners must operate under reasonable rules, and heedless violations of rules by employees cannot be tolerated.

The problem of vacations and holidays is often vexing. Since the clients' demands are paramount, it is well to have a definite understanding with new staff employees when employment begins. While everyone, without exception, should get his agreed-upon vacation some time during the 12-month period, staff workers must be warned against making inflexible vacation plans because, all too frequently, deferment may be necessary. This is a traditional hazard of the profession.

Traveling Expense and Arrangements

The practice of a flat traveling per diem allowance plus transportation is gradually disappearing in favor of allowing actual reasonable expenditures. The preponderance of firms allow breakfast, lunch and dinner, but some do not include lunch on the ground that this is not an added burden when away from home. Normal gratuities are considered to be reimbursable. Most firms visited allow 7¢ per mile to those using their own cars, regardless of the number of passengers. A few make small extra allowances for the first and second extra persons going on firm business.

Several firms permit those conducting protracted out-of-town engagements to come home for week-ends provided the distance is not too great, transportation schedules are reasonable as to time consumption and cost, and the client's interest is not unduly affected. The custom of charging the client with traveling time within the normal workday is prevalent.

Responses to Questionnaire

The replies to questions asked about traveling expenses follow:

Question. Ordinarily all traveling expense is charged at cost to clients on whose behalf disbursement is made.

% Yes

S 94

M 94

L 100

Question. Where staff members use their own cars to travel on the firm's business, they are compensated for such travel expense.

Answers show that practically all firms pay a stated rate per mile.
Only two firms reported paying a flat sum.

Question. The rate or sum allowed:

Varies according to the number of staff personnel in each car.
A few firms do this.

Is limited so that the total expense will not exceed train, bus or plane fare to the same point.

An appreciably larger number favor this.

Varies according to any appreciable saving in time resulting from course compared with travel by public conveyance.

Almost no firms practice this.

Question. Where a mileage rate is used, it is a minimum of _____¢ a mile for one person, plus _____¢ a mile for each added person.

	Amount per Mile For One Person or More					
	5¢	6¢	7¢	7½¢	8¢	10¢
Small firms (%)	13	26	21	10	17	13
Medium firms (%)	0	27	47	7	19	0
Large firms (%)	0	33	67	0	0	0
All firms (%)	7	27	34	7	17	8

One small firm pays 5¢ per mile for one person and 5¢ for each additional person, and one pays 7½¢ for one person and 3½¢ for each additional. A third pays 5¢ for one person plus gas and oil. One large firm pays 7¢ for one person and 1¢ for each one additional. Another large firm pays 7¢ for one person, and where there are more persons, the owner of the car may charge the equivalent of the aggregate railroad fares.

Supplies

Supplies and stationery cost is a substantial one in the accountant's expense statement. In most firms the physical handling is probably a bit loose. Rarely, indeed are there practitioners using such refinements as perpetual inventories, printed or written requisitions, or even periodic physical inventory-taking — except at the close of the accounting year, and not even then in some firms. Although most firms place the responsibility for purchasing on one individual, there are many who permit the head stenographer to buy all the supplies needed for her department without clearing through a partner or office executive.

Control over Supplies

The size of the firm, naturally, governs the extent to which controls should be applied. It would be absurd for the beginner with, perhaps, one or two staff assistants and one secretary-typist who also does most of the bookkeeping, to employ requisitions and purchase orders and to maintain perpetual records of inventories on stationery and supplies. But larger firms are wise to keep control of their most expensive supply items at least.

An intelligent middle ground should be sought, especially by the small and medium-sized firms. The author thinks the following constitutes minimum watchfulness:

1. Check frequently on high cost, large-volume items, the stocks of which undergo almost daily withdrawals by staff members and others, especially if withdrawals are not cleared by some official employee in charge.
2. Check on items, regardless of cost, which are special to the firm, obtainable from perhaps one or few suppliers, and consequently not as easy to acquire as are the more standard, competitive products. These should be watched, not necessarily from the standpoint of cost only, but also in the light of the inconvenience their unexpected depletion would cause.

Among those usually coming within the two categories outlined above are ruled columnar work paper, preprinted work sheets, and special forms, such as confirmations bearing the firm name. This is, of course, only a partial list. Some other high cost stationery need not have as close surveillance. Falling under that latter classification would be those items with which the head stenographer comes in daily contact, such as engraved letterheads and envelopes and report covers, and made-to-order report bond paper with particular rulings. Since these are usually in packs of a certain number each, and stacked in cabinets or shelves to which the stenographers, by virtue of their daily needs, frequently resort,

it would be unlikely that they would not observe the degree of diminution of the various packs, and arrange for reorder.

Postage, especially in medium-sized and large firms, is worthy of consideration; but too much time should not be given to worrying about relatively low cost units, such as carbon paper, typewriter ribbons, file folders, second sheets and the like.

When an office manager or some other executive has charge of purchasing — a desirable control when feasible — the solution to the problem of waste is eased. He establishes maximum-minimum requirements. Even without a system of requisitions and purchase orders and formal inventory cards or accounts, he can pursue a course similar to the one adopted by a medium-sized firm in the South which is described briefly.

That firm multiliths inventory blanks which show, by classifications, all sizes and kinds of supplies used in the office. These blanks serve the following purposes:

1. A physical inventory of quantities only (ignoring broken packages) is taken in pencil at the close of each month.
2. Using the same type of sheets, listings are made in ink from vendors' invoices of the dates and numbers of packages of stationery and supplies received, continuing until the end of the semiannual period. No inventories are recorded on this sheet.
3. At close of the first and the second half of each fiscal year, a complete physical inventory is taken, priced and extended.
4. A summary then is prepared showing inventory at the first of the period, purchases, inventory at the end of the period, and amount used. By keeping past performance figures, a fair judgment can be formed regarding waste as well as future inventory requirements.

This firm purchases from one producer, at an agreed price fixed in advance, columnar work paper and certain confirmation forms not expected to change. The producer stocks two years' supply and the firm draws against this stock as needed, at which time the producer invoices the firm. The firm guarantees the purchase of the entire quantity, subject to the usual warranties of quality.

Another firm, a small one, saves considerable time by taking physical inventory of stationery and supplies as follows:

1. A sample sheet of the item about to be counted is lifted from one of the stacks, or from a loose group of the forms.
2. After counting, the number of packages is written on the sample sheet.
3. The inventory quantities and descriptions are listed from the sample sheets.

Questionnaire Replies

Questionnaire answers follow:

Question. Is the responsibility for purchasing supplies placed on one individual?

% of Firms

S 81

M 100

L 90

1. If so, is he a partner?	S	38
	M	22
	L	6
2. Is he the office manager?	S	13
	M	56
	L	30
3. If a partner does not do the purchasing, does one of the partners supervise that activity?	S	47
	M	61
	L	70
4. Are purchases of supplies controlled by a supplies budget?	S	9
	M	6
	L	10

Question. Do you maintain perpetual records of supplies inventories?

% Yes	
S	8
M	33
L	40

Question. Are withdrawals of supplies made by written requisition?

% Yes	
S	0
M	11
L	20

Question. Are they charged to specific departments as issued?

% Yes	
S	0
M	0
L	0

Question. If you have no perpetual inventory and no requisitions, are all staff members free to take supplies as they are needed?

% Yes	
S	84
M	67
L	60

Entertainment

Firms visited follow more or less the same policy on entertainment as those who answered the questionnaire. Practically no limitation is imposed on partners, while practices vary with respect to seniors; no firms allow juniors to entertain clients or their employees. As to seniors, generally the participants in entertainment are old-line staff men who know certain particular clients well, especially out-of-town clients with whom those seniors talk oftener than do the principals.

Because of the rather strict burden-of-proof provisions in the tax laws

and regulations, detailed entertainment expense records are asked for by practically all firms.

Accounting Records of Operation

Much has already been said about the accounting records used by firms under the subjects Time Reports, Time and Overtime Records, Work Progress Records and Accumulation of Charges to Clients. These discussions also covered certain elements of costing.

It has already been stated that less than one-half of the firms use actual costs on work in progress. Those who accumulate charges to clients' accounts on a basis which includes salaries, overhead and profit are growing in number. A "standard" or "ideal" rate is chosen by each firm for this purpose. Few firms use an offsetting reserve when accumulating charges. A large part of the bookkeeping is done on loose-leaf forms and sheets, such as time reports, time ledgers, unbilled receivables ledgers (for time and dollar accumulations).

Fiscal Year

As stated in the questionnaire answers, there is an appreciable number of firms not using the calendar year for their own operations. May 31, June 30, August 31 and September 30 are the more popular closing dates. Several who choose April 30 reason that, although it is not the close of a normal calendar quarter, it nevertheless represents the last heavy month of the rush season. It is possible at such a time to bill out a large portion of the accrued receivables, thus permitting a more accurate determination of earnings.

Accounting Basis

The accrual basis is definitely gaining favor over the cash basis. Hybrid bases are rare. Prevalent in all sizes of firms is the custom of charging expenses directly from the cash disbursements and setting up unpaid bills and accrued expenses at the close of each accounting period during the year, frequently on working papers only.

Books and Records

For qualified accountants, a discussion of columnar general books of original entry and ledgers would be superfluous. As a supplement, however, to the special "forms bookkeeping" covered already in other sections, it is pertinent here to present special approaches to objectives which are pertinent to the accounting practitioner, particularly in payroll systems and charts of accounts. It also is deemed advisable to furnish an example of how one firm accumulates its time, salary costs and expenses through the ultimate points where (1) the client is billed and (2)

to earnings. At the close of the accounting periods, entries are made clearing the accumulations in the promotional traveling and other nonrecoverable expense accounts by transferring them to proper general ledger accounts. Offsetting credits, naturally, go to Undistributed Expenses — Clearing Account.

The procedure used by one smaller firm differs in several respects. Its system involves holding open its cash disbursements book until all creditors' bills come in and current social security and withholding taxes are computed. Then the firm draws checks and makes entries for all of these items in order to have the nominal accounts charged through that single source into the month in which they belong. No accounts payable or accruals are set up. All monthly charges to clients for traveling are shown on a columnar analysis sheet which the firm terms a traveling expense summary. This sheet is prepared from the details entered daily onto a large distribution sheet taken from weekly reports of partners and staff men. The traveling expense summary provides for a list of the staff on the left followed by debits for accounts receivable, traveling expenses, and miscellaneous expenses. Credits are provided for cash in bank, traveling expenses and advances. A column is provided for check number and a number of columns for the names of clients to whom charges are to be made. These columns give the details of the debit to accounts receivable, which are in turn later cleared out by billing.

Special Forms and Methods for Payrolls

Several modern systems of handling payrolls are available. All embody the same major principles of time-saving and the fulfillment of wage-and-hour and withholding-tax law requirements. Many stock forms, not unified with others into a full system, are on the market. Except for the classification of employees, little difference exists between the payroll of the public accounting office and those of most businesses.

One large firm uses a National Cash Register machine to handle its payroll records. Several firms reported the separation of funds for payroll purposes by a separate "payroll" bank account handled as a revolving fund with a fixed balance. Besides affording better protection and a clearer record, the numerous "payroll" account checks may be signed by a key employee other than a partner, thus saving the latter's time.

Charts of Accounts

Charts of accounts furnished by a small practitioner, a medium-sized firm and a large firm, appear as Figures 1, 1 (a), 1 (b), and 1 (c). Also, Charles S. Rocky¹⁴ suggests two charts of accounts for a medium-sized firm, one maintained at the main office, the other at the branch. A study of them, with his explanations, should prove interesting.

From these charts of accounts and supporting records are prepared the financial statements, with details as desired. Of the firms answering the

questionnaire on this point, 60% make up financial statements monthly, 12% quarterly and 24% only yearly. One makes them up semiannually, another "when curious." With few exceptions, the statements seem to be limited to the statement of income and expense and the balance sheet.

**Model of System Used to Accumulate Time,
Costs and Expenses and to Bill Clients**

Included in Appendix B is a list of Exhibits A through H, further identified as Figures 23 (a) to 23 (h) inclusive, which comprise the accounts and forms utilized by a medium-sized firm to record the accumulations of time, costs and expenses against clients, resulting in the final bill to one of said clients. For convenience the assumed client name, X.Y.Z. Corporation, is used to follow through the transactions.

The following description of the forms and their uses may be helpful in studying them:

Exhibit A

Numbers and names of the principal general ledger accounts involved in recording the transactions. To the right of each account, where deemed necessary to proper understanding, appear the names of the forms or books of original entry from which the postings came.

Exhibit B

Filled-in time report (front) and expense report (back) of partner, Mr. A., for the week ended May 18, 1952. The time against the X.Y.Z. Corporation is 18¼ hours; the expenses against the same client, \$18.65 for Mr. A.

Exhibit C

Filled-in cost sheet for the X.Y.Z. Corporation from April 6, 1952 (date of first charge), through May 18, 1952 (date of final charge). The April entries in the Cost Summary at the bottom of the cost sheet show \$618.00 for partners and \$262.43 for staff. As to the expenses of \$368.69, details of postings on the cost sheet during April total this figure. Entries to the cost sheet emanate from time and expense reports, hence Mr. A's column, line 5/18/52, shows 18¼ hours and expenses of \$18.65. (See Exhibit B).

Exhibit D

Summary of time reports, month of April 1952. A cut-off at April 30 was applied purposely instead of taking the summary through the final cost sheet date, in order to emphasize the step-by-step progress. Likewise, and for the same reason, only the weekly and accumulated charges of X.Y.Z. Corporation time — no other clients or noncharged time — with dollars and cents extensions, are shown to facilitate checking against Exhibit C. Postings to this form come from partners' and employees' time reports. (Exhibit B, front). The digits after the decimal points represent fractions of hours.

Exhibit E

Summary of expense reports, filled in only for Mr. A's expenses for week ended May 18, 1952, showing numbers and names of accounts to be debited and credited when processing expense allowance. Postings to this form come from partners' and employees' expense reports. (Exhibit B, reverse side).

Exhibit F

Cost of jobs billed, filled in to take in total charges to date for salary costs and expenses against the X.Y.Z. Corporation only. The “articulation” section at the bottom of the form (compare with Exhibit C) shows that the entries for billing and for accrued costs on engagements (X.Y.Z. Corporation) will be:

<i>Debit Account</i>			<i>Credit Account</i>		
<i>No.</i>	<i>Name</i>	<i>Amount</i>	<i>No.</i>	<i>Name</i>	<i>Amount</i>
* 121—	Accounts Receivable	\$3,081.50	401—	Professional fees (income)	\$3,081.50
411—	Direct costs:		131—	Inventory of direct costs on	
	Salaries — partners (an			engagements in progress:	
	expense account)	835.00		Salaries — partners (asset)	835.00
412—	Direct costs:		132—	Inventory of direct costs on	
	Salaries — staff (an			engagements in progress:	
	expense account)	392.27		Salaries — staff (asset)	392.27
** 121—	Accounts Receivable —		133—	Inventory of direct costs on	
	for chargeable expenses			engagements in progress:	
	only	491.81		Expenses (asset)	491.81
	* Fee for services, exclusive of expenses	\$3,081.50			
	** Charge for expenses	491.81			
	Total bill to client (See Exhibit C)	\$3,573.31			

Exhibit G

Inventory of work in progress, filled in to take in April entries only covering salary costs and expenses accumulated to date, but not yet billed to the X.Y.Z. Corporation. The memorandum at the bottom of the form shows that each column must agree with its respective subcontrolling account and that the total of all columns must conform with the balance in the main controlling account of direct costs on engagements in progress, #130.

Exhibit H

A continuous debit and credit summary, by months, of entries made to the various detailed accounts controlled by account #130, direct costs on engagements in progress. The "additions" and "deductions" each month come from sources as explained on the Note on Exhibit H. The totals of the detailed amounts accumulated against the clients but still unbilled to them, at the close of any month, as listed to the right of the names of clients in the inventory of work in progress, Exhibit G, must balance with the corresponding end-of-month "balance" figures on Exhibit H.

Replies to Questionnaires

The information collected on accounting records of operations by questionnaire shows the following:

Question. Do you use the calendar year in accounting for your operations?

<i>% Yes</i>	
S	44
M	22
L	20

If not, when does your fiscal year close:

Of those closing their books other than on a calendar year basis, 20% close September 30, 17½% June 30, 17½% August 31, and 12½% May 31.

Question. Please state which of the following bases of accounting you use:

	% of Firms	
1. Cash basis	S	45
	M	30
	L	10
2. Accrual basis	S	55
	M	70
	L	90
3. Accrual for expenses, cash for income	S	0
	M	0
	L	0
4. Accrual for income, cash for expenses (included under item 2).	S	13
	M	6
	L	10

One each of the small, medium and large firms uses the cash basis for income tax purposes and accrual basis for financial statements.

Cost or Selling Price Basis

Question. Which of the following bases for accumulating charges on an engagement do you use?

	% of Firms	
1. Cost basis	S	37
	M	36
	L	36
2. Selling price basis	S	43
	M	50
	L	45
3. Average per diem earned	S	0
Previous month	M	0
Previous accounting year	L	0
4. "Standard" per diem for class of work performed (for reasons of ease and uniformity) with offsetting reserve for that part of accumulated charge not expected to be billed.	S	20
	M	14
	L	19

Question. If you use a cost basis for accumulating charges, do you adjust to selling price for work in process:

	<i>% of Firms Using Cost Basis</i>		
1. At the end of an accounting period?	S	0	
	M	11	
	L	25	
2. Upon completion of an engagement	S	30	
	M	11	
	L	0	
3. At time of billing client?	S	70	
	M	78	
	L	75	

Books of Account

Question. Please check any of the following divisions which you use in classifying your income accounts and cost accounts:

	<i>% of Firms</i>		
1. General audits	S	25	
	M	28	
	L	50	
2. Special audits	S	16	
	M	6	
	L	30	
3. Tax returns	S	25	
	M	28	
	L	40	
4. System installations	S	13	
	M	17	
	L	40	
5. Consultation with clients' management	S	3	
	M	0	
	L	20	
6. Investigations	S	6	
	M	0	
	L	10	

Question. Please check any of the following types of journals and ledgers which you use:

	<i>% of Firms</i>		
1. Cash receipts book	S	100	
	M	100	
	L	90	
2. Cash disbursements book	S	82	
	M	90	
	L	90	

Several firms combine (1) and (2)

3. General journal	S 82
	M 100
	L 100
4. Voucher register	S 7
	M 21
	L 0
5. Check register	S 46
	M 37
	L 40
6. General ledger	S 100
	M 95
	L 100
7. Cost ledger (statistical)	S 32
	M 42
	L 50
8. Clients' ledger	S 90
	M 95
	L 100

Financial Statements

Question. How often do you make up financial statements?

	Per Cent of Firms		
	Monthly	Quarterly	Yearly
Small	59	15	26
Medium	57	14	29
Large	86	0	14
All	<u>63</u>	<u>12</u>	<u>25</u>

In addition, one small firm makes up statements semiannually and another "when curious."

Question. Do you prepare comparative statements:

% Yes
S 61
M 76
L 80

Question. Do you prepare income statements on a percentage basis?

S 19
M 22
L 37

Other Problems of Operation

Insurance Coverage

A comprehensive treatment of this problem is afforded by the numerous questionnaire answers. Recommendations of an insurance expert in Louisiana outlining desirable coverage for a public accounting firm will be found as Appendix C to this chapter.

Answers to questionnaire on insurance coverage follow:

Question. Which of the following do your insurance policies show as the insured?

	% of Firms
1. The firm name	S 74 M 100 L 88
2. All individual partners	S 22 M 0 L 12
3. All partners listed as individuals doing business under the firm name.	S 4 M 0 L 0

Question. Bonding of employees

	% Yes
1. Are all of your employees placed under fidelity bond?	S 21 M 28 L 50
2. Does such bonding cover any loss resulting from the handling of clients' funds by members of your staff?	S 17 M 28 L 40
3. Does your bond coverage include all temporary employees taken on at peak seasons?	S 14 M 22 L 50
4. Please indicate below what type of bond is in effect in your firm.	

Answers indicate most firms have a blanket bond. Schedule and individual bonds are also used in a few cases and one medium firm occasionally gets special bonds on special engagements.

Question. Do you carry valuable papers insurance?

	% Yes
	S 25 M 33 L 22
1. Does valuable paper coverage apply only to the records kept in your firm's premises?	S 12 M 17 L 0

2. Where papers outside the premises are covered, what portion of the liability for loss does the insurer cover?

Three small firms report 100%, two others 10%. Two medium firms say 100% and one says to \$1,000. One medium firm reports it has full coverage on current working papers and only 35% on papers

of prior years. One large firm reports 100% up to a maximum of \$1,500, another reports 100% (without any limitation).

3. The "valuable papers" insurance specifically covers:

	<i>% of Firms</i>
Working papers	S 89 M 83 L 50
Reports	S 67 M 67 L 50

4. How do you determine the value of papers to be insured?
(Please explain)

Representative answers are:

Firm

No. Small Firms

- 1 Replacement time at regular billing rates.
- 2 Necessary reproduction value.
- 3 Nominal amount only. Never suffered a loss.
- 4 Flat \$5,000 — sufficient to cover cost of reproduction on our present largest single assignment.

Firm

No. Medium Firms

- 1 "Step it off" at \$20,000.
- 2 Arbitrary lump sum — \$1,000 for loss from any cause; \$1,000/\$20,000 for loss from any cause except misplacement or disappearance.

Large Firms

Approximate cost of reproducing the lost papers.

5. If you have no "valuable papers" insurance in effect, does your fire insurance cover the destruction of such papers by fire?

<i>% Yes</i>
S 38
M 38
L 67

Question. Liability coverage

1. Insurance is carried to cover the firm against loss through claims by clients based on allegations of negligent or fraudulent acts or omissions by the firm in engagements.

<i>% of Firms</i>
S 77
M 83
L 100

2. The actual liability insurance now carried:

Small Firms: Range: \$20,000 to \$500,000. Six firms have \$20,000, three \$30,000, three \$100,000 and two \$50,000. One each has \$40,000, \$60,000, \$200,000, \$250,000 and \$500,000.

Medium Firms: Range: \$20,000 to \$1,000,000. Three have \$100,000, two \$40,000 and one each \$20,000, \$60,000, \$80,000 and \$1,000,000.

Large Firms: Two have \$250,000 and one each \$100,000, \$200,000, \$5,000,000, \$750,000, and \$1,000,000.

3. Where such liability insurance is carried, does the policy provide that in every loss thereunder, the insured shall absorb all loss up to a specified amount?

% Yes

S 26

M 13

L 45

4. The amounts specified in 3 are all small, ranging from \$500 to \$1,500 in each loss.

5. The liability insurance policy carried extends for

	<i>One Year</i>	<i>Two Years</i>	<i>Three Years</i>
Small firms (%)	72	6	22
Medium firms (%)	62	0	38
Large firms (%)	67	0	33
	—	—	—
All firms (%)	<u>69</u>	<u>3</u>	<u>28</u>

6. Where liability insurance is carried, does it protect the firm also against loss or claims against it resulting from work delegated by the firm to an outside accounting firm?

% Yes

S 36

M 45

L 57

Where there was coverage as to delegated work, an extra charge for it was made in only one-tenth of the cases and then only as a flat charge (not extra premium) in the case of large firms.

Question. Other forms of insurance carried include the items checked below:

Answers on this phase of the questionnaire show that 75% of all the small firms and practically all of the medium and large firms carry public liability insurance on automobiles. Next in order of frequency is workmen's compensation insurance with about similar holdings except that the proportion for small firms is reduced to about 67%. Fire insurance is carried by almost as many firms of all sizes as have workmen's compensation insurance. Then comes partnership life insurance carried by about one-third of all firms. Insurance against theft is held by about one-fifth of small firms and one-third of medium and large, and forgery and sprinkler leakage

by appreciably less. (Various forms of group life, accident and health insurance, as well as pension and retirement plans, are also in effect. These are discussed separately in Chapter 10).

Question. On insurance covering automobiles owned by staff members.

	% of Firms	
1. The premiums are paid by the car owners, who are reimbursed by the firm, and the firm is designated in the policy as one of the insured.	S	21
	M	13
	L	0
2. The firm itself carries nonowner insurance on the cars.	S	63
	M	87
	L	100

Question. Partnership life insurance is carried to provide cash funds essential to liquidation or reorganization under the partnership agreement.

% of Firms	
S	31
M	33
L	40

Question. The partnership life insurance arrangement

	% of Firms	
1. Provides separate policies on life of each partner.	S	100
	M	100
	L	100
2. A joint policy covering all lives where the partnership shares are equal.	S	0
	M	0
	L	0
3. Policies payable as endowments at given periods instead of death benefits.	S	0
	M	0
	L	0

Premiums are paid

	% of Firms	
1. By partners on all of their lives according to their respective shares in the profits	S	18
	M	29
	L	0
2. From a pool to which partners contribute on some other stipulated basis	S	9
	M	15
	L	0
3. By each partner on each of his partners' lives or his appropriate share of the total premiums on the insurance covering his partners	S	18
	M	29
	L	33
4. By each partner in the amount of the premium on his own policy	S	45
	M	0
	L	33

Library and Information Services

Most firms have libraries. Many keep up-to-date card indexes on their books. Readers should refer to Chapter 4 for a comprehensive discussion of professional literature.

One accountant states¹⁵ that his firm's accounting books and pamphlets of lasting interest are indexed three ways — by authors, titles and subjects. Periodicals, except those of lasting interest, are retained for only a short time. Particularly interesting articles are cut out of the periodicals and placed in an indexed scrapbook. A master list of the books in the library is prepared at irregular intervals for distribution to the staff. As new books are added, a notice is placed on the bulletin board. He suggests that every CPA should obtain the Accountants' Index, issued by the American Institute of Accountants.

Replies to Questionnaire

Answers to questionnaire items about practices of maintaining and using a library reveal the following:

Library and Information Services

Question. Do you maintain a staff library?

% of Firms

S 94

M 94

L 100

Question. If yes, please indicate below the different types of books (exclude tax services) you have and the approximate number of volumes of each general type:

	<i>Average No. of Volumes</i>
1. Accounting texts	34
2. Reference books	23
3. Auditing texts	14
4. Commercial law	14
5. Banking and finance	7
6. Business organizations	9
7. Economics	4
8. Statistics	6
9. Marketing	6
10. Public utilities	3
11. Professional	13

Question. Please indicate below the different types of tax services you use and the number of each (if more than one):

		Per Cent of Firms Having Services Using Number Shown					
		1	2	3	4	5	7
1. Federal income tax	S	54	14	25	7	0	0
	M	29	29	21	7	7	7
	L	42	29	0	29	0	0
2. State tax	S	92	4	0	0	4	0
	M	84	8	8	0	0	0
	L	83	17	0	0	0	0
3. Social security tax	S	95	5	0	0	0	0
	M	85	0	15	0	0	0
	L	100	0	0	0	0	0
4. Unemployment insurance	S	94	6	0	0	0	0
	M	85	15	0	0	0	0
	L	100	0	0	0	0	0
5. Tax court	S	95	5	0	0	0	0
	M	77	23	0	0	0	0
	L	86	14	0	0	0	0
6. Capital changes	S	100	0	0	0	0	0
	M	80	10	10	0	0	0
	L	100	0	0	0	0	0
7. Estate tax	S	88	12	0	0	0	0
	M	73	9	18	0	0	0
	L	86	14	0	0	0	0

Problems of Branch Office Arrangements

With the very large firms which operate branches in many cities of the United States and in foreign countries, the procedures are so standardized that little diversification is to be found regardless of location of the offices. Generally, less standardization becomes apparent as firm sizes get smaller, although there are exceptions. Since major policies, objectives and attitudes usually spring from the main office, having been tested there and found desirable, it is important that sufficient control by the home office be maintained over the branches to insure adherence to these desired practices. A large measure of uniformity should prevail, even in routine matters. For example, audit reports issued by all branches should be standardized.

The questionnaire answers set forth later suggest that branch office operations vary widely. The majority of the firms contacted pursue these policies:

1. Branch office management is in charge of a resident partner, who may or may not delegate the function.
2. Procedures are designed to minimize variations from home office practices.

3. Branch managers are brought in to the home office for conferences frequently.
4. Reports are written in the branches. In branches having resident partners, reports are signed by them; when in charge of a non-partner manager, reports are usually signed at the home office.
5. A little more than half the firms have their branches process and type reports. The great majority keep the permanent files of reports and working papers for branch office clients at the branch. In most instances, copies of typed reports and tax returns go to the main office.
6. When under a resident partner, the branch does its own billing and collecting; the opposite prevails when the manager is not a partner.
7. In many cases, the resident branch partners are not general partners of the firm, but participate in the affairs of their particular branch only.

Frequent Meetings Desirable

In the author's opinion, nothing can take the place of personal contact in keeping the operations of branches running smoothly. Through one means or another, meetings between main and branch office personnel should be held frequently. The partners should get together with each other and with assistants. Specialists at the home office should confer with their confreres at branches, particularly the tax men. Many round-table discussions should be held. Junior staff members should not be ignored. On the contrary, their participation in the deliberations will give them a feeling of being recognized and is bound to lift morale. Besides, it is not at all unusual to learn matters of consequence from the lower ranks. If there are many branches, at least one meeting each year should be held with all the partners present.

Reviewing Branch Office Reports

A medium-sized firm in the South permits its single branch office to process and type its interim reports on monthly and quarterly as well as run-of-the-mill small engagements, but no annual reports are released without home-office review of them and their supporting working papers. Sometimes the review takes place after the branch has already typed the report. No trouble of significance has ensued from this practice.

The partner of a large firm in the Middle West emphasized his belief that his firm's policy of permitting no reports to be released by a branch before home office review is the only safe course. His views are shared by others.

Interchange of Field Workers

The advantage of interchange of field workers is enjoyed by firms with branches, but only to a limited degree if the branches are few. A small firm with a nearby branch using three staff assistants sends men from the

home office when requisitioned by the branch manager. A more-or-less regular schedule is maintained, however, thus minimizing sudden calls.

Branch Office Records

Records similar to those at the home office are necessary at the branches, except that, usually, cash disbursements other than revolving fund payments are made by the main office. Branch records should include, but are not always limited to, accounts receivable collection lists (not ledgers which are almost always kept by home office), a simple general ledger with home office controlling account, a cash receipts record supported by deposit slips bearing payors' names, time reports and records, expense reports and records, and accountants' service records. Financial statements should be prepared by the branches at frequent and regular intervals.

Inquiry into Laws of State where Branch Office Is Planned

It is important to obtain legal advice from an attorney of the state where a new branch office is planned. The period of residence prior to opening, the matter of certification of partners, and other elements of partnership requirements should be inquired into before definite arrangements are made.

Replies to Questionnaires

The questions about branch office arrangements and the replies received to these questions present some information as to existing practices and ideas. The questions and significant replies follow:

Problems of Branch Office Arrangements

Question. Do you operate any branch offices?

% of Firms	
S	16
M	44
L	70

Question. Do you have correspondents or agents in cities where you have no offices?

S	13
M	28
L	90

Question. If you do have branch offices

% of Firms With Branches

1. Are they under the management of resident partners?

S	80
M	75
L	100

2. If not managed by resident partners, are such offices under the immediate supervision of partners?	S	20
	M	25
	L	0
3. Are the procedures used by branch offices designed to prevent any major variation from those of the home office?	S	100
	M	100
	L	100
4. Are nonpartner branch-office managers frequently brought in to home office for conferences?	S	100
	M	75
	L	67
5. Are reports written by the branch office?	S	60
	M	88
	L	100
6. Are reports signed by branch office manager? If he is a partner?	S	100
	M	67
	L	100
If he is not a partner?	S	0
	M	25
	L	100
7. Are reports processed and typed in branch office?	S	60
	M	71
	L	71
8. Are permanent files of reports and working papers for branch-office clients kept at the branch office?	S	100
	M	90
	L	100
9. Do branch offices handle their own billings and collections where they make an audit? If the branch manager is a partner?	S	80
	M	50
	L	85
If the branch manager is not a partner?	S	0
	M	25
	L	100

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Appendixes — Chapter 7

APPENDIX A — DETAILED DESCRIPTIONS OF FILING SYSTEMS

SYSTEM OF FIRM No. 1

Personnel in Charge of Filing Department. Physical Arrangement and Equipment (In Main File Room; In Working Paper Files). Initial Step in Starting a New File. Arrangements by Names, Types of Material, etc. (Procedure for Correspondence and Miscellaneous Materials; Procedure for Working Papers). Transfer of Inactive Material. Indexing. Cross-Filing. Controls of Withdrawals (Authorization for Removal of File; Established Rules Regarding Withdrawals). Destruction of Papers, Reports and Tax Return Records. Binders for Working Papers.

SYSTEM OF FIRM No. 2

Personnel in Charge of Filing Department. Physical Arrangement and Equipment. Initial Step in Starting a New File. Subdivisions of General Files. Indexing, and Cross-Filing of Working Papers. Arrangement by Names of Clients, Types of Materials, etc. Transfer of Inactive Files. Indexing. Cross-Filing. Controls of Withdrawals (Withdrawal Procedure; Established Rules Regarding Withdrawals). Retention and Transfer of Papers, Reports, and Tax Return Records. Binders for Working Papers (Correspondence; Working Papers; Tax Returns). Jackets.

VARIATIONS IN PRACTICE FOUND IN OTHER FIRMS

Firms Numbers 3, 4, 5, 6, 7, 8 and 9.

APPENDIX B — EXAMPLES OF OFFICE FORMS

APPENDIX C — INSURANCE COVERAGE RECOMMENDATIONS

Workmen's Compensations. Comprehensive General Liability. Comprehensive Automobile Liability. Comprehensive Fire, Theft and Collision. Comprehensive Dishonesty. Destruction and Disappearance. Accountants' Liability. Valuable Papers. Sprinkler Leakage, Fire and Extended Coverage. Plate Glass Insurance. Accident and Health Insurance. Partnership Insurance. Employee Benefit Plans.

Appendix A

DETAILED DESCRIPTIONS OF FILING SYSTEMS

Because of the importance to an accounting office of an efficient filing operation and the difficulties of giving general rules which are helpful, the filing systems in use in two firms are described in detail. In addition, certain pronounced variations in the general filing systems of seven other firms are discussed.

Terminology varies with different practitioners. Therefore, the following definitions will be used:

File — Term used to designate the whole file, consisting of outside jacket, inside folder(s) and contents of each folder.

Jacket — Term applied to the outside envelope or container only.

Folder — Term used to describe the inside container to which papers are bound.

SYSTEM OF FIRM NO. 1

This large firm files numerically. Its filing system is far more complete than would be appropriate for a small office. However, the methods followed can be adapted into a system for use by any medium-sized or small firm; or individual ideas may be obtained from the recited procedures.

Personnel in Charge of Filing Department

In this firm, a woman is responsible for the filing function. While she has ultimate responsibility for the entire filing, she has very little contact with engagement working papers, filing of which is under direct charge of a former accountant who has one assistant. However, even working papers clear through the office of the woman in charge, who maintains the master index. For convenience, the woman will be referred to as the chief filing executive, the man in charge of working papers as the head file clerk. Retired policemen and firemen, who may also serve part time in the mailroom and run errands, pick up files from and return them to the filing department. Occasionally, accountants do this themselves but they are not permitted access to the filing department.

Physical Arrangement and Equipment

This office has two separate file areas. The large main file room is separated from the engagement working paper file rooms by a short hall. In the main file room are the desks of the chief filing executive and five assistants, one of whom sits nears the entrance to the room and through whose hands all papers must pass. For convenience, this young man is

referred to hereinafter as the file clerk. All documents, except engagement working papers, are filed in this main file room. Copies of audit reports (in formal covers properly designated) are placed on open steel shelves, latest one to the right. All other records are placed in steel cabinets.

Several rooms house the steel shelving holding the engagement working papers, and in the approximate center of this space is located the office of the head file clerk and his assistant. Material to be filed is divided into the following groups and stored as indicated.

In Main File Room

Manner of Filing

- | | |
|---|---------------------------------------|
| 1. Correspondence (other than letters belonging in engagement working paper files) | In folders in steel drawer cabinets |
| 2. Interoffice communications | } In folders in steel drawer cabinets |
| 3. Copies of bills sent to clients | |
| 4. Various forms used by the firm, each with its own identifying number | |
| 5. Copies of typed reports (numbers assigned to reports of branches are preceded by letter x) | In own covers on open steel shelves |

In Working Paper Files

- | | |
|---|--|
| 1. Engagement working papers, other than in "permanent file" and "permanent tax file" (including correspondence pertaining to these) | } On open steel shelves in one common jacket |
| 2. Tax returns of the same year | |
| 3. Permanent file (audit engagements) | } On open steel shelves in separate jackets |
| 4. Permanent tax file (containing accumulated information of special note, including a record of tax cases settled, stepped-up bases of assets, depreciation basis different from books, et cetera) | |

Initial Step in Starting a New File

A new file usually is opened as a result of a letter which frequently is from an outsider but which sometimes originates within the firm. Occasionally, the initial step is an intraoffice communication. The events in a typical instance are as follows:

1. On April 1, 1952 a letter is received from the "Iron and Steel Co. of America, Inc.," asking the firm to audit the company's books.
2. After replying, the partner handling this letter sends the original letter and the answer to the file clerk.
3. After ascertaining that no file number has been established for that company, the file clerk enters a new (next consecutive) number on each letter and also in a small book measuring approximately 6 x 14 inches, each page designated by dates. A Bates numbering machine is used, the number being placed in the book at the left of the name of the new client. On the same April 1, 1952 page are entered the numbers and names of every document reaching the file clerk, whether or not the file is an old or a new one.

4. After numbering, the papers are deposited in a file basket until they are removed for filing by an assistant.

Arrangement by Names, Types of Material, et cetera

Procedure for Correspondence and Miscellaneous Materials

The files of the hypothetical client, Iron and Steel Co. of America, Inc., will undergo step-by-step handling in approximately the following order:

1. The client's original letter and partner's reply have been numbered, let us assume, 78871. As stated before, the file clerk machine-numbered the letters themselves and the left margin of the master book (same line as name of client) under date of April 1, 1952, when they first reached his hands. From then on all letters, working papers, reports, memos, requisitions, bills, et cetera, for that company will be given that number.
2. The letters are picked up from the file basket, Acco-fastened at the top to a correspondence-size manila folder on which is written on the outside in the upper right-hand corner "78871 — Iron and Steel Co. of America, Inc." Beginning at the extreme left, a little lower down, is shown, on this first folder, "April 1, 1952 to _____." Assuming the folder has all it can hold by the close of July 31, 1952, that latter date is inserted in the blank space, and a new folder is identified as "78871-2," and "August 1, 1952 to _____." Separate folders and filing cabinets are maintained for copies of bills (latest on top, the number preceded by the letter B), and formal office forms (all numbered 78871 for that client). A separate inside folder is maintained for interoffice and intraoffice memos and placed within the client's correspondence folder. The same cabinet may contain numbers 78871 to 78871-12 inclusive, covering say, two years.

Procedure for Working Papers

Before the working paper files are handed to the file clerk, they have been placed in proper order for final filing by a member of the audit staff. The senior in charge of the engagement writes in ink on the front (lower left) of the jacket itself, information similar to the following:

1. Name of client (Iron and Steel Co. of America, Inc.)
2. Designation of the jacket in which the papers are to be filed: (a) Current engagement file, or (b) Permanent file, or (c) Current tax file (accumulated papers on open cases. Tax returns go in "current engagement" jacket).
3. Fiscal year or period.
4. Summary of contents, as, for example: Semiannual report and working papers or permanent file (including amendments to charter and all minutes through December 31, 1951).

The senior does not record the file number. It is entered by the file department after the material has cleared through the file clerk. Although the senior in charge is responsible for binding his working papers in the proper order, the file is checked by the chief file clerk before the jacket is placed permanently on the shelves.

A master book also is maintained by this section showing under "today's" date the numbers and names of all files, new and old, handled that day, with (1) a short description of the material in the jacket, and

(2) an indication as to whether the material was sent in for the first time on that day or whether it had previously gone out and now is being returned to the working paper files.

In the upper right-hand corner of the jacket (easily visible on shelves) the client's number and fiscal year are entered by one of the two assistants. A heavy line is drawn under the top-line data, and beneath it is written, in order to standardize labeling, the file man's own version of proper content listing. If the same period requires two or more jackets, they are further designated as Jacket #1, #2, #3. In many instances, accumulations of several years go into the same jacket.

The head file clerk mentioned to the author that he was considering a separate jacket for each engagement year, even for clients for whom few working papers have accumulated. Although very little trouble has arisen from the cumulative process, he stated that one jacket for one year might be an improvement. Of course, this bears no reference to the permanent file or permanent tax file, the information in which is always cumulative.

Transfer of Inactive Material

No transfers of files are made due to age or bulk. The files remain in their original numerical sequence until destroyed in accordance with the firm's policies (see below).

Indexing

White cards, 4 x 6 inches, filed alphabetically by classifications, are maintained in neat, uniform rows of steel cabinets of appropriate size. The cabinet labels are clear and easy to read. Information on new files is posted several times daily from the master book.

Cross-Filing

Whenever a letter intended for filing in the correspondence section includes information bearing on an audit, tax or other engagement, extra copies are prepared for filing in the other appropriate folder(s). If the letter is long, and goes into other matters not related to that which is the subject of the other folder(s), only the related matter is copied and referenced to the original letter.

Controls of Withdrawals

Authorization for Removal of File

No signed receipt is required when files are removed. Withdrawals are recorded by means of either a "requisition" or a "charge slip." Assuming senior Louis Jordan had sent a messenger for three Registration Forms A for the Iron and Steel Co. of America, Inc., delivery would be made only

after placing a letter X through the printed line "Form A," on the requisition, writing the number 3 — as well as number 78871 at the right of the line and writing opposite "to whom charged" the senior's name, "L. Jordan." The requisition then is placed on a spindle resting on a table next to the file basket, to be destroyed after the file clerk has recorded the forms.

Assuming that tax department head John Levine has called for the entire permanent tax file for a client, a charge slip is used. The name and number of the removed file, the date and the name "J. Levine" are recorded on the slip, which is destroyed when the file is returned. No receipt is given by the filing department upon return of files, which are carefully checked before re-filing. The file clerk's master book is the only written record of the transaction.

Established Rules Regarding Withdrawals

These are some of the established rules on filing, in addition to those governing procedures listed elsewhere:

1. Correspondence and interoffice communication files must not leave the office nor be retained unreasonably long outside the filing department. They are not available except to partners for conferences with outsiders.
2. Copies of reports, tax briefs and important documents may be removed from the office only by special permission.
3. If, for example, a letter or working paper is asked for, the entire folder to which it is fastened must be delivered without removal of any part.

Destruction of Papers, Reports and Tax Return Records

Very seldom are working papers destroyed before the expiration of twenty years. The firm's stringent cremation policy is based on a plan carefully studied and approved by its attorneys. To err, if at all, on the side of retaining too many papers too long is better, it is thought, than taking a chance on premature destruction. Papers are never cremated without first submitting a list and a brief but adequate description of them to the attorneys. Frequently, files which are normally due for cremation under the approved plan are retained even longer, either because of some specific reason or as an added precaution. Papers deemed of sufficient importance are microfilmed before cremation.

Binders for Working Papers

The senior in charge of an engagement prepares an inside folder of heavy manila cardboard to hold side-bound working papers. The tax returns are filed in a manila folder bound on top. These folders are then placed in fibroid jackets, terra cotta color, of the accordion variety. Jackets are of the school wallet variety, apparently of the largest fibroid accordion type available, with covering flaps extending well down the sides. They are stoutly constructed and fastened by a lightweight ribbon.

SYSTEM OF FIRM NO. 2

This medium-sized firm files alphabetically rather than numerically. While modifications of its system might be desirable if it is to be used by a small firm, its procedures can be adapted to meet the requirements of firms of various sizes.

Personnel in Charge of Filing Department

A former accountant, referred to here as the head file clerk, is in charge of the filing system which was revised recently under his direction. He has full authority to manage the department under policies set by the firm. He has one part-time assistant who also runs errands and helps with multilithing and mailing. All papers sent in for filing are under the head file clerk's jurisdiction. These include correspondence, intraoffice memoranda, copies of reports, working papers, tax returns and protests, and documents relating to tax cases and controversies (after the tax department has settled them).

Physical Arrangement and Equipment

The entire file room is located in an enclosed hallway of the office building in which the firm rents most of one floor. The head file clerk's desk faces the entrance with a narrow aisle beside it, through which access to the file room is obtained. In front of his desk are three 4-drawer steel cabinets for temporary storage of "in use" file-folders.

The head file clerk has a 2' x 6' table on which to accumulate and sort papers. He has a typewriter to type file labels.

Two 3-drawer cabinets stand behind his desk. These are for "correspondence — other than clients." Casual letters are filed unbound in a special folder for each letter of the alphabet. If volume with one correspondent warrants it, a folder for that correspondent is opened. Correspondence with clients is filed in the jackets for the clients.

The shelving consists of sixteen stout steel sections, each with spacing of 11 inches in height, 15 inches in depth and 42 inches in length. The tiers are of six shelves each, the first being 11 inches from the floor. These shelves run down both sides of the hallway.

Initial Step in Starting a New File

A file is opened usually as a result of an intraoffice memorandum by a partner or supervisor stating that a new engagement is under negotiation or has been obtained. Also, files are opened based on letters from or to new or prospective clients. Because of the head file clerk's familiarity with the firm's affairs, special written instructions on starting new files are not needed. Questions are asked and answered orally.

**Subdivisions of General Files, Indexing,
and Cross-Filing of Working Papers**

The files are classified as follows:

<i>Classification</i>	<i>Manner of Filing</i>
Correspondence—other than clients	Loose — or bound if volume requires — in folders in file cabinets.
Correspondence — clients (other than letters belonging in working paper files) and Interoffice memoranda — clients	} Fastened in folders (Acco base only; no top bar fastener) in clients' jackets on shelves.
Copies of typed reports (blue covers to distinguish from clients' copies which are gray)	Permanent binding in own cover. One copy filed in current jacket; one copy in jacket for next period (senior may mark up this copy in writing next report).
Engagement working papers, other than those in "Permanent File" and "Tax File" (including related cor- respondence)	Bound with staples or "brads" at side. Filed in clients' jackets on shelves.
Permanent file	Bound with staples or "brads" at side. Filed in clients' jackets on shelves.
Tax returns — typed copies, also original pencil drafts	Acco-bound at top, one folder for each year. Filed in clients' jackets on shelves. (The typed copies of 1952 returns will go immediately into a 1953 tax return folder for use by the accountant when preparing the later return. On the 1952 typed schedules for returns, spaces are left to the right in which the accountant will enter the 1953 figures. By offset printing, the firm has had all pages of all tax blanks reproduced on one side of a page for each. For working as well as for ref- erence purposes, this makes it much easier for the user, since he does not have to turn the pages at any time. As little typing as possible is done on return blanks. Frequently, extra copies of audit report schedules are used in returns.)

Classification

Tax file (including tax history sheet and drafts of protests)

Manner of Filing

Acco-bound at top, one folder for each year. Filed in clients' jackets on shelves. (Every client has a tax history sheet inserted in his tax file folder. If there is nothing else in the folder, it is moved into the latest jacket for the client, as also is the permanent file. Only the tax history sheet, which is always on top in the tax file folder, is removed if the tax file has other papers (identified by year or period) which require it to remain in a special jacket. A new folder is then made for the tax history sheet and placed in the latest jacket for the client. The tax history sheet gives such information (written in as events occur) as: state in which client operates, last year examined, date deficiency or overassessment report was filed, and year covered. The history also shows whether or not the report has been agreed to and, if so, date of agreement form; date of protest (if filed); whether protest is of entire or part only of agent's report; date of conferences with adequate references to correspondence or intraoffice memos relating to conference; date of refund claims with references to actual claim forms; data relating to capital loss carry-over and operating loss carry-over; et cetera.)

***Arrangement by Names of Clients,
Types of Materials, et cetera***

As stated before, casual letters from and to persons or firms other than clients are placed loosely in folders, one of which is kept for each letter of the alphabet. When accumulations are sufficient in volume, such letters are bound together at the top to a folder which is placed in alphabetical order in the same cabinet. When a company with which there has been correspondence becomes a client, applicable letters are transferred to client correspondence and filed in appropriate jackets.

In general (but with variations noted), all papers for a client for a particular period are filed in the same jacket. The permanent file is always enclosed within the latest jacket, as is the tax history sheet. Tax papers on cases or controversies in process are kept in the tax department in steel cabinets. Several years of papers may be in one jacket, but if that for 1950 includes all the papers for that year no part of 1951 papers

may be added to it unless all of 1951 is included. It must contain *all* papers for 1950 and *all* for 1951, otherwise a new 1951 jacket is made.

Variations occur depending on circumstances. For instance, a company may have been only a tax client for years. One jacket may contain the last ten years of tax returns, each year's returns bound in one folder. An audit engagement for that client would not call for a change in filing procedure; the tax returns would still be filed in the same tax return jacket which, when filled, would be closed and replaced by a similarly-titled one. (Another variation to the set policy occurred on one occasion when the system was revised. Working papers for many clients had already been cremated, but all typed report copies and tax return copies were on hand. It was decided to place all reports in one jacket, all returns in another, properly labeled as to contents and dates. Later papers were filed according to the new policy.)

Two sizes of jackets are used, both of which are rigid and stand upright without need of extra support. The folders are of strong manila. Those used for working papers have two separate covers with surface areas measuring $9\frac{1}{2} \times 14\frac{1}{4}$ inches and with four holes at the side matching the binder-ring holes of the paper. Staples or brads are used in fastening the papers to them. At the top of the manila cover, written in ink by the in-charge senior, or under his supervision, the following appear:

1. Name of client.
2. Description of contents (current engagement, special investigation, permanent file, or tax file). Example: Examination of financial condition and review of operations.
3. Fiscal year or period.

The in-charge senior sees that papers are in proper order before sending them to the review department. The head file clerk glances over them before placing them in the jacket.

Labels (of gummed paper) are $2 \times 4\frac{5}{8}$ inches, the visible side being white with red-line trimming at the top and bottom edges. They are glued over the ends of the jackets about three inches from the top. For the sake of appearance, care is taken to place the labels in a uniform position. The following is an example of the identification typewritten on a label:

CLARK
A. B. Clark and Company, Inc.
New Orleans, La.
1950 --1952

If a letter is received from a prospective client in 1951 asking the firm to be his auditor beginning with the calendar year 1952, the 1951 correspondence will be placed in a 1952 folder and jacket when the audit agreement is closed. However, future letters will be filed within the jacket bearing the date (year) of the letters themselves.

Letters covering a tax controversy for 1949, written in 1952, go in the

1949 tax file folder and jacket after settlement. Cross-filing is accomplished by means of extra copies or memos and by proper narrative on the tax history sheet (see below).

Transfer of Inactive Files

As in the case of the large firm's system described previously, no transfers are made for noncurrent or inactive files. All jackets pertaining to one client are filed together, regardless of the age of contents. For example, the Grand Monarch Physics Laboratory, Inc., of New Orleans, La., could have these jackets standing in the order listed:

- Jacket No. 1 Income and Excess Profits Tax Returns 1938-1947
- Jacket No. 2 Income and Excess Profits Tax Returns 1948 —
- Jacket No. 3 Special Investigation
- Jacket No. 4 Current Engagement

The absence of dates following the dash in example No. 2 signifies that later papers are to be included. The jacket is still "current." If the engagement requires more than one jacket, the year (or years) covered are not followed by an open-end dash.

Indexing

No index is used. Two of the firm's partners feel that there should be one, despite the safeguard (limited) against undetected loss provided by the tickler system's old and current cards.

Cross-Filing

As with the large firm's system described earlier, related folders are appropriately provided with full copies or excerpts of letters. When, for example, in 1952 a deficiency report is received covering the years 1948 and 1949, the original or a copy is placed in the tax file folder 1948-1949; then a comprehensive memorandum for each year goes into the tax files (Acco-fastened to the 1948 and 1949 returns) and into the current folder to contain the next return.

Controls of Withdrawals

Withdrawal Procedure

No signed receipt is required when material is withdrawn. Withdrawals are recorded on an OUT card (Figure 32, measuring $9\frac{1}{2}$ x $11\frac{3}{4}$ inches. If Mark Solis, staff member, receives tax returns for 1950-51, his last name is placed in the first column, the description of the removed folders in the second column, the date in the third. These remain until the returns are replaced, at which time a line is run through the notations by the file person receiving them. With the three sets of columns on both sides, the OUT cards last a long time. The OUT card is placed

in the jacket from which a folder was removed, remaining there until the material is returned. No receipt is given at the time material is returned.

Established Rules Regarding Withdrawals

No bound working paper sheet or single letter can be removed. The entire folder is delivered. Jackets must never leave the file room. Whereas a rule forbids anyone but a file employee to remove folders from jackets, it is not always enforced, because there are times when neither of the two file employees are available.

Since no papers are allowed on desks at night or during the absence of the users, they are placed in the "in process" drawer cabinets. Each drawer is assigned (with exception) to three accountants whose names are typed on the drawer tags. Several slide supports within each drawer provide a convenient, flexible separation medium. A supply of school wallet jackets is furnished for use of accountants to enclose papers temporarily stored. When on jobs the field men are provided with ring binders. The working papers are side punched to fit these binders.

All papers supporting tax controversies at the levels of the field, conference, appellate staff or tax court, are retained in the tax department in special cabinets until settled. If original revenue agents' reports cannot be permanently retained by the firm, copies are made. Adequate summaries of revenue agents' reports by years are maintained in the tax file's tax history sheet.

Correspondence and intraoffice memos do not leave the office, and are not exposed when conferences with outsiders are held, except by express permission of a partner.

Retention and Transfer of Papers, Reports and Tax Return Records

All copies of reports and tax returns are retained permanently, as are the permanent file and the tax file. In slightly more than 50% of all cases, engagement working papers older than five years, and correspondence of the same age, are cremated after getting approval of the firm's attorney following an oral report to him. A brief record of name of client, general nature of papers, and of period covered is kept. Cremation occurs only after consideration by a partner. Any document of possible importance to the client is retained. Working sheets too important to destroy are transferred to the permanent file. All pencil manuscripts of reports are destroyed earlier after careful rechecking against typed copies. (Some firms destroy these immediately after typing.)

Prior to inauguration of the present filing system, many files older than five years were transferred and are still maintained in a nearby warehouse room. All keys to the room are in the possession of the firm. File jackets in the warehouse are maintained in the same order as in the office.

All engagement papers and correspondence of clients who ended relations with the firm more than five years ago are cremated. When they are brought to the incinerator in an enclosed truck, one of the seniors of the firm accompanies the driver to make sure that all papers are properly destroyed. In some instances, present and former clients have asked that working papers be turned over to them. While not encouraged as good procedure, such requests have been granted under condition that the firm's attorneys approve their release and render a written opinion that the transfer steps taken afford adequate protection.

Binders for Working Papers

This subject has already been outlined but is summarized here.

Correspondence

Binding is at the top to straight manila folders of $9\frac{1}{2} \times 14\frac{3}{4}$ inch size. The bases only of Acco-fasteners are used to save time. The staples are bent outward.

Working Papers

The in-charge senior gets an assistant to remove working papers from the ring-binders, after review, and brad them at the side to the two $9\frac{1}{2} \times 14\frac{1}{4}$ inch covers. The information mentioned previously is placed on the top cover, usually by the in-charge senior. Nothing else will be added to that package.

Tax Returns

Manila folders, with lips extending $\frac{7}{8}$ of an inch, of two sizes, are used. For smaller blanks, such as individual forms 1040, size $9\frac{1}{2} \times 14\frac{3}{4}$ inch is utilized. The larger corporation 1120's, and various states' returns of substantially similar size, take $9\frac{3}{4} \times 16$ inch folders. This avoids curling or tearing. Only one return is filed in each folder for each year. Correspondence relating to each year's return is bound with it, cross-filed to the other appropriate folders. If the Green Company has many partners whose returns are prepared by the firm, a separate folder for *each* partner is prepared and filed, not in the partnership's jacket but in a separate jacket for each. A gummed identification label is placed on the extended lip of each folder.

Jackets

Instead of school wallet envelopes (as used by most accountants) a "knocked-down" box type of container, without a cover, is purchased. These are easy to clip together into a standing position. The result is a strong, neat, upright box which, when placed beside hundreds of others

on the steel shelves, with uniformly placed labels, gives a surprisingly attractive, dignified appearance. The purchase price per jacket (average for two sizes) is currently less than 9¢. The box jackets measure:

Smaller size	1¾ inches thick, 10¾ inches high, 16¼ inches deep
Larger size	2¾ inches thick, 10¾ inches high, 16¼ inches deep

VARIATIONS IN PRACTICE FOUND IN OTHER FIRMS

Firm No. 3

This large firm, with many branches, commands admiration for its precision filing of work papers. As a new engagement is started, the first papers are placed in a fresh folder which is given the next available "engagement" number of a series which is distinctive from the "client" number series. If the client is new, he is assigned the next number in the "client" series. Let us assume that John Doe is an old client, #751, and his current audit began this afternoon. This morning, I. Brown, a new client, to whom was assigned #996, ordered a special investigation conducted, and the engagement was given "engagement" #11,051, preceding the "engagement" #11,052, of Doe, whose work began a few hours later.

Recorded alphabetically in a book resembling a large looseleaf general ledger, Doe's composite number, 751-11,052, will appear in his index account in the D's along with all previous numbers (for example, 751-3050; 751-8095) and such other cumulative data as experience dictates desirable. Brown's account, #996-11,051, will appear in the B's, of course. A cross-reference list by numbers is also kept up-to-date, as a means both of identifying the name of the client from the file number and of ascertaining quickly the last used series number, as to client and engagement.

As long as the particular engagement is current, all papers are kept in a current jacket, frequently in the possession of the senior in charge. Finally, the jacket is filed permanently by client number, each engagement jacket for that client being arranged side by side, the latest one to the right of the others. All are placed upright on shelves in a fireproof vault, the file numbers appearing in large figures at the upper edges. Separate jackets are always used for different fiscal years or special engagements.

This firm keeps three copies of all audit reports, one in the main office, the other two in the branch office which prepared the report. Of these two, one is filed with the work papers, the other in a continuous file bound by dates, the latest on top. This copy is given a consecutive number and is indexed alphabetically for ready reference.

Firm No. 4

This small firm segregates its alphabetically filed documents in two types of containers: metal cabinets and fibroid jackets.

The following are filed in metal cabinets:

1. Tax returns and tax case files.
2. Correspondence — clients.
3. Correspondence — other.
4. Copies of audit reports within a yellow office copy cover. These are filed with the latest one in front. The binding side is up with the client's name placed near its top edge.

All engagement work papers are placed in fibroid keystone jackets without flaps, with stiff outer end edges re-enforced with gussets to keep the labels from being distorted and to keep the jackets themselves standing up straight. These jackets are filed on metal shelves.

This firm's permanent files are made to include not only copies or excerpts of the original charter or original partnership agreements and amendments, and other information relating to the history of the client, but also facts and figures showing developments and trends in operations. Contracts affecting, or which might affect, earnings or additions to fixed assets are maintained in this permanent file. Wherever possible, the firm urges the client to furnish photostatic copies of as many permanent file documents as feasible, to save the auditors' time.

Firm No. 5

This large firm binds all work papers, copies of reports and tax returns into varicolored covers bound by bradding at the left. The covers are made of substantial material, each with a showing surface after binding measuring $11\frac{3}{8} \times 14$ inches, to accommodate uniform-size papers and reports. Two different sets of preprinted, light cream-colored covers hold:

1. The pencil manuscript and the typed office copies of audit reports. (See Figure 33(a) in Appendix B.)
2. The working papers. (See Figure 33 in Appendix B.)

The permanent file cover used by this firm is bright red, and the black print used clearly indicates the nature of the folder, and shows the name and location of the client.

The income tax return cover is blue with black printed information on the outside folder cover, as well as on the inside. Figure 33 (b) give the details of this cover.

All of these files are stored in a large file room in metal cabinets, which are also used for correspondence with clients and with others who are not clients. Correspondence having to do with tax cases or controversies is kept, together with all revenue agents' reports and other related data, in the tax department where they remain permanently.

The rules regarding filing are very rigid in this firm. No persons except those authorized (the file department head and his assistants) ever enter the file room, and this rule includes the partners. The head of the file department insists on enforcing the firm's rules. He seldom

leaves the room and there is always an employee on duty in the file room. No file or folder can be withdrawn without a receipt on 3 x 5 inch form which is reproduced below. The receipt cards are kept in a box to fit on the desk of the file department head. The receipt is destroyed in the presence of the signer when papers are returned.

FILE CHARGE-OUT CARD				
Client				
Report No.	Month	Day	Year	
Working Papers No.	Month	Day	Year	
Miscellaneous				
Permanent File				
1120	Month	Day	Year	
1121	Month	Day	Year	
1065	Month	Day	Year	
Received	Month	Day	Year	By

All branch office files eventually reach the main office. Without exception, every report is sent to the main office for review and a copy is retained. The file material is kept intact for several years, depending on the circumstances in each case. It is then transferred to permanent storage in a warehouse located about one mile from the office. The filing in the warehouse is alphabetical and is segregated according to the same classifications maintained at the office. All files for clients still being served are retained intact. Papers are not destroyed unless the former client has been declared bankrupt or has stopped doing business with the firm for ten years or more. Even so, other circumstances may cause retention of the files.

Confirmation replies are usually filed in the working paper folders, unless they are too numerous. In some bank audits, confirmations are filed in a bound book; that is, those covering deposits, notes receivable, et cetera. All labels or tags appearing on the outside of filing cabinets are white except for the cabinets containing tax case or tax controversy files, which have red labels.

In this firm, "in process" file cabinets are retained (a) in the file room for audit work papers (some firms maintain the "in process" cabinets in or near the staff room instead of the file room), and (b) in the tax department for tax cases and controversies.

Firm No. 6

A large firm which has no branch offices, but which has a representative in Washington, keeps all its files in metal drawer cabinets alphabetically, as follows:

1. All jackets are of heavy fibroid without covering flaps at the top.
2. All work papers and pencil reports for each client go in separate folders for each year — no exceptions.
3. Another separate folder for each client holds, for one year only:
 - a. Pencil and typed copies of tax returns (including individual returns in the folder of the firm with which the individuals are connected).
 - b. Typed copy of report.
 - c. All correspondence for the year other than that bearing on verification of audit items, which later go in the work paper folder.
4. Correspondence with businesses or individuals who are not clients is Accofastened to special correspondence folders and placed in a separate set of cabinet drawers.

All folders are of the same color.

At no time must any letter or other document be removed from any file folder. Usually the file clerk is present to give and to receive folders. When the file clerk is out, the men take care of their own needs but the entire file must be removed and returned intact, not part at a time. No OUT cards are used to control withdrawals.

The review department, which is trained to do so, checks to see that the entire file of working papers is in order before it is sent to the filing department. The file is labeled before it leaves the review department. The file clerk is expected only to keep the jackets in the proper cabinets.

All papers must be off the desks of staff members at night and placed in brief cases or on special tables. The office manager of this firm, however, thinks that a separate set of large file drawers, locked, with several keys given to staff men, is the best method of temporary filing of papers overnight. He holds the staff men responsible for the papers in their custody.

On the top of the regular filing cabinets, this firm has specially constructed metal, 2-door cabinets with two shelves in each to keep file folders containing papers older than the four current years which are maintained in the audit work paper cabinets. This firm also rents warehouse space to house very old files. No working papers are ever destroyed, because the firm considers it dangerous to do so. However, correspondence is destroyed when six years or more old, depending on conditions.

A typed copy of every tax return is retained. Tax case papers are kept by the tax department which maintains its own master index tickler system.

Firm No. 7

A medium-sized firm divides its correspondence filing to include three separate classifications: (a) with clients, (b) general and (c) private. One

of the firm's senior partners, writes in various published technical papers that, at his office, work papers are arranged by the in-charge accountant prior to the first review, in the following order: (1) program; (2) trial balance working sheet; (3) adjusting entries; (4) analyses and (5) summaries.

After being reviewed and typed, the pencil copy of the report is placed with the working papers in a temporary file drawer. The following procedures then take place:

1. The entire set of papers is removed from the drawer, inspected to see that all are in proper order and stapled in manila covers. The client's name, file number and contents are then written on the cover.
2. These bound files then are entered in an alphabetical clients' index and are placed in manila jackets which hold, in some instances, the papers of several years.
3. These jackets then are filed side by side on steel shelves in the file room. The jacket shows the client's number imprinted on all four corners on both sides.
4. The typed, signed copies of all reports are filed in special stiff covers arranged numerically by clients.
5. Tax work papers and pencil copies of returns are filed separately from audit papers, but in a similar manner. The outer manila jacket bears the letter "T" in front of client's card file number to indicate tax file. A separate clients' card index is maintained for tax files.

At one time, this firm stored inactive files in a room in a nearby warehouse. At present, it uses a roomy, dry cellar in which large, galvanized iron cabinets fitted with padlocks have been built. Periodically, a partner who is thoroughly familiar with all the clients goes through the card index and marks items to be destroyed by cremation. When marking files for cremation, the following factors are considered:

1. Are we currently doing work for the client?
2. How long has it been since work was done for the client?
3. What is the nature of the contents?
4. Are there any government regulations requiring retention?

All typed copies of reports are retained permanently. Files for former clients are retained for at least ten years.

Firm No. 8

A sole practitioner binds all copies of audit reports by separate years, one binder for each year containing all reports issued for all clients. He indexes them alphabetically with visible index tabs by clients, all copies of reports issued to one particular client side by side. He then numbers all the pages consecutively. His 1951 binder numbered 961 pages. It took him, personally, three days during the early days of 1952 to assemble his index. In addition, a topical index is prepared and filed under the last report. The text material is indexed so that one paragraph, for instance, may show up under several different topics or subjects. This practitioner keeps all files permanently.

Firm No. 9

A sole practitioner in the Middle West retains copies of audit reports in the same type of formal cover as that used for clients' copies. The latest year is placed loosely in the current file. Later it is placed with previous reports in a transfer cabinet in a red fibroid jacket, without top flap, one jacket for each client, the latest report in front. When that jacket is filled, another one is begun and filed in front of the previous one, so that the latest report is always the first one meeting the eye.

Tax returns are filed without folders. The current returns are filed in the current file jacket; later, they are transferred to a special light buff jacket without flap, one for each client, latest on top. All correspondence, revenue agent's reports, protests, et cetera, bearing on tax cases and controversies are fastened permanently with Acco-fasteners bound at the top in a separate file for each case involved. The practitioner personally makes cross-references. For example, he may note in the 1949 section that there is a letter in the 1951 folder which has a bearing on 1949. That letter has been filed in 1951 because it also has reference to a transaction in that year. On the letter itself is noted the fact that it bears on the 1949 matter. The jackets themselves and the folders within are marked as to the year or years involved.

As to correspondence, this practitioner makes a separate Acco, top-bound folder as soon as four letters are in a file for, or from, one client or prospect. Prior to this, loose letters are filed by the first letter of the surname.

This practitioner believes that it is dangerous to destroy files. He has a very large storage basement at his home which he uses for storage. A client must have been lost for many years before this accountant destroys anything pertaining to an engagement.

Appendix B

EXAMPLES OF OFFICE FORMS

Part I of this appendix contains a co-ordinated set of forms for an accountant's office (Figures 1 through 33 inclusive), pages 6 to 38.

Part II contains alternative and supplementary forms, Figures 1 (a) through 33 (b), which appear on pages 40 to 95 inclusive. Figures in Part II bear the same numerical designation as the figures in the co-ordinated set to which they are related.

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A PUBLIC ACCOUNTANT'S OFFICE**

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Part I

Co-ordinated Set of Forms
for a
Public Accountant's Office

Figure 1. Chart of Accounts

CHART OF ACCOUNTS		Liabilities
Assets		
101	Cash in banks	
	(Separate account for each active bank)	
102	Petty cash	
111	Notes receivable - billed	
112	Accounts receivable - unbilled	
113	Accounts receivable of accumulated charged time and (Consent not yet billed to clients)	
	cost for billing adjustments	
114	Allowance for billing adjustments	
	Valuation accounts	
115	Miscellaneous receivables	
	(Sundry non-clients: Expense Advances)	
121	Receivables - Employees: Other	
141	Prepaid insurance	
142	Other prepaid items	
143	Interoffice account	
201	Deposits	
301	Land	
302	Building	
303	Depreciation to date - building	
304	Automobiles	
305	Depreciation to date - automobiles	
306	Furniture and equipment at	
307	Depreciation to date - furniture and equipment	
308	Leasehold improvements	
309	Amortization to date - leasehold improvements	
401	Library	
402	Investments	
CHART OF ACCOUNTS		Liabilities
Assets		
501	Loans and notes payable	
502	Accounts payable	
511	Taxes and deductions - payable	
512	Taxes payable (other)	
513	Fees billed in advance	
514	Accrued payroll	
515	Accrued bonus and additional compensation	
516	Other accrued expenses	
517	Capital	
	Capital accounts	
601	(Separate account for each partner)	
641	Drawing accounts	
642	(Separate account for each partner)	
681	Profit and Loss	
	Income	
1101	Charged time account for each department	
1201	Provision for billing adjustments and uncollectible accounts	
1301	Other income	
	Expenses	
2101	Salaries (Separate account for each department and additional compensation)	
2151	Bonus expense and training	
2201	Employee benefit	
2202	Travel and entertainment: non-automobile and	
2203	(Includes automobile and expenses)	
CHART OF ACCOUNTS		Expenses (continued)
2204	Supplies	
2301	Commissions	
2302	Professional services	
	(Excludes correspondence and forwarding fees)	
2401	Charged to specific jobs	
2402	Contributions	
2403	Employment agencies' expense	
2404	Books, magazines and tax services	
2501	Depreciation	
2502	Insurance	
2503	Payroll taxes	
2504	Rent and light	
2505	Stationery, supplies	
2506	Postage	
2507	Telephone and telegraph	
2508	Maintenance	
2509	General office expenses	
2510	(Includes all office not chargeable to other specific expenditures such as hotel service, water, Christmas cards and flowers sent to clients and others, miscellaneous office services and other similar expenditures)	
2601	Interest	
2602	Moving expense	
2603	Gain or loss on disposition of fixed assets	

Figure 2. Application Blank — Staff

Complete in your own handwriting using ink

APPLICATION FOR EMPLOYMENT - STAFF

Application for position as _____ Date _____

NAME _____
 (Please print name) (Last) (First) (Middle)

ADDRESS _____ City _____ Telephone Number _____

Have you ever applied to this firm for a position _____ Date _____

Who referred you to this firm _____

Date of birth _____ Place of birth _____ U. S. Citizen _____

Age _____ Height _____ Weight _____ Physical defects _____

Married () Single () Separated () Divorced () Widowed ()

Full name of husband or wife _____ Your sex _____

Dependents, names, ages, and relationships _____

In case of accident notify _____

Date available _____

Time lost through illness during last two years _____

Draft Status _____ Social Security No. _____

Father's occupation _____

References - other than relatives (name three)

Name	Address	Occupation

(over)

Figure 2. (Cont'd.) Application Blank — Staff

Education	Years	Name and Location of School	Course of Study	Degree
High School				
College				
Business				
Other				

EXPERIENCE Give complete record of all employment you have had. Record most recent position first and work back. May we write to your present employer? _____

Dates of Employment (Month & Year)	Name and Address of Employer	Annual Salary	Description
From _____	Name _____	Start _____	Duties _____
	Address _____		
To _____	Immediate Supervisor _____	Final _____	Reason for leaving _____
From _____	Name _____	Start _____	Duties _____
	Address _____		
To _____	Immediate Supervisor _____	Final _____	Reason for leaving _____
From _____	Name _____	Start _____	Duties _____
	Address _____		
To _____	Immediate Supervisor _____	Final _____	Reason for leaving _____
From _____	Name _____	Start _____	Duties _____
	Address _____		
To _____	Immediate Supervisor _____	Final _____	Reason for leaving _____

Do you have a C.P.A. certificate _____ Date obtained _____

State in which taken _____ Do you plan to take C.P.A. examination _____

I affirm that all of the information I have set forth in this application is true to the best of my knowledge and belief

Signature in full

Remarks

Figure 3. Application Blank — Non-staff

Complete in your own handwriting using ink

APPLICATION FOR EMPLOYMENT - NON-STAFF

Application for position as _____ Date _____

NAME _____
 (Please print name) (Last) (First) (Middle)

ADDRESS _____ City _____ Telephone Number _____

Have you ever applied to this firm for a position _____ Date _____

Who referred you to this firm _____

Date of birth _____ Place of birth _____ U. S. Citizen _____

Age _____ Height _____ Weight _____ Physical defects _____

Married () Single () Separated () Divorced () Widowed ()

Full name of husband or wife _____ Your sex _____

Dependents, names, ages, and relationships _____

In case of accident notify _____

Date available _____

Time lost through illness during last two years _____

Draft Status _____ Social Security No. _____

Father's occupation _____

References - other than relatives (name three)

Name	Address	Occupation
_____	_____	_____
_____	_____	_____
_____	_____	_____

(over)

Figure 3. (Cont'd.) Application Blank — Non-staff

Education	Years	Name and Location of School	Course of Study	Degree
High School				
College				
Business				
Other				

EXPERIENCE Give complete record of all employment you have had. Record most recent position first and work back. May we write to your present employer? _____

Dates of Employment (Month & Year)	Name and Address of Employer	Annual Salary	Description
From _____	Name _____ Address _____ Immediate Supervisor _____	Start _____ Final _____	Duties _____ Reason for leaving _____
To _____			
From _____	Name _____ Address _____ Immediate Supervisor _____	Start _____ Final _____	Duties _____ Reason for leaving _____
To _____			
From _____	Name _____ Address _____ Immediate Supervisor _____	Start _____ Final _____	Duties _____ Reason for leaving _____
To _____			
From _____	Name _____ Address _____ Immediate Supervisor _____	Start _____ Final _____	Duties _____ Reason for leaving _____
To _____			

Check below the office appliances and equipment that you know how to operate

() Adding machine () Addressograph () Calculator () Comptometer
 () Dictating machine () Duplicating machine () Electric typewriter () Graphotype
 () Mimeograph () Multigraph () Multilith () Stenotype
 () Switchboard () Transcriber () Typewriter () Varsityper

Typewriting speed (words per minute) _____ Stenographic speed (words per minute) _____
 Transcribing speed (words per minute) _____

I affirm that all of the information I have set forth in this application is true to the best of my knowledge and belief

Signature in full

Remarks

Name _____
Date _____

Procedures to be followed with new staff members:
(The personnel assigned to instructing these persons are to initial to indicate that each of the following items has been taken care of):

Provide:

- Withholding tax information (W-4)
- Hospitalization Insurance Record
- Group Insurance Record
- Savings bond application

Introduce to:

- Members of firm
- Staff
- Office personnel, particularly switchboard operator, typing and bookkeeping departments

Exhibit and/or Explain:

- Time report form
- Expense report form
- Office hours
- Vacation policy
- Supper money allowance
- Filing system
- Mall boxes

Issue to new employees:

- Personnel list No. _____
- Firm's report manual No. _____
- Key to office

Staff bulletins

Brief case, if necessary No. _____

Business cards, if the employee is at least a senior accountant

The new employee to read and study where necessary:

- Manual of forms used by staff and explanation of their use.
- Indexing of work papers, sets of work papers, headings, and cash reconciliations
- Firm's report manual
- Office memoranda file
- Issues of house organ to date
- Duties of Junior Accountant
- Duties of Senior Accountant
- Contemporary Accounting - A.I.A.
- Releases of the Committee on Accounting and Auditing Procedures - A.I.A.
- The successful Practice of Accounting - Paul E. Beas
- Good book on business letter writing
- CPA Handbook

Figure 4. Indoctrination Procedures

Figure 5. Employment Contract for Employees Not Subject to Federal Wage and Hour Law

EMPLOYMENT CONTRACT

(FOR EMPLOYEES NOT SUBJECT TO FEDERAL WAGE AND HOUR LAW)

This contract is made and agreed to this.....day ofA. D.....
by and between (NAME OF COMPANY) Certified Public Accountants, of Chicago,
Illinois, a copartnership, hereinafter called the company, and
hereinafter called the employee. In consideration of the mutual covenants herein set forth, the company
hereby employs the employee upon the following terms and conditions:

(1) The company will pay the employee a salary of \$..... (.....
.....) per month, payable in equal semi-monthly installments
during the period of actual employment and only during that period in which services are actually
rendered.

(2) The employee agrees to work for the company in the classification of a.....
..... and to render satisfactory services within the custom-
ary meaning of that term, and further agrees to devote his full time to such employment. Full time
shall be defined to mean the regularly established working hours of the company, plus such reason-
able overtime as the requirements of the company and the servicing of its clients dictate, consistent
with the usual service standards of the accounting profession and of the company.

(3) The employee shall not undertake any work as tax consultant, accountant, auditor or book-
keeper, directly or indirectly, for any person, firm or corporation so long as he is in the employ of the
company, nor shall he maintain any office facilities other than those furnished to him by the company.
He shall, however, refer to the company any work of said nature which may come to his attention or
under his control, but the company shall have the right to accept or reject such work within its sole
discretion.

(4) It is understood and agreed that when and as the abilities demonstrated by the employee shall
so warrant, in the judgment of the company, he shall be advanced in position and duties to a position
bearing a higher rate of compensation, notwithstanding the provisions of paragraph (1) hereof. Any
such change in classification or compensation shall not affect the other provisions and restrictions in this
agreement.

(5) The employee hereby agrees that for a period of three years after the termination of his em-
ployment by the company, either voluntary or involuntary, he will not on either his own account or as
a member of a firm, or on behalf of another employer, or otherwise, directly or indirectly, work as a tax
consultant, accountant, auditor or bookkeeper for or solicit such business from, any client of the
company.

(6) Both parties hereby agree that this contract shall continue for one year from the date
executed, it being fully understood that the term of employment may thereafter be renewed from year
to year by mutual agreement, but it also being understood that the term of employment may be terminated
by either party at the end of any month during the first or any succeeding year by giving to the other party
adequate oral or written notice. Adequate notice shall be defined as notice of one calendar week during the
first six months of the contract and two calendar weeks thereafter.

(7) The employee further agrees that for a period of two years after the termination of his employ-
ment under the provisions of this contract he will not employ nor offer to employ nor solicit employment of
any employee of the company.

(a)

Figure 5. (Cont'd.) Employment Contract for Employees Not Subject to Federal Wage and Hour Law

(8) In the event that the employee violates the terms of any part of this agreement, the company shall have the right to apply to any court or competent jurisdiction for an injunction restraining the employee from further violation. The employee further agrees that he will pay on demand to the company as liquidated damages for any violation of paragraph (5) of this agreement a sum equivalent to the fees charged by the company in the preceding twelve months to the client or clients for whom any work was done or solicited.

(9) The employee agrees that his right of termination as set forth in Article (6) shall be effective only during the period April 1 to October 31, inclusive, of each calendar year.

WITNESSETH the hands and seals of the parties hereto the day and year above written.

(NAME OF COMPANY) (SEAL)

By _____ Partner

(the Employee) (SEAL)

WITNESS:

(Name)

(Address)

(Name)

(Address)

Figure 6. Employment Contract for Employees Subject to Federal Wage and Hour Law

EMPLOYMENT CONTRACT

(FOR EMPLOYEES SUBJECT TO FEDERAL WAGE AND HOUR LAW)

This contract is made and agreed to this.....day ofA. D.....
by and between (NAME OF COMPANY), Certified Public Accountants, of.....
....., a copartnership, hereinafter called the company, and
hereinafter called the employee. In consideration of the mutual covenants herein set forth, the company hereby employs the employee upon the following terms and conditions:

(1) The company will pay the employee a salary of \$.....per month, payable in equal semi-monthly installments, it being understood that this salary represents a regular rate of pay of.....cents per hour for each 40 hours worked in each workweek and a rate of.....cents for all hours worked in excess of 40 but not to exceed.....hours in each workweek and that the company guarantees to the employee this pay for the above-named.....hours in each workweek during which the employee actually renders services or has time off in accordance with the provisions of article 2, even if in any one workweek the employee should work less than the said.....hours. In case the employee should work, in any one workweek, in excess of.....hours, any such excess will be paid to him at 1½ times his regular rate orcents per hour, which excess will be paid simultaneously with his regular pay at the end of the month following the rendition of services in excess of.....hours per week.

(2) The employee agrees to work for the company in the classification of.....
.....and to render satisfactory services within the customary meaning of that term, and further agrees to devote his full time to such employment. Full time shall be defined to mean the established working hours of the company, to the exclusion of other business activity, plus such reasonable overtime as the requirements of the company and the servicing of its clients dictate, consistent with the usual service standards of the accounting profession and of the company; provided, however, that during any calendar year the employee shall not be required to devote more than 2,024 working hours, less any allowable vacation time. In the event the employee is not employed by the company during the entire calendar year, he shall not be required to devote more than such number of working hours (on the basis of 2,024 per year less any allowable vacation time) as corresponds pro rata to the portion of the calendar year during which the employee was actually employed by the company. To effect these provisions by which the employee is not required to devote more than 2,024 hours per year (or such applicable portion thereof) less any vacation time, the company may give the employee time off at any time. For any time worked by the employee in excess of the 2,024 hours (or applicable portion thereof) less allowable vacation, and for which no time off is given, the employee will be paid at least 1½ times his regular rate, and such amount will be paid within a reasonable time, not to exceed three months, following the end of the calendar year during which such excess hours were worked.

(3) The employee shall not undertake any work as tax consultant, accountant, auditor or bookkeeper, directly or indirectly, for any person, firm or corporation so long as he is in the employ of the company, nor shall he maintain any office facilities other than those furnished to him by the company. He shall, however, refer to the company any work of said nature which may come to his attention or under his control, but the company shall have the right to accept or reject such work within its sole discretion.

(4) It is understood and agreed that when and as the abilities demonstrated by the employee shall so warrant, in the judgment of the company, he shall be advanced in position and duties to a position bearing a higher rate of compensation, notwithstanding the provisions of paragraph (1) hereof. Any such change in classification or compensation shall not affect the other provisions and restrictions in this agreement.

(b)

Figure 6. (Cont'd.) Employment Contract for Employees Subject to Federal Wage and Hour Law

(5) The employee hereby agrees that for a period of three years after the termination of his employment by the company, either voluntary or involuntary, he will not on either his own account or as a member of a firm, or on behalf of another employer, or otherwise, directly or indirectly, work as a tax consultant, accountant, auditor or bookkeeper for or solicit such business from, any client of the company.

(6) Both parties hereby agree that this contract shall continue for one year from the date executed, it being fully understood that the term of employment may thereafter be renewed from year to year by mutual agreement, but it also being understood that the term of employment may be terminated by either party at the end of any month during the first or any succeeding year by giving to the other party adequate oral or written notice. Adequate notice shall be defined as notice of one calendar week during the first six months of the contract and two calendar weeks thereafter.

(7) The employee further agrees that for a period of two years after the termination of his employment under the provisions of this contract he will not employ nor offer to employ nor solicit employment of any employee of the company.

(8) In the event that the employee violates the terms of any part of this agreement, the company shall have the right to apply to any court or competent jurisdiction for an injunction restraining the employee from further violation. The employee further agrees that he will pay on demand to the company as liquidated damages for any violation of paragraph (5) of this agreement a sum equivalent to the fees charged by the company in the preceding twelve months to the client or clients for whom any work was done or solicited.

(9) The employee agrees that his right of termination as set forth in Article (6) shall be effective only during the period April 1 to October 31, inclusive, of each calendar year.

WITNESSETH the hands and seals of the parties hereto the day and year above written.

(NAME OF COMPANY) (SEAL)

By _____ Partner

(the Employee) (SEAL)

WITNESS:

(Name)

(Address)

(Name)

(Address)

Figure 7. Authorization for Change in Payroll Status

Employee _____

**AUTHORIZATION FOR
CHANGE IN PAYROLL STATUS**

Date _____

Payroll Department

Please change your payroll records effective _____

() Add to payroll	Rate _____
	Classification _____
() Increase salary	From _____ To _____
() Increase charge time rate	From _____ To _____
() Change in classification	From _____ To _____
() Terminate	Final check to include _____ date _____

Remarks:

Authorized by

Approved

Entered on Payroll records by _____ Date _____

Figure 8. Overtime Voucher

OVERTIME VOUCHER

Name of Employee _____	Week Ending _____									
	Before 8:30			12 to 1 P. M. *			After 5 **			Total Hours
	From	to	Hrs.	From	to	Hrs.	From	to	Hrs.	
MONDAY										
TUESDAY										
WEDNESDAY										
THURSDAY										
FRIDAY										
SATURDAY										

* Saturday 11:30 to 1 P. M. ** Saturday after 1 P. M.

Approved by _____ Signature _____

Figure 10. Client Master Card

[Name of Company]		CLIENT MASTER CARD	
Client	_____	Corporation	Partnership
Street	_____	Individual	Fiduciary
	Tel. _____	Other	_____
City	Zone _____ State _____	State of incorporation	_____
Principal	_____	Date org. or incorp.	_____
Partner contact	_____	Mail reports to	_____
Related clients	_____	Referred by	_____
Attorney	_____		
Type of business	_____		
Recurring Operations Cards in Active File		Nonrecurring Operations	
Annual Audit	State tax returns & due dates	Cards in history file	Date mailed
Annual statements	_____	Description	_____
Monthly statements	_____	_____	_____
Quarterly statements	_____	_____	_____
Ending	Special tax matters	_____	_____
Monthly work, no report	_____	_____	_____
Other	_____	_____	_____
_____ 1120 _____ 1065	Special reports	_____	_____
_____ 1040 _____ 1040ES	Cont'd on reverse side	_____	_____
Other	_____	_____	_____
Remarks		YEAR ENDS	
_____		1	2
_____		3	4
_____		5	6
_____		7	8
_____		9	10
_____		11	12

Figure 11. Engagement Memorandum

		Route:
		Report Dept _____
		File Dept _____
		(Fee File) _____
		No. E _____

ENGAGEMENT MEMORANDUM	
Client of _____	Office _____

Client _____	Partner in charge _____
Street _____	Supervisor _____
City _____	Fiscal _____
	year ends _____
Form of organization _____	Subsidiary or _____
(Corp, partnership, individual, etc.)	affiliate of _____

Incorporated in _____

Business _____

(Describe principal functions, products and services)

(Listed on a stock exchange? _____ Which? _____)

Is client (Registered with the SEC? _____)

(Subject to federal income taxes? _____)

Name of outside legal counsel _____

Description of work, other than tax work _____

Are we to prepare or review tax returns or do other tax work? _____

(If so, attach "Tax Engagement Memo")

Open account for (check): Audit _____ Taxes _____ SEC _____ Special _____

(Describe)

Arranged with _____

By _____ Date _____

INFORMATION FOR FILES

Is this a new client? _____

(If so, attach "mailing list")

If not a new client, is mailing list in Report Dept up-to-date? _____

(If not, attach new list or "Amendment to Engagement Memo")

Does client have active subsidiaries or affiliates? _____

If so, is "list of active subs and affiliates" in Report Dept up-to-date? _____

(If not, attach new list or "Amendment to Engagement Memo")

Prepared by _____ Date _____

Approved by partner _____ Date _____

Figure 13. Short-Range Forecast and Staff Location Chart

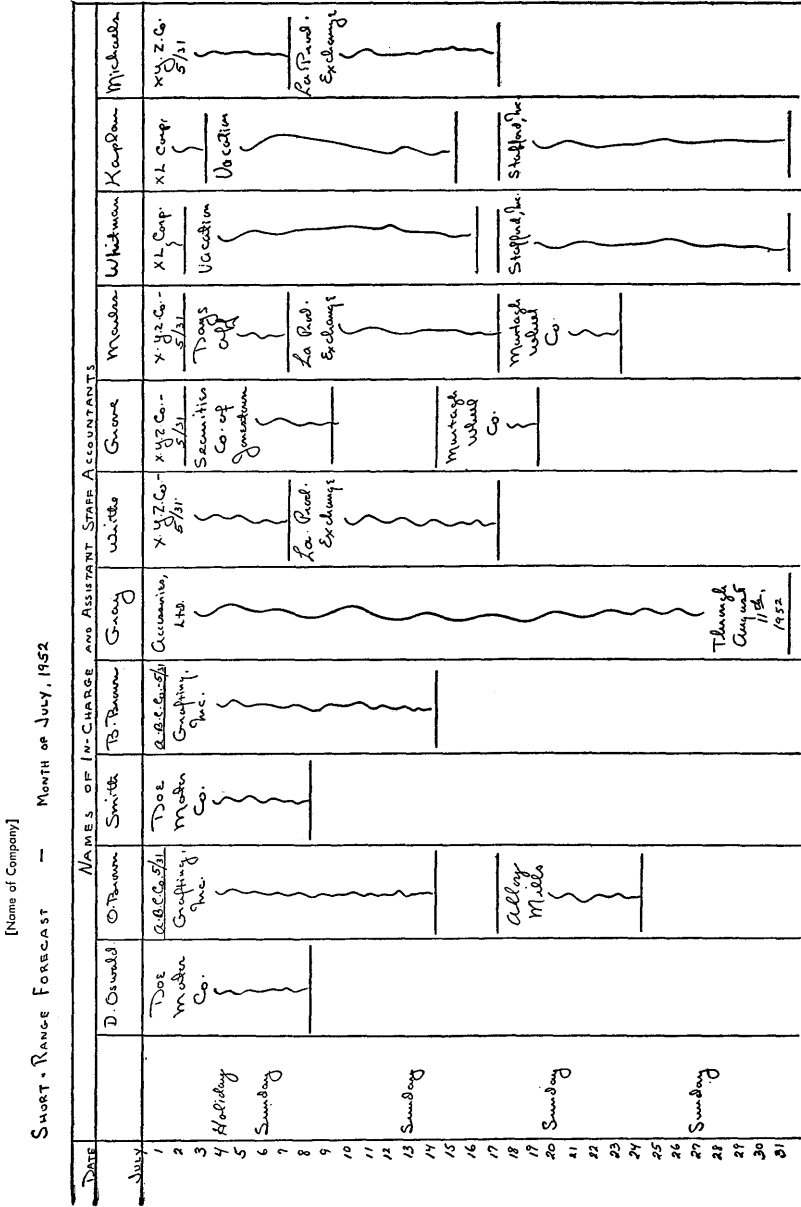


Figure 14. Daily Work Analysis Schedule

[illegible]

Figure 15. Summary Classification of Time

SUMMARY CLASSIFICATION OF TIME												
CLIENT _____												
YEARS ENDED _____	19			19			19			19		
CLASSIFICATION OF WORK	PRELIMINARY	YEAR END	TOTAL	PRELIMINARY	YEAR END	TOTAL	PRELIMINARY	YEAR END	TOTAL	PRELIMINARY	YEAR END	TOTAL
CASH												
RECEIVABLES:												
CONFIRMATION OF BALANCES												
CHECKING LEDGERS, ETC.												
INVENTORIES:												
OBSERVATION OF PHYSICAL COUNTS												
PRICE TESTS, ETC.												
INVESTMENTS												
PLANT ACCOUNTS												
RESERVES FOR DEPRECIATION												
DEFERRED CHARGES												
NOTES AND ACCOUNTS PAYABLE												
PROVISION FOR TAXES												
OTHER ACCRUED LIABILITIES												
RESERVES												
CAPITAL STOCK AND SURPLUS												
INCOME ACCOUNTS												
COSTS AND EXPENSE ACCOUNTS												
CURRENT PROVISION FOR TAXES												
OTHER P. & L. ACCOUNTS												
MINUTES, AGREEMENTS, ETC												
CONFERENCES WITH CLIENT												
GENERAL SUPERVISION AND PLANNING												
REPORT AND STATEMENTS												
10-K												
PREPARATION OF TAX RETURNS:												
FEDERAL												
STATE												
SPECIAL TAX WORK												
SURVEY OF INTERNAL CONTROL												
MAINTENANCE OF PERMANENT FILES												
TRAVEL												
OTHER MATTERS (SPECIFY IF MATERIAL)												
TOTAL HOURS												

POSTED FROM DAILY WORK
ANALYSIS SCHEDULES
(FIGURE 14)

Figure 16. Operations Card — Audit

[Name of Company] **OPERATIONS CARD**

Client _____

Assignment _____ As of _____

Mail to _____

Recurring	Nonrecurring	No. of copies	Due date
For _____	Ended _____		
In Charge			
Preliminary—Started			
Preliminary—Finished			
Final—Started			
Final—Finished			
In Review			
Mailed			
Field Hours			

Remarks:

Figure 17. Operations Card — Tax Work

On the tax control cards, returns that are due before the 15th of the month are flagged with red metal tabs in the upper right hand corner.

White cards—audit control (Figure 16)

Blue cards—1120 control

Pink cards—1120 EP control

Yellow cards—state tax control

Orange cards—individual tax return, partnership tax return and estate and trust tax return control

OPERATIONS CARD — TAX WORK

Client _____

Assignment _____ As of _____

Mail to _____

Recurring	Nonrecurring	No. of copies	Due date
For _____	Ended _____		
In Charge			
Completed by Accountant			
Received — Review Department			
Received — Tax Department			
Review Completed			
Received — Comparing & Proving			
Mailed			
Field Hours			

Remarks:

Figure 18. Engagement Memorandum and Report Guide Sheet

(Name of firm) _____ <u>Engagement Memorandum and Report Guide Sheet</u>	Engage. No. _____
Client (exact name) _____ Address _____ Specific nature of engagement _____ _____ _____ Period: From _____ To close of business _____ Number of copies of report required _____ Date promised _____ Detailed mailing instructions _____ _____ _____ Client's material to be returned _____ _____ _____ Approved for typing: In-charge Accountant _____ Supervisor _____ Review _____ C & P _____ Typing _____	
<u>TYPING DEPARTMENT</u>	
Type of paper _____ Form of report _____ Cover to read _____ _____ _____ _____ Date wanted _____ Approved for assembly _____ Date received _____ Date released _____	
<u>OFFICE CONTROL</u>	
Entered on control card _____ Date _____ Approved for release: C and P _____; Final _____ Date _____ Date of transmittal letter _____ No. _____	
<p>Note: Form to be typed as to client, address, engagement and period by control department in duplicate; original to supervisor and copy to review department as in-process file. In-charge accountant completes original at end of job and forwards with report draft and working papers to review department, who files copy in working papers and forwards original with report draft to typing. Original is bound with office copy of report. Copy of transmittal letter goes to bookkeeping department as notice to bill.</p>	

Figure 19. Tax Guide Sheet

	Engage. No.
(Name of firm) <u>Tax Guide Sheet</u>	
Taxpayer (exact name) _____	
Due date _____	Date promised _____
Nature of return _____	

Period covered _____	
Number of copies of return required _____	
Detailed mailing instructions _____	

Client's material to be returned _____	

Other returns to accompany this one _____	

Reasons, if any, we should <u>not</u> sign this return _____	

Approved for typing: In-charge Accountant _____ Supervisor _____	
Tax review _____	C & P _____ Typing _____

<u>TYPING DEPARTMENT</u>	
Date wanted _____	Approved for assembly _____
Date received _____	Date released _____

<u>OFFICE CONTROL</u>	
Entered on control card _____	Date _____
Approved for release: C & P _____	Final _____ Date _____
Date of transmittal letter _____	No. _____

<p>Note: Form to be typed as to client, address, engagement and period by control department and forwarded to supervisor. In-charge accountant completes original at end of job and sends with report draft and working papers to review department, who forwards with report draft to typing. After typing form is filed with working papers. Copy of transmittal letter goes to bookkeeping department as notice to bill.</p>	

Figure 20. Memorandum Route Sheet

MEMORANDUM ROUTE SLIP
(Other Than Reports)

CLIENT'S NAME: _____ DATE RECEIVED: _____
SUBJECT: _____ DATE WANTED: _____
PREPARED BY: _____
SUBMITTED TO (TYPIST) _____
APPROVED FOR TRANSMITTAL TO C & P _____
CHECKED (C & P) BEFORE TYPING BY _____
TYPED BY _____
PROOFED BY _____ DATE RELEASED: _____

Figure 21. Review Department Report

[illegible]

(This form can be adapted to any phase of operation deemed to require control)

Figure 25. Bill Draft

(NAME OF COMPANY)		
Bill Draft		
CLIENT _____		BILL DRAFT NO. _____
ADDRESS _____		
	ATTENTION _____	DATE OF BILL _____
(please check)		
_____ (1)	Regular (Special) accounting and tax services rendered during the month of _____ (period from _____ to _____)	\$ _____
_____ (2)	Services rendered in connection with examination of accounts (preparation of financial statements from books without audit) as at _____ and preparation of report thereon; preparation of corporation income tax return for the year ended _____ (fiscal year ended _____); preparation of State of _____ income tax return for the year _____ (fiscal year ended _____); and preparation of partnership return of income for the year ended _____ (fiscal year ended _____)	\$ _____
_____ (3)	Special services rendered during the month of _____ in connection with review of installation of accounting system and procedures	\$ _____
_____ (4)	Services rendered in connection with preparation of Federal income tax return for the year _____ and preparation of declaration of estimated tax for the year _____	\$ _____
_____ (5)	Other services--detail text of bill	\$ _____
	Travel and hotel expenses	\$ _____
	Total	\$ _____
LEDGER DATA AS OF _____ 19		
LEDGER SHEETS BALANCE AMOUNT BILLED BILLING ADJUSTMENT BALANCE		
SPECIAL ALLOCATIONS AND REMARKS		
		Prepared by _____
		Approved by: _____

		Supervisor _____
		Typed by _____ Bill # _____

Figure 26. Mail Received Report and Control Sheet

MAIL RECEIVED REPORT AND CONTROL SHEET					
Date: <u>October 4, 1951</u>					
Time: <u>8:30 A. M.</u>					
Distributed by: <u>LHP & MLB</u>					
<u>Name of sender</u>	<u>Date</u>	<u>General subject matter</u>	<u>Distributed to</u>	<u>Answer Required</u>	<u>Date Answered</u>
John R. Jones	Oct. 3	Enclosing contracts re Brown Corporation	Barnes	Yes	
Agent's Office	Oct. 3	Enclosing 870 on Frank & Co.	Slater	Yes	
Construction Buyers Directory	Oct. 2	Letter re survey for Chicago Engineering Syndicate	Novak	Yes	
Leo Marx & Bro.	Oct. 3	Enclosing operating statement of Leo Marx & Bro.	Slater	No	
Government Travel Survey	Oct. 2	Letter re distribution of questionnaire	Iling	No	
South Center Utilities	Oct. 3	Enclosing computation of deficiency re Mobile venture	Michaels	Yes	
Smith & Brown	Oct. 3	Draft of letter re Markham Hardware Co.	Lake	No	
Doe & Doe	Oct. 2	Draft of letter re bond purchases of J. B. Trask	Lake	No	
New York Office	Oct. 3	Enclosing working papers for Albany Black Co.	Murphy	No	
Checks Received					
		Leo Marx & Bro.	\$	55.56	
		Smith & Brown		70.00	
		Doe & Doe		185.00	
		Frank & Co.		670.00	
		South Center Utilities		2,240.00	
			\$	3,220.56	
Date: <u>October 3, 1951</u>					
Time: <u>3:00 P. M.</u>					
Los Angeles Office	Oct. 2	Prospective employee for New Jersey Aircraft Corp.	Prince	No	
Los Angeles Office	Oct. 1	Enclosing inventory work papers for Black Ignition Co.	Price	No	
Frank & Co.	Sept. 29	Enclosing inventory work papers for Black Ignition Co.	Price	No	
New Orleans office	Oct. 2	Request for information re August expenditures	Blake	Yes	
Checks Received					
		McMurray & Smith	\$	295.00	
		Total checks received	\$	3,515.56	

Figure 27. Outgoing Mail Log

(Name of Company)

OUTGOING MAIL LOG

October 27, 1952

<u>Addressee</u>	<u>Description</u>	<u>Enclosure</u>	<u>Subject</u>	<u>Sender</u>
John Jones	L	no	Tax Case	E.R.
T. Smith	Copy of letter sent to John Jones			" "
Branch Office	Of	Tax Return	Review	T.D.
Thomas & Co.	L	C	Subscription	B.O.

L. Letter
 Of Office Memorandum
 C. Check
 T.D. Tax Department
 B.O. Business Office

Figure 28. Lost Client Report

(Name of Company)

LOST CLIENT REPORT

January 1, 1952 to June 30, 1952

<u>Client</u>	<u>Reason for Loss</u>	<u>Total billings for last twelve months</u>
ABC Corporation	Poor financial condition	\$ 225.00
Jones & Murphy Co.	Voluntary withdrawal of C. P. A. Accountant & Co.	125.00
The Scott Press	Change of ownership	<u>500.00</u>
	Total	<u>\$850.00</u>

Figure 33. Binder Cover for Files—Working Papers

	<u>Reports No.</u> <hr/> <hr/> <hr/> <hr/>
WORKING PAPERS	
<hr/>	
Name of Client	
<hr/>	
Location	
<hr/>	
Kind of Service	
<hr/>	
Period Covered or Closing Date	
<hr/>	
[Name of Company] CERTIFIED PUBLIC ACCOUNTANTS <hr style="width: 20%; margin: 0 auto;"/> Office	
Supervisor	
<hr/>	
Accountant in charge	
<hr/>	
Assistants	
<hr/>	
<hr/>	
<hr/>	
<hr/>	

Part II

Alternative and Supplementary Forms

Figure 1 (a). Chart of Accounts for a Small Practice

CHART OF ACCOUNTS		
a/c No.	Assets	Expense
101	Cash in Bank	501 Advertising for Personnel
103	Cash on Hand	502 Automobile Expense
104	Petty Cash	504 Depreciation
111	Accounts Receivable	505 Dues & Subscriptions
114	Travel Advances	506 Exchange & Bank Fees
141	Furniture & Fixtures	507 Insurance
142	Allowance for depreciation, furniture and fixtures	508 Interest
143	Automobiles	509 Legal
144	Allowance for depreciation, automobiles	510 Postage
161	Meter deposits	511 Rent
	<u>Liabilities</u>	512 Salaries
200 to 209	Various current liabilities as required (being on cash basis, no accounts payable a/c is used; all bills paid 10th prox.)	513 Stationery and Office Supplies
		515 Sundry
211	Salaries payable (although on cash basis, this is a control a/c for employees' earnings ledger, which is kept in balance and therefore payroll tax reports cannot be in error)	516 Taxes
		517 Telephone and Telegraph
		518 Travel & Promotional
		519 Utilities
212	Taxes payable S.S.	Everything on cash basis except Accounts
213	" " W.H.	Receivable. For tax purposes, add opening
	<u>Proprietor</u>	Accounts Receivable to fees, and subtract
301	Proprietor	closing Accounts Receivable.
311	Withdrawals	
	<u>Income</u>	
401	Miscellaneous income (non-business)	
402	Capital Gains (non-business)	
403	Fees	
404	Capital Gains (business)	

CHART OF ACCOUNTS

ASSETS

Petty cash
Cash in banks
Notes receivable
Accounts receivable - billed
Estimated uncollectible accounts - billed
Unbilled receivables
Estimated uncollectible receivables - unbilled
Expense advances
Employees loans
Miscellaneous accounts receivable
Prepaid insurance
Prepaid interest
Deposits
Furniture and fixtures
Allowance for depreciation - furniture and fixtures

INCOME

Chargeable time
Partners
Administrative staff
Special service department
Tax department
Audit staff
Comparing and typing department
Office and stenographic
Billing adjustments
Recoveries on charged off accounts
Miscellaneous income

EXPENSES

Salaries
Partners
Administrative staff
Special service department
Tax department
Audit staff
Comparing and typing department
Office and stenographic
Bonus to employees
Carfare
Depreciation
Dues and subscriptions
Employees' life insurance
General travel
Insurance
Interest
Office expense
Placement fees and advertising for employees
Postage
Professional services
Rent and light
Social security taxes
Stationery and supplies
Telephone and telegraph

LIABILITIES

Notes payable
Accounts payable
Employees bond deductions
Accrued social security taxes
Withholding tax deductions
Accrued bonus

CAPITAL

Capital accounts
(By partners)
Drawing accounts
(By partners)

**Figure 1 (c). Chart of Accounts
for a Medium-Sized Practice**

Figure 2 (b) (Cont'd.). Personal History

ACTIVITIES:	
1. Membership in club, professional or social organization _____	
2. Hobbies or interests (past or present) _____	
3. In what additional activities would you like to engage _____	
4. What type of vacation do you prefer _____ Date started _____ Date discharged _____	
U.S. SERVICE EXPERIENCE: _____	
If in service, indicate: Branch _____ Highest rank or grade _____	
Oversight _____	
Type of discharge _____	
Subsequent Service classification _____	
Business Experience: (Please start with your present position) _____	
1. Firm _____ Address _____ Date began _____	
2. Title _____ Department _____	
3. Nature of work _____ Salary or _____	
4. Immediate superior _____ 5. Salary range _____	
6. What do you most like about your job _____	
7. What do you least enjoy _____	
8. Previous Employment _____	
1. Firm _____ Address _____	
2. Title _____ Department _____	
3. Nature of work _____ Date began _____	
4. Immediate superior _____ Salary or _____	
5. Salary range _____	
6. What did you like about the work _____	
7. What did you dislike _____	
8. Reasons for leaving _____	

III.	
1. Firm _____	Address _____
2. Title _____	Department _____
3. Nature of work _____	Employed _____
4. Immediate superior _____	From _____
5. Salary or _____	To _____
6. What did you like about the work _____	Salary range _____
7. What did you dislike _____	
8. Reasons for leaving _____	

Other Positions Held:	
Name of Company _____	Type of Work _____
Date _____	Date _____
Left _____	Reason for Leaving _____

AIMS:	
1. What additional education or experience have you had that you think is useful in your present job or would be of value if you were to be promoted to a more responsible position _____	
2. Regardless of your present salary, what income would you need to enable you to live as you would like to live? (This relates to type of housing, and general living conditions you may desire ultimately; and your response will not be confined to a distinction with your present salary.) _____	
3. What are your plans for the future _____	

Figure 3 (a). Application for Employment — Nonstaff

(NAME OF COMPANY)		APPLICATION FOR EMPLOYMENT	
(THE USE OF THIS APPLICATION FORM DOES NOT INDICATE THAT THERE ARE ANY POSITIONS OPEN AND DOES NOT IN ANY WAY OBLIGATE (NAME OF COMPANY) OR ANY OF ITS SUBSIDIARIES)			
NAME _____ (Last) _____ (First) _____ (Middle or Maiden)			
ADDRESS _____ (Number) _____ (Street) _____ (City & State)			
TELEPHONE NUMBER _____		SOC. SEC. NUMBER _____	
SEX _____	AGE _____	DATE OF BIRTH _____	
HEIGHT _____	WEIGHT _____	DO YOU WEAR GLASSES? _____	
LIST ANY PHYSICAL DEFECTS _____			
SINGLE _____	MARRIED _____	WIDOWED _____	DIVORCED _____ SEPARATED _____
NUMBER OF CHILDREN _____ OTHER DEPENDENTS _____			
NAME _____		ADDRESS _____	
(Name of person to notify in case of accident)			
TELEPHONE NUMBER _____		RELATIONSHIP _____	
POSITION APPLYING FOR _____		SALARY DESIRED _____	DATE AVAILABLE FOR WORK _____
BY WHOM WERE YOU REFERRED TO US? _____			
SCHOOL		ADDRESS	YEARS ATTENDED
GRADE			DATE OF GRAD.
HIGH			
BUSINESS			
COLLEGE			

Figure 3 (a) (Cont'd.). Application for Employment — Nonstaff

CHECK BELOW THE OFFICE APPLIANCES & EQUIPMENT. THAT YOU KNOW HOW TO OPERATE

- ☐ ADDING MACHINE ☐ ADDRESSOGRAPH ☐ CALCULATOR ☐ COMPTOMETER
☐ DICTATING MACHINE ☐ DUPLICATING MACHINE ☐ ELECTRIC TYPEWRITER ☐ GRAPHOTYPE
☐ MIMOGRAPH ☐ MULTIGRAPH ☐ MULTILITH ☐ STENOTYPE
☐ SWITCHBOARD ☐ TRANSCRIBER ☐ TYPEWRITER ☐ VARIETYPER

TYPED WRITING SPEED (WORDS PER MINUTE) _____ STENOGRAPHIC SPEED (WORDS PER MINUTE) _____ TRANSCRIBING SPEED (WORDS PER MINUTE) _____

CHARACTER REFERENCES (OTHER THAN RELATIVES OR FORMER EMPLOYERS)

NAME	ADDRESS
NAME	ADDRESS

PREVIOUS EMPLOYMENT RECORD

FROM	TO	NAME OF COMPANY	ADDRESS	IMMEDIATE SUPERIOR	POSITION HELD	SALARY	REASON FOR LEAVING

FOR PERSONNEL DEPARTMENT USE ONLY

DEPARTMENT		SUPERVISOR		POSITION (TITLE)	
ADDITION	REPLACEMENT (NAME)	PERMANENT	TEMPORARY	EMPL. CLASS	
EFF. DATE	SALARY	PER	POS. CLASS	CHARGE	OFF. HOURS

IF I AM EMPLOYED BY THE (NAME OF COMPANY) OR ANY OF ITS SUBSIDIARIES, I AGREE TO ABIDE BY AND OBSERVE ALL RULES AND REGULATIONS OF THE COMPANY.
 I UNDERSTAND THAT PERMANENT EMPLOYMENT DEPENDS UPON THE RESULTS OF A THREE MONTHS' TRIAL PERIOD, SATISFACTORY REPLIES FROM MY REFERENCES AND ACCEPTANCE BY THE BONDING COMPANY. ANY MISREPRESENTATION ON THIS APPLICATION IS SUFFICIENT REASON FOR IMMEDIATE DISMISSAL.

_____ (Date)
 _____ (Applicant's Signature)

MAILING LIST				LIST of ACTIVE SUBSIDIARIES and AFFILIATES			
Route: Report Dept. _____ File No. _____ (See File) _____ No. M. _____				Route: Report Dept. _____ File No. _____ (See File) _____ No. L. _____			
Name _____ Street _____ City _____				Principal client Street _____ City _____			
Form of organization _____ (Corp, partnership, individual, etc.)				Partner in charge _____ Supervisor _____ Subordinate or affiliate of _____			
Business _____ (Describe principal functions, products and services)				Business _____ Client of _____			
Is client subject to federal income taxes? _____ List all officers and key accounting personnel:				Name _____ Title _____			
Name and Address* _____				Office or other accountants' name _____			
Date _____				Date _____			
*Supply address if different from that of client				Date _____			
Prepared by _____				Date _____			
Approved by supervisor _____				Date _____			
Approved by partner _____				Date _____			

**Figure 10 (a). Client
Mailing List**

Figure 10 (d). Notice of Contract — Front

NOTICE OF CONTRACT	
DATE _____ 195__	
Client _____	NAME OF PARTNERS _____
Street and No. _____	_____
Town and State _____	_____
Kind of Business _____	_____
Corporation____ Partnership____	_____
Single Proprietorship____	Name of Proprietor _____
Closing Period _____	Name of Office Manager, Comptroller, Auditor or Head Bookkeeper _____
MANAGEMENT	
Name of Pres. _____	When Ready to Start _____
Names of Principal Stockholders _____	Arranged by _____ With _____
_____	Kind of Service _____
_____	_____
_____	_____
_____	_____
_____	_____

Figure 10 (d) (Contd). Nature of Contract — Reverse

PER DIEM RATES AGREED TO	
Partners _____ \$ _____	_____
Seniors _____ \$ _____	_____
Juniors _____ \$ _____	_____
Typists _____ \$ _____	_____
Are Expenses to be added? _____	_____
Maximum Fee Agreed to \$ _____	_____
Flat Price Agreed to \$ _____	_____
Are Expenses to be added? _____	_____
Are We to Prepare Franchise and Capital Stock Tax Returns? _____	_____
Agreed Fee Therefor \$ _____	_____
Are We to Prepare Federal and State Income Tax Returns? _____	_____
Agreed Fee Therefor \$ _____	_____
_____	_____
_____	_____
_____	_____
_____	_____

Figure 11 (a). Income Tax Calendar for Individuals

Memo from:				
(Name of Accounting Firm)				
1951 INCOME TAX CALENDAR				
Mr. & Mrs. _____				
Deadline	Thing to Do	Amount to Pay		
		Husband	Wife	Joint
3/15/51	File 1950 Federal Return	\$ _____	\$ _____	\$ _____
3/15/51	File 1951 Federal Estimate, Pay 1/4	_____	_____	_____
5/15/51	File 1950 Louisiana Return, Pay 1/3	_____	_____	_____
6/15/51	Pay 2nd and 1/4 Federal Estimate	_____	_____	_____
8/15/51	Pay 2nd 1/3 State Tax	_____	_____	_____
9/15/51	Pay 3rd 1/4 Federal Estimate	_____	_____	_____
11/15/51	Pay 3rd 1/3 State Tax	_____	_____	_____
1/15/52	Pay 4th 1/4 Federal Estimate	_____	_____	_____

Note: Your 1951 Estimate ^{was} based on 1950 earnings. If not, it must be ^{was not} amended by 1/15/52 to equal at least 80% of the actual tax; otherwise it requires no amendment.

Make all Federal checks payable to: U. S. Collector of Internal Revenue,
Customhouse, 423 Canal Street
New Orleans 16, Louisiana

Make all State of Louisiana checks payable to: Collector of Revenue,
State of Louisiana
Baton Rouge 1, Louisiana

(For use with respect to Louisiana married couples on a calendar year basis.
For single persons, use first column only. For fiscal year taxpayers, alter dates)

**Figure 11 (b). Reminder to Clients of Tax Obligations and Reports
(Other Than Income Taxes)**

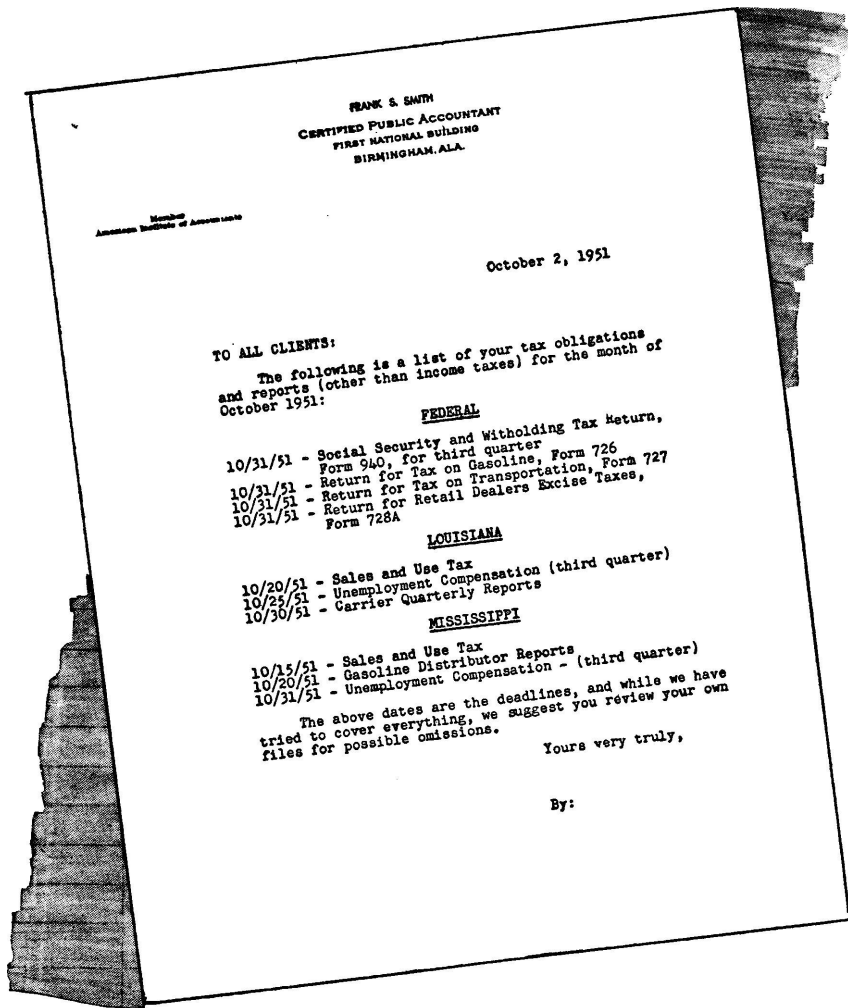


Figure 13 (a). Assignment Forecast (and Branch Requisition for Personnel)

[Name of Company]

Assignment Forecast

FOR THE WEEK OF December 15, 1951

Day of Week	NAME OF STAFF MEMBER AND CONTEMPLATED ASSIGNMENT				
	H. D. Miller IC	John Brown WD	Dick Harris IC	Herbert Smith WD	Howard Peters <input checked="" type="checkbox"/>
MONDAY	A. B. Mfg. Co.	A. B. Mfg. Co.	Smith & Co.	Smith & Co.	
TUESDAY	A. B. Mfg. Co.	A. B. Mfg. Co.	Smith & Co.	Smith & Co.	
WEDNESDAY	A. B. Mfg. Co.	A. B. Mfg. Co.	Smith & Co.	Smith & Co.	
THURSDAY	A. B. Mfg. Co.	A. B. Mfg. Co.	Smith & Co.	Smith & Co.	
FRIDAY	A. B. Mfg. Co.	A. B. Mfg. Co.	Smith & Co.	Smith & Co.	
SATURDAY					
SUNDAY					

CODE	IC - In Charge.	WD - Will Drive.	R - Rush Assignment.	F - Fill-in; No Rush
	X - Expect to Assign in Some Manner. <input checked="" type="checkbox"/> - Available for Assignment Elsewhere			
EXTRA HELP NEEDED	Will Need <u>2</u> Seniors <u>3</u> Semi-Seniors <u>1</u> Juniors for <u>5</u> Days			
	Beginning <u>December 17th</u> and Ending <u>December 22nd</u> For <u>1951 Audit</u>			
	<u>John Doe & Company</u> at <u>121 Pine Street</u> in <u>St. Louis, Missouri</u>			
	SIGNED <u>C. W. C. - Elkhart</u>			

NAME OFFICE

Figure 13 (b). Estimated Inventory of Work on Closings

ESTIMATED INVENTORY OF WORK ON CLOSINGS, AS OF JUNE 30, 1952
(AS LISTED FROM OPERATIONS CARDS - EXCLUDING MONTHLY ACCOUNTS)

CLIENT	WORK REQUIRED	ESTIMATED TIME		PARTNER IN CHARGE	SUPERVISOR	IN-CHARGE ACCOUNTANT	ASSISTANTS	ESTIMATED STARTING DATE	FIELD WORK			REPORT MAILED	REMARKS
		No. of MEN	DAYS						DATE BEGUN	DATE COMPLETED	DAYS CONSUMED		
Pine Motor Co. Graphic, Inc. Accord, Inc., Ltd. Louisiana Rice Exchange Securities Co. of Minnesota Muntag-Welch Co. Alloy Mills Shuff-D., Inc.	A - yr. A - Q SPEC. INV. SERV. A - SA A - yr. A - S.A. A - Q A - S.A.	2 2 1 3 1 2 1 2	12 20 35 27 5 10 6 45	L.M.F. L.M.F. M.S. L.M.F. L.H.P. L.H.P. M.S. L.H.P.	Doner Tullitt Doner Doner Brine Brine Tullitt Brine	D. Churchill O. Brown Gray Whitt Grave Grave O. Brown Kaplan	Smith B. Brown none Miles, Miles none Miles none Whittman	7/1 7/2 7/1 7/8 7/3 7/5 7/18 7/18	7/5 7/2 7/1 7/9 7/2 7/18 7/18 7/17	7/20 7/18 7/18 7/10 7/22 7/25		8/14 8/10 7/24 8/12	

Legend:
A - Audit
SPEC - Special service
yr - Year
S.A. - Semi-annual
Q - Quarterly

Figure 13 (e) . Day Book

DAY BOOK				SHORT SHEET			
MONTH OF <u>July</u> 19 <u>62</u>				DATE <u>7-28</u>			
Productive Partners & Staff Members				Amount Type			
	Address	Phone No.		Earned	W	Name of Client	
				Today	Work		
1	STENHOUSE, Sidney T (Partner)	165 Roselawn	J-6472	140.00	T	H. W. Hanover + Co.	
2	RAMOS, Louis R	2807 Riverside DR	7-3468	140.00	A	I. M. Graham	
3	CASSIDY, HARRY	34 Cedar Blvd.	1-8594	140.00	A	HARMONY Bros.	
4	DUDLEY, OSCAR	1330 Lincoln Way	3-1683	56.00	A	LAKESIDE LIA Co.	
5	FARRELL, George M	1582 Whitney ST	8-5769	56.00	A	I. M. Graham	
6	FRANKLIN, ROBERT	Apt 8 GRANT Apts	3-8402	42.00	T	H. W. Hanover + Co. (Asst)	
7	GRAYSON, Fred J	4140 Second ST.	6-1367	70.00	I	M. L. HARGROVE Imp. Co.	
8	HARVEY, Roy	3209 Washington DR.	3-1391	105.00	T	Weber + Holmes, Inc.	
9	IRONWOOD, Leon	1447 CENTRAL ST.	5-1585	70.00	A	H. E. ETTINGER + Co.	
10	JENKINS, Alfred	2116 Main Ave	2-7235	56.00	A	R. M. WERTMORE + Son	
11	JOHNS, Earl H	90 WILTON DR	8-7344	42.00	I	M. L. HARGROVE Imp. Co.	
12	LEVERT, Louis V	134 FULTON ST.	4-4140	56.00	A	HARMONY Bros.	
13	NOLTE, John E.	8432 Ivory Lane	9-6462	42.00	A	R. M. WERTMORE + Son	
14	RYBURN, ANTHONY	2248 MAGNOLIA Pl.	6-6774	56.00	S	O. F. OSTERFORD Mfg.	
15	STONE, Lawrence J.	Apt. 3 GRANT Apts.	3-6739	42.00	S	O. F. OSTERFORD Mfg.	
OTHER NAMES LISTED - TOTAL OF ST							
Comptometer Operators							
1	ELLIOT, Joyce	3528 FAWN ST.	4-6738	28.00	T	H. W. Hanover + Co.	
2	HOFF, Mary	384 LILAC AVE	J-3476	28.00	A	I. M. Graham	
3	STAMM, Hazel	9371 HAZELHURST ST	No Phone	28.00	A	H. E. ETTINGER + Co.	
TOTAL (Est.)				1727.00			
Non-Productive Partners & Others							
1	RANDOLPH, Henry (Partner)	276 Woodlawn Ave	J-6271				
2	HYMAN, LOUIS E (OFFICE MGR)	Apt. 6 GRANT Apts	3-7546				
3	PETERSON, ALBERT	1027 FIRST ST.	6-2589				
4	STONE, JAMES L	847 Ivy Ave	4-2726				
5	WILLIAMS, ELVINA	3027 DEJUNE ST	7-5067				
6	ZANNER, CATHERINE	2679 NORTH LANE	8-2983				
7							
8							
Legend:				Legend:			
Partners	Standard	Rate		A - Audit			
Tax Specialists	15.00	140.00		T - Tax Work			
Supervisors	10.00	70.00		S - System			
Seniors	8.00	56.00		I - Investigation			
Assistants	6.00	42.00		Special			
Compt. Operators	4.00	28.00		O - Other			

Figure 15 (a). Time Budget

TIME BUDGET

Client _____ Examination Date _____

Prepared by _____ Approved } Supervisor _____ Date _____

Partner _____ Date _____

Preliminary Work: _____ Final Work: _____

Start _____ End _____ Start _____ End _____

	Budget (in hours)	
	Apr. to Oct.	Nov. to Mar.
Cash		
Receivables:		
Confirmation of balances		
Checking ledgers, etc.		
Inventories:		
Observation of physical counts		
Price tests, etc.		
Investments		
Plant accounts		
Reserves for depreciation		
Deferred charges		
Notes and accounts payable		
Provision for taxes		
Other accrued liabilities		
Reserves		
Capital stock and surplus		
Income accounts		
Costs and expense accounts		
Current provision for taxes		
Other P and L accounts		
Minutes, agreements, etc.		
Conferences with client		
General supervision and planning		
Report and statement		
Survey of internal control		
Maintenance of permanent files		
Travel		
Other matters		
Total budgeted hours		
Total actual hours preceding engagement		

(Excludes tax and report departments' time)

Figure 16 (a). Kardex Tickler

John Doe & Co.		PERMANENT CARD
President, John Doe, Sr.		
Vice President, John Doe, Jr.		
Secretary, Mrs. John Doe		
Treasurer, Mrs. John Doe, Jr.		
Directors: Officers + A. B. Smith, Comptroller.		
Bookkeeper, Miss Mary Brown.		
Attorney: B. C. Jones, c/o Jones, Jones, Jones & Jones, 1452 XYZ Bldg. RA 6369		
Fiscal Year Ends Oct. 31 Chartered May 2, 1922.		
Engagement:	Semi-annual audit	
	Income Tax Returns	
	Corporation Franchise Tax Returns	
Special Features:	Branch in Mississippi - Occupational tax due August 1.	

Figure 16 (a) (Cont'd.). Kardex Tickler — Reverse

✓ 1949-50 Audit Report and Returns mailed 1-3-51	
✓ City Occupational Tax 2-1-51	OK - AME
✓ State " 3-1-51	OK - AME
✓ 5-1-51 Commence S/A Examination	OK - AME
✓ 6-10-51 Balanced S/A Report to J.D. Jr.	AME also handled Miss occupational
✓ Bring up 9 mos 8/1/51	Completed 9/2/51 B.
✓ Last closing visit Oct.	
Commence audit about 11/8/51	
During this audit make complete study of Base Period income for future EPT use. Particularly study advisability of capitalizing advertising chgd. to exp.	

The diagram shows a physical representation of the Kardex Tickler card. It is a long, narrow card with a grid of numbers (1-25) along the top. The card is divided into sections by vertical lines. The left section is labeled 'Orange Indicator' and contains the text 'John Doe & Co., Inc. Corp.'. The middle section is labeled 'Blue Indicator' and contains the text 'Mr. Doe Sr. Private Phone LY 1429'. The right section is labeled 'Orange Indicator' and contains the text '432 James St. N.O. 12 RA 6369'. A 'Red Line' is indicated between the left and middle sections. The card is shown being inserted into a slot.

Figure 17 (a). Follow-up on Tax Returns

FOLLOW-UP ON TAX RETURNS		
John Doe Corporation		
Year Ended _____		
<u>Sent To Office For Typing</u>	<u>Final Filing Date</u>	<u>Return Delivered To Client</u>
7-2-51	7-15-51	7-12-51 Client
7-15-51	7-15-51	7-19-51 delv'd by DEP
7-1-51	7-15-51	7-12-51 Client
7-1-51	7-15-51	7-12-51 Client
6-1-51	6-30-51	6-25-51 Client

FEDERAL TAX RETURNS

Form 1120 - Tentative

Form 1120 - Final

OTHER STATE RETURNS

CALIFORNIA Franchise Tax Return
This return must be filed with the Franchise Commissioner within 2 months and 15 days after the close of the income year, together with remittance payable to the Franchise Tax Commissioner.

CONNECTICUT Income Tax Return (form 66-B)
This return must be filed with the Tax Commissioner, State Capitol, Hartford, Conn., within 90 days after the close of the fiscal year.

MICHIGAN Corporation and Securities Commission Report
This report must be filed annually with the Michigan Securities, Lansing, Michigan, within 60 days after the close of the fiscal year. The filing fee is \$3.00.

Figure 18 (a).
Instruction Sheets for
Processing Reports

INSTRUCTION SHEET		INSTRUCTIONS TO REPORT DEPARTMENT	
(The original of this form must be filed on the first page of the office copy of the completed report.)		Client.....	
IN-CHARGE ACCOUNTANT.....	PARTNER.....	Time charged to.....	
CLIENT.....	SUPERVISOR.....	Date wanted.....	
	REVIEWED BY.....	If reports should be dated other than date typed specify date.....	
		..... Partner in charge	
		No. of copies: Client.....	
		Deliver all or..... copies to.....	
		..... Offices..... Total.....	
FORM OF REPORT.....		No. of Pages draft.....	
TYPE OF PAPER.....		Type: Rough draft.....	
COVER TO READ.....		S.E. Standard form.....	
		O.P.A.....	
		Letter.....	
		Stat'y { Plain: Statement, Report, Circle	
		{ Firm watermarked	
		{ Other	
		{ Registration	
		{ O.P.A.	
DATE RECEIVED.....		WORDING FOR COVER	
COMPLAINING AND PROVING DEPARTMENT.....		Audit Program Prepared by.....	
RELEASED FOR TYPING BY.....		Audit Program Approved by Partner.....	
RELEASED FOR ASSEMBLY BY.....		Mailing List Prepared and Attached	
DATE OF TON.....		Prepared by.....	
		Passed by Supervisor.....	
		Passed by Partner.....	
DELIVER COPIES TO.....		Date.....	
(indicate number).....		Date.....	
		Date.....	
		Date.....	
		Date.....	
FINAL READING.....		REMARKS.....	

Figure 18 (b). Instruction and Progress Sheet

INSTRUCTION AND PROGRESS SHEET

Report on _____

Period ended _____

Approximate time quota _____

Reviewed by partner _____ Report by _____

Number of copies to be delivered to client _____ Assistants _____

Is there a particular date report is to be delivered _____ Date Released _____

Reports to be delivered or mailed to _____

Are Journal Entries to be typed _____

Are Closing Entries to be typed _____

To whom should they be sent _____

Will there be tax returns _____

Special remarks _____

Changes for next year's working papers (see over) _____

Working papers completed _____

Footed before typing by _____ Trial Balance _____

Typed by: Comments _____

Footed after typing by _____ Report _____

Final reference by _____ Performed before typing by _____

Journal Entries mailed to _____ Booklets _____

The returns mailed to _____ Mailed by _____

Audits mailed to _____ Date _____

Date _____

PROGRESS SHEET

NAME SHEET TO BE ATTACHED TO ALL DRAFTS

(Please fill in all items)

Copies to: _____

Number of copies _____

Name of student _____

Kind of student _____

Room, floor, etc _____

Phone, room, etc _____

Address _____

City _____

State _____

Zip _____

Other (Specify) _____

Prepared by _____ Date _____

Special instructions _____

Typed by _____ Date _____

Reviewed and/or _____

Student to _____

Revised comments: _____

Figure 18 (c). Engagement Program — Other Than Monthly

[Name of Company]

**ENGAGEMENT PROGRAM
AUDITS OR ENGAGEMENTS OTHER THAN MONTHLY**

Date _____

Approved by _____

A. CLIENT—OFFICIAL TITLE (Print) _____

B. LOCATION OF OFFICE _____

C. TO WHOM REPORT SHOULD BE ADDRESSED _____

D. PERIOD TO BE COVERED BY ENGAGEMENT:

1—From _____ To close of business _____

2—As of close of business _____

E. SPECIFIC NATURE OF SERVICE (Include special instructions as to scope of engagement, etc.) _____

F. REPORT—NUMBER OF COPIES (____); SHOULD INCLUDE:

1. Comments:

a. Comprehensive _____

b. Special emphasis on:

1. Internal control _____

2. Operations _____

c. Certificate _____

2. Balance Sheet _____

3. Statement of Surplus _____

4. Statement of Profit and Loss _____

5. Statement of Income and Expense _____

6. Statement of Operations _____

7. Special Schedules _____

G. WORK ON ENGAGEMENT COMMENCED _____ COMPLETED _____

H. ACCOUNTANTS _____

I. TIME—Audit and Tax Returns _____ COMMENTS _____ REVIEW _____

GENERAL INSTRUCTIONS

Complete the Internal Control questionnaire (Page 2) before adopting the engagement program, as the information from this source is most important in determining the scope and extent of examination necessary for proper verification. The engagement program is primarily a valuable guide for the accountant on an engagement as it suggests the most important operations to be covered in the audit procedure. The accountant in charge should confer with the supervising partner before deleting or curtailing the adopted program or increasing the scope; and the said partner should note in the program his approval of the change. The accountant in charge should study the program before commencing the actual work so that he will be able to organize the routine of the procedure.

Cash counts should be "surprise" counts and should be made simultaneously at all locations, and at the same time all investments and negotiable instruments should be placed under the control of the accountant until examined.

Inaccurate or incomplete programs will be returned for correction; hence before leaving client's office be certain that the program is complete or changes therein are approved and supported by good reasons.

An "X" should be placed at the left of the item in the program indicating that the item should be included in the procedure, and an "X" should be also placed over the numerals at the top of the columns indicating the months in the period in which the items of procedure are to be applied. The hours (to ¼ hr.) consumed in completing the procedure should be noted in the proper column and the initials of the accountant performing the item of procedure should be placed in the column headed "acct." as each operation is completed together with a "✓" in the "month" column indicating the completion thereof.

Figure 18 (d). Engagement Program — Monthly

[Name of Company]

ENGAGEMENT PROGRAM**BOOKKEEPING AND SPECIAL MONTHLY EXAMINATION****ENGAGEMENT:**

MONTHLY _____ Approx. date of Visit _____ DATE _____
 QUARTERLY _____ APPROVED BY _____
 SEMI-ANNUALLY _____
 ANNUAL CLOSING DATE _____

A—Client—Official Title (print) _____

Executive to contact _____

B—Location of Office _____ Location of Records _____

Type of Business _____ Type of Organization _____

C—Period to be covered by engagement:

1. From _____ To close of business _____

D—Specific Nature of Service (include Special Instructions as to scope of engagement, etc.) _____

E—Report—Typed (_____)—Pencil Copy (_____).

Monthly _____, quarterly _____, semi-annually _____, annually _____

1. With Comments _____

2. Without Comments _____

3. Number of Copies _____

4. Address to (if other than client) _____

F—General:

Period	Time	DETAIL WORK	SUPERVISION AND REVIEW		TOTAL TIME
		Accountant	Time	Name	
1.	_____	_____	_____	_____	_____
2.	_____	_____	_____	_____	_____
3.	_____	_____	_____	_____	_____
4.	_____	_____	_____	_____	_____
5.	_____	_____	_____	_____	_____
6.	_____	_____	_____	_____	_____
7.	_____	_____	_____	_____	_____
8.	_____	_____	_____	_____	_____
9.	_____	_____	_____	_____	_____
10.	_____	_____	_____	_____	_____
11.	_____	_____	_____	_____	_____
12.	_____	_____	_____	_____	_____
Total	_____	_____	_____	_____	_____

SPECIAL INSTRUCTIONS

The accountant assigned to a Bookkeeping engagement should study the program carefully and familiarize himself as to the detail work called for. He should also study the operation of the business and be familiar with the actual system of handling transactions. He should ascertain the nature of the General Ledger accounts and should be certain that the workpapers contain a chart of the operating accounts. (This may not be necessary if a Trial Balance is included in workpapers.)

If possible, where a monthly Trial Balance is required, this should be taken on 16 column worksheet using one column for each month with Assets, Liabilities, Income and Expenses on separate sheets as provided for in the Procedure Manual. Continuing schedules of Property accounts and analyses of certain expenses can be carried in workpapers each month, adding the month's transactions on the monthly visit, thus eliminating the necessity for additional time for preparing such schedules at the time of the annual closing.

The Accountant actually performing the work of the engagement should note briefly in spaces provided any recommendations for changes in system that will improve the system of recording transactions and the system of internal control. These changes should be discussed with the Supervising partner and "cleared" by him by a notation of his action thereon. All recommendations should be dated and signed by the accountant.

Approval of the supervising partner should be obtained before any changes in the scope of this engagement are made.

Figure 21 (a). Typing Department Work Summary

_____, Certified Public Accountants (Firm name)		
WEEKLY OFFICE REPORT	WEEK ENDING _____ 19__	
<u>WORK COMPLETED SINCE</u> _____ 19__ :		
Mr. and Mrs. John M. Brown	5/31/52	Federal and State income tax returns
M. & M. Dress Shop	5/31/52	Report, journal entries, individual Federal and State income tax returns
Efficiency Lumber Co., Inc.	2/29/52	Report, journal entries, corporation Federal and State returns.
B. & D. Products Co.	5/31/52	Federal and state partnership returns
<u>WORK IN PROGRESS:</u>		
Estate of Harry Williams	4/30/52	Federal and State fiduciary returns
Emery K. Smith Co.	5/31/52	Report
First District Auto Dealers Adv. Fund	6/30/52	Report
John J. and Miriam H. Lewis	1948	Individual and joint petitions
<u>WORK ON HAND:</u>		
St. James Products Co., Inc.	6/30/52	Report

[illegible]

Figure 22 (e). Time Sheet — Semimonthly

PERIOD _____ 19____

REPORT OF _____

NAMES OF CLIENTS	APPROVED	DIT	TAX	ES	SPECIAL	DISTRIBUTION OF TIME BY DAYS																															TOTAL HOURS	TOTAL MONTHLY HOURS
						1-7							8-14							15-21							22-28							29-31				
						1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31		
<div style="position: relative; width: 100%; height: 100%;"> <div style="position: absolute; top: 0; left: 0; width: 100%; height: 100%; background: repeating-linear-gradient(45deg, transparent, transparent 2px, black 2px, black 4px);"></div> </div>																																						
TOTAL HOURS CHARGEABLE TO CLIENTS																																						
ADMINISTRATION																																						
LOST TIME																																						
VACATION																																						
UNASSIGNED																																						
RESEARCH AND STATISTICS																																						
FEDERAL TAX RESEARCH																																						
OVERTIME TAKEN																																						
HOLIDAYS																																						
TOTAL NON-CHARGEABLE HOURS																																						
COMBINED TOTAL																																						

FOR OFFICE _____
 USE ONLY _____

SPLIT WEEK _____
 FROM PRIOR PERIOD: _____
 EARNED _____
 PREPAID _____

OVERTIME _____
 WEEK ENDING: _____

Figure 23 (a). Time and Expense Accumulation System**Partial Chart of Accounts****EXHIBIT A**

**Ledger Accounts Used In Connection With
Recording Time, Expenses And Billing Of Engagements
(Accrual basis system)**

Current Assets - Inventory:**Entry from****130 Direct costs on engagements in progress:****131 Salaries - partners)****132 Salaries - staff)****133 Expenses****138 Professional services****Summary of time reports****Summary of expense reports****Income and Expenses:****Direct costs:****411 Salaries - partners****412 Salaries - staff****418 Professional services****Expenses:****01 Salaries - partners****02 Salaries on engagements in progress -
partners (credit)****03 Salaries - staff****04 Bonuses - staff****05 Salaries on engagements in progress -
staff (credit)****07 Professional services
(Forwarding fees paid)****08 Professional services on engagements
in progress (credit)****91 Expenses chargeable to clients (credit)****Cash disbursements journal****Summary of time reports****Cash disbursements journal****Cash disbursements journal****Summary of time reports****Cash disbursements journal****Summary of expense reports**

Figure 23 (b). Time and Expense Accumulation System
Time Report — Front

TIME REPORT		EXHIBIT B - FRONT							
OFFICE <u>SAGINAW</u>		NAME <u>Mr. A.</u>							
		WEEK ENDED <u>May - 18, 1954</u>							
CLIENT AND WORK DONE	Order No.	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday	TOTAL
<u>XYZ Corp.</u>	<u>944</u>	✓	✓ 3/4		1/2	7			<u>18 1/4</u>
<u>ABC Co.</u>	<u>943</u>		1/14						<u>1 1/4</u>
<u>J. Doe</u>	<u>936</u>			7	2 1/2				<u>9 1/2</u>
<u>J. BERNARD</u>			OUT						
<u>FUNERAL</u>			1/2						
			3						
TOTAL CHARGEABLE HOURS		✓	7	7	8	7			<u>29</u>
NON-CHARGEABLE HOURS					4				<u>4</u>
TOTAL HOURS FOR THIS OFFICE		✓	7	7	7	7			<u>33</u>
HOURS FOR OTHER OFFICE									
TOTAL HOURS		✓	7	7	7	7			<u>33</u>

Figure 23 (b) (Cont'd.). Time and Expense Accumulation System
Expense Report — Reverse

EXPENSE REPORT		EXHIBIT B - BACK							
OFFICE <u>SAGINAW</u>		NAME <u>Mr. A.</u>							
		WEEK ENDED <u>May - 18, 1954</u>							
DAY	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday	TOTAL	
ITINERARY			<u>SAGINAW TO FLADWIN</u>		<u>SAGINAW TO DETROIT</u>				
MILEAGE CHARGEABLE			<u>170</u>		<u>180</u>				
TRANSPORTATION									
MILEAGE			<u>17 -</u>		<u>18 -</u>			<u>30 -</u>	
HOTEL									
MEALS									
PARKING					<u>65</u>			<u>65</u>	
TOTAL			<u>17.00</u>		<u>18.65</u>			<u>30.65</u>	
DISTRIBUTION									
DEBITS				CREDITS				REMARKS	
CLIENT	Order No.	Amount	Account No.	Amount	Account No.	Amount			
<u>T. Doe</u>	<u>936</u>	<u>17.00</u>	<u>41</u>	<u>65</u>	<u>309 W</u>	<u>65</u>			
<u>X. Y. Z Co.</u>	<u>944</u>	<u>18.65</u>	<u>133</u>	<u>30.65</u>	<u>91</u>	<u>30.65</u>			
TOTAL		<u>30.65</u>							

Figure 23 (c). Time and Expense Accumulation System

Cost Sheet

COST SHEET

EXHIBIT C

CLIENT		<u>XY Z Corp.</u>						ORDER NO.		<u>974</u>	
ADDRESS								DATE		<u>4/1/52</u>	
ENGAGEMENT		<u>3/31/52 Audit</u>						INVOICE NO.		<u>847</u>	
		<u>Examination of accounts for the fiscal year ended March 31, 1952, preparing federal and state income and excess profit tax returns for fiscal year.</u>						DATE		<u>5/31/52</u>	
								TIME \$		<u>3081.50</u>	
								EXPENSES \$		<u>491.81</u>	
								TOTAL \$		<u>3573.31</u>	
TIME		<u>PARTNERS</u>						<u>STAFF</u>		<u>STENOGRAPHER</u>	
1952	WEEK ENDED	A	B	C	D	E	F	WEEK ENDED	TYPE	AMOUNT	
	4/6	7	14	10 3/4	3/4			4/1	Tel.	8.13	
	4/13	75		71 3/4				4/13	Post.	104	
	4/20	31		26 1/2				4/20	Post.	140	
	4/27	17 1/2				3 3/4	1/4	4/27	Post.	108	
	4/30	10		9 1/2				4/30	Post.	74	
	5/4	21						4/13	Travel	338.05	
	5/11	10 1/2	4 7/2	13 3/4	5 1/4	2 1/4	10 1/2	4/27	Travel	19.75	
	5/18	18 1/4				25 1/4	26 1/2	5/4	Travel	91.66	
		190 1/4	18 1/2	132 1/4	6	31 1/4	37	5/4	Post.	08	
								5/11	Post.	04	
								5/11	Tel.	17.69	
								5/18	Travel	18.65	
										491.81	
<u>BILLING</u>											
								208 3/4	10-	2087.50	
								132 1/4	6-	793.50	
								6	5-	30.00	
								68 1/4	250	170.50	
										3081.50	
COST SUMMARY											
PERIOD	PARTNERS	STAFF	PROF. SERV.	EXPENSES	PERIOD	PARTNERS	STAFF	PROF. SERV.	EXPENSES		
APRIL	618.00	262.43		368.67							
MAY	217.00	129.84		123.12							
TOTAL	835.00	392.27		491.81							

Figure 23 (d). Time and Expense Accumulation System**Time Report Summary****EXHIBIT D****Summary of Time Reports
Month of April, 1952**

		Week ended					Total		Amount
		6	13	20	27	30	Time	Rate	
A	Charged	7.	75.	31.	17.2	10.	140.2	(a)) \$ 618.00
	Non-charged								
	Total								
B	Charged	14.					14.	(a)))
	Non-charged								
	Total								
C	Charged	10.3	71.3	26.2		9.2	118.2	(b)))
	Non-charged								
	Total								
D	Charged	.3					.3	(b)) \$ 262.43
	Non-charged								
	Total								
E	Charged				3.3		3.3	(b)))
	Non-charged								
	Total								
F	Charged				.1		.1	(b)))
	Non-charged								
	Total								
G	Charged))
	Non-charged								
	Total								
H	Charged))
	Non-charged								
	Total								
J	Charged))
	Non-charged								
	Total								

Note: Time filled in for X.Y.Z. Corp. only, for convenience in tracing.

(a) Dr. 131; Cr. 02

(b) Dr. 132; Cr. 05

Figure 23 (f). Time and Expense Accumulation System
Cost of Jobs Billed Schedule

EXHIBIT F

Cost of Jobs Billed May __, 1952				
Invoice No.	Client	Order No.	Billing Partner	Staff Professional Services Expense
847	X.Y.Z. Corp.	924	3,081.50	835.00 392.27 491.81
Total for month				

(Accounts receivable)
(Professional fees)

• Dr. 121 Dr. 411 Dr. 412 Dr. 418 Dr. 121
Cr. 401 Cr. 131 Cr. 132 Cr. 138 Cr. 133

Figure 23 (g). Time and Expense Accumulation System
Inventory of Work in Progress Schedule

EXHIBIT G
Inventory of Work in Progress
April 30, 1952

Client	Order No.	Partner	Staff	Professional Services	Expenses
X.Y.Z. Corp.	924	618.00	262.43		368.69
Totals					

Agree with balance of 131
Agree with balance of 132
Agree with balance of 138
Agree with balance of 133

Direct cost on engagements in progress, and 130

Note: This inventory of work in progress lists the names and amounts applicable to each client for work still unbilled. See explanation as to Exhibit H, annual accumulation of direct costs of engagements in progress in classified totals.

Figure 23 (h). Time and Expense Accumulation System**Continuous Summary of Entries to Control Account**

EXHIBIT H

Direct Costs On Engagements In Progress

	Salaries Partners	Salaries Staff	Professional Services	Expenses
Balance - September 1, 1951				
September additions				
September deductions				
Balance - September 30, 1951				
October additions				
October deductions				
Balance - October 31, 1951				
November additions				
November deductions				
Balance - November 30, 1951				
December additions				
December deductions				
Balance - December 31, 1951				
January additions				
January deductions				
Balance - January 31, 1952				
February additions				
February deductions				
Balance - February 28, 1952				
March additions				
March deductions				
Balance - March 31, 1952				
April additions				
April deductions				
Balance - April 30, 1952				
May additions				
May deductions				
Balance - May 31, 1952				
June additions				
June deductions				
Balance - June 30, 1952				
July additions				
July deductions				
Balance - July 31, 1952				
August additions				
August deductions				
Balance - August 31, 1952				

Note: Postings to this form of "additions" for each month emanate as follows:

<u>Cost of</u>	<u>From</u>
Salaries:	Summary of time reports - Ex. D
Prof. Services:	General Ledger account
Expenses:	Summary of expense reports - Ex. E

Postings to this form of "deductions" for each month emanate from cost of jobs billed - Ex. F.

The firm's fiscal year close is August 31st.

Figure 23 (i) (Cont'd). Time Ledger Sheet — Reverse

ANALYSIS FOR FINAL BILLING					
ACCOUNTANT	HOURLY RATE	TOTAL HOURS	IDEAL FEE	BILLED FEE	MEMO
ABC	10.00	15	150.00	153.81	
DEF	6.00	17½	105.00	107.67	
GHI	4.00	11	44.00	45.12	
TYPIST	3.00	2	6.00	6.15	
TRAVEL	None	6			
TOTAL FOR ACCOUNTANTS		51½	305.00	312.75	Ratio of Billed Fee to Ideal Fee 102.54%
EXPENSE			37.25	37.25	
TOTAL			342.25	350.00	

STEPS

- 1 Time posted from time reports to this time summary monthly.
2. At termination of job, totals are posted to reverse side of sheet.
3. Hours multiplied by accountants' billing rate to arrive at ideal fee.
4. Total of ideal fee column is then considered in connection with actual billing—actual bill is made—usually in a rounded figure covering both time and expense. In most cases billed fee is at as close to 100% as possible. However, on special engagements the ratio is increased or decreased to fit the type of special engagement and, of course, on a fixed fee engagement there will be some variation from the 100% ratio.
5. The billed fee is then prorated back over the staff who worked on the engagement to find each one's share of the billed fee.
6. At the end of the year each staff member's share of the billed fee is accumulated from all engagements in which he participated and his annual compensation for the year is computed at 50% of his share of the accumulated billed fees. From such annual compensation is deducted the guaranteed drawing account paid monthly and the balance is paid to him in the form of a bonus.

Figure 33 (a). Binder Cover for Files — Audit Reports

<u>Delivery of Reports</u>		
_____ Copies to _____	_____ Address _____	No. _____
_____ " " _____	_____ Address _____	Received _____
_____ " " _____	_____ Address _____	Censored _____
_____ " " _____	_____ Address _____	Typ. Dept. _____
_____ File _____		Issued _____
_____ Total _____		
<u>Binding</u>		<u>VIA</u>
_____ Copies Paper		Report _____
_____ " Leather		File Copy _____
		Manuscript _____
		Work Papers _____
_____ Name of Client _____		
_____ Location _____		
_____ Title _____		
_____ Period Covered or Closing Date _____		
[Name of Company]		
CERTIFIED PUBLIC ACCOUNTANTS		
_____ Office _____		
<u>APPROVALS</u>		<u>SPECIAL INSTRUCTIONS</u>
General _____		_____
Manager _____		_____
Supervisor _____		_____
Accountant in charge _____		_____
_____		_____

Figure 33 (b). Binder Cover for Files — Income Tax Returns (Front)

DELIVERY OF RETURNS

FOR ATTENTION OF _____

ADDRESS _____

REPORT NO. _____

DATE RECEIVED _____

DATE TO TYPING _____

DATE MAILED _____

_____ INCOME TAX RETURNS

NAME OF CLIENT

ADDRESS

KIND OF SERVICE

PERIOD COVERED OR CLOSING DATE

[Name of Company]

CERTIFIED PUBLIC ACCOUNTANTS

OFFICE

SUPERVISOR _____

ACCOUNTANT IN CHARGE _____

ASSISTANT _____

TAX DEPARTMENT

REVIEWED BY _____

SPECIAL INSTRUCTIONS

Appendix C

INSURANCE COVERAGE RECOMMENDATIONS

(The following excerpts from a letter written by an insurance agency are presented solely as a survey of available insurance which may be applicable to public accounting firms. It is not meant to indicate proper insurance coverage for every firm. Insurance agents should be consulted for appropriate coverage and desirable policy features and costs.)

Workmen's Compensation

Although certified public accountants are not required by law in some states to be covered by workmen's compensation insurance, this protection is always desirable.

A workmen's compensation policy covers the regular employees of an auditing firm, even when services are performed outside of the state in which the firm is located. If the firm maintains branch offices in other states, the policy should be indorsed in order to cover employees of such offices. Since most auditing firms are proprietorships or partnerships, any workmen's compensation policy written will exclude the owner or partners.

A typical policy should include full medical coverage in the maximum amount of \$10,000 for any one claim and a limit of not less than \$100,000 under paragraph I(B). The latter affords protection for a very nominal cost against "common-law suits" which may arise when claims are not filed under compensation laws. Workmen's compensation policies are written for a term of one year only.

Firms which arrange annual outings and similar events for their employees frequently find it desirable to secure special accident insurance coverage for the specific occasion. The cost is usually small and the policy protects against unusual accidents in athletic events and similar activities.

Comprehensive General Liability

Comprehensive liability insurance covers any and all activities and hazards not specifically excluded by the policy. The policy not only covers known and ratable hazards, but also includes those not enumerated. It does this without the necessity of any notification to the insurance carrier. It is a combination, in one policy with one insurer, of several kinds of liability insurance which formerly were written on an individual basis or on schedule policies. It thus avoids the unnecessary expense of overlapping insurance and at the same time prevents gaps. The premium is determined by a survey of the hazards described and rated in liability manuals covering manufacturers' and contractors' lia-

bility, owners', landlords and tenants' liability, elevator liability, products liability, owners' or contractors' protective liability and contractual liability.

In order to make possible a broader form of contract, and to eliminate from the policy contract any reference to "caused by accident," the policy should be written with the "occurrence endorsement."

Comprehensive Automobile Liability

Comprehensive automobile liability insurance provides coverage on all cars owned by the auditing firm, even where specific notification to the insurance carrier is not made. The policy should include coverage on hired cars as well as nonownership liability and property damage. Such protection provides for rented automobiles, as well as those owned by employees, operated in the course of the auditing firm's business.

Comprehensive automobile liability insurance should include bodily injury liability limits of not less than \$100,000/\$300,000, a property damage liability limit of \$25,000 and medical payments coverage of \$2,000. Such limits are recommended in view of the trend to large awards in present-day court decisions.

Comprehensive Fire, Theft and Collision

Automobiles owned by an auditing firm should be insured under the comprehensive fire and theft and collision form. Because of the higher cost of repairs and the consequent larger premiums for insurance of the deductible type, 80% collision coverage is desirable. A policy of this type provides for the payment of 80% of any applicable loss to a limit of \$250 and full reimbursement of any portion in excess of \$250.

Both this and the preceding type of insurance are usually written for a term of twelve months but may be obtained for longer periods.

Comprehensive Dishonesty, Destruction and Disappearance

A policy under this form is an "all risk" protection against the loss of money and securities caused by dishonesty, mysterious disappearance and destruction, whether the property belongs to the auditing firm or to others, but is in the custody of the firm. The latter protection should be stated in writing. Loss due to dishonesty of employees, damage to premises and equipment, loss of securities in safe deposit and forgery are included in the protection. Such insurance takes the place of individual insurance contracts known as broad form money and securities, blanket position bond and forgery.

The policy should provide about \$2,500 coverage in blanket form, with appropriate additional coverage in the case of employees entrusted with securities.

Accountants' Liability

Accountants' liability insurance protects an auditing firm against direct pecuniary loss and expense arising from any claim made because of legal liability for damages caused or allegedly caused by any member of the firm in the performance of professional services. Such liability may arise through neglect, dishonesty or fraud, unless such fraud is committed by the firm or any of its partners with actual intent.

Unless specifically provided, coverage does not extend to loss due to libel or slander, liability due to the "Securities Act of 1933," or to any expense arising from loss of time occasioned by any claim or suit.

At such times as work is delegated to other auditing firms, the insurance company should be notified and the policy properly endorsed. If this is not done the policy will apply only to actual employees of the insured firm.

Valuable Papers

Valuable papers insurance indemnifies the auditing firm against all loss, damage or destruction of valuable papers whether on the premises or outside, excluding losses occurring while in the custody of any public carrier or in the mail. Hazards specifically excluded, however, are misplacement, mysterious disappearance, gradual deterioration or inherent vice, as well as war, insurrection and similar clauses. The mysterious disappearance exclusion may be removed in consideration of an additional premium.

Sprinkler Leakage, Fire and Extended Coverage

Protection under these coverages is applicable to office equipment. Similar damage to valuable papers is covered under the valuable papers policy.

Plate Glass Insurance

Plate glass insurance covering desk tops and glass in partitions may be purchased at nominal cost, and may be advisable in a well-rounded insurance program.

Accident and Health Insurance

Accident and health insurance should be purchased in order to protect the partners of an auditing firm who are not covered by workmen's compensation insurance. Limits of the policy should be sufficient to provide for exposure during the use of airline transportation.

Partnership Insurance

The purpose of partnership insurance is to provide cash for the purchase of the interest in the firm of a deceased partner. This is often desirable since such an interest includes a portion of goodwill, which may be substantial. It may provide the most satisfactory solution as to the disposition of each partner's interest both from the standpoint of surviving partners and the deceased partner's estate. (Reference is made to Chapter 3 for detailed data on goodwill, tax consequences regarding death and retirement benefits and uses of partnership insurance. — Editor)

Ordinary life or a preferred risk coverage is usually desirable, if available. It is generally arranged in crisscross fashion with each partner owning the insurance on the life of the others and with the proceeds payable to the survivors.

Employee Benefit Plans

With the widespread adoption of various employee benefits by industry and the resulting competition for employees, such plans as group life, group accident and health and hospitalization insurance should be considered. This coverage may be available through state societies.

Appendix D

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CHAPTER 8

OFFICE PROCEDURES FOR CORRESPONDENCE AND REPORTS

PERSONNEL

Sources of Personnel. Selection of General Office Employees. Employee Relations.

UTILIZATION OF PERSONNEL

CORRESPONDENCE

Paper and Envelopes. Procedures. File Copies. Extra Copies. Removal of Correspondence.

EQUIPMENT

Dictating Equipment. Typewriters. Reproduction Methods.

REPORTS

Preparation and Review. Stationery. Report Covers and Envelopes. Typing. Schedule of Work. Typing Suggestions. Erasures on Reports. Review and Referencing. Proofreading. Final Review and Delivery. Distribution Record. Form Manual.

TAX RETURNS

APPENDIX

Style Manual for Report Writers, Typists, and Stenographers of a Public Accounting Office.

CHAPTER 8

Office Procedures for Correspondence and Reports

BY STEPHEN CHAN

IT IS SURPRISING to the uninitiated that so many methods and varieties of procedures exist in the offices of accountants with similar practices. Many are far from efficient. It is evident that there is a need for greater attention on the accountant's part toward making his office methods as efficient as those he installs for his clients.

This chapter will describe some of the methods which have proved practical in the conduct of a moderate-sized public accounting practice, together with some of the alternatives or variations used by others. It should be understood that no one procedure is necessarily the best in all situations, and that the type of practice, locality, and number of staff and clients will affect to some extent the choice of office procedures.

PERSONNEL

In engaging stenographers and typists it is necessary to consider the fact that certain temperaments and aptitudes are most desirable in accounting offices. Since the stenographic and typing work consists largely of figures, it is futile to train someone who has an antipathy to figures. Statistical typists are not born with the required experience and since the schools do not concentrate on statistical work, these typists must be trained.

For a small office it is well to hire a girl who has had some experience with a larger accounting firm. However, in a small community this may not be feasible. In fact, a practitioner just starting his office may find a thoroughly experienced person somewhat beyond his means and he is more apt to lose trained personnel to larger firms than to secure competent workers from them. He is likely to find that he will have to select and train someone with simply potential ability and aptitudes, and perhaps, initially at least, use only part-time office help. He should therefore seek at the outset a married woman who has had previous experience in an accounting office in his town or in a larger center and who is receptive to income from part-time work.

For a larger firm, with one or two experienced girls, it is practical in

hiring additional help to obtain young women with a small amount of typing experience and train them in the firm's procedures. The more experienced girls can then handle the more complicated work, permitting the less experienced ones to do the smaller reports and tax returns. If the size of the office does not justify a full-time clerk or telephone operator, the new girl can also assume some of these duties.

Some firms have a new employee work for about a month studying their typing manual, which has rules, examples, and explanations for setting up most types of statements, report comments, et cetera.

To relieve the monotony, the new girl is given simple work to type, and also types tax returns.

Sources of Personnel

The main sources for typists are private employment agencies, help wanted advertisements in newspapers, business schools, situation wanted advertisements, leads furnished by associates or employees, and records of previous applicants for employment. The sources to use depend on such factors as nature and urgency of the need, past experience in securing help, and the general or special customs followed in the community. The sources just given are listed in the order of regular use as reported by a large number of firms.

Selection of General Office Employees

These firms also report that when engaging general office help they attach great importance to the following points: (1) ability and willingness to do quantities of columnar typing and tabulation, (2) liking for work involving figures and detail, (3) adequate knowledge of English, (4) willingness to work overtime during peak seasons, and (5) ability and willingness to use special purpose (broad-carriage) typewriters. Knowledge of general office routine was not considered essential, and proficiency in using adding machines, calculators, and so on, and a knowledge of bookkeeping were set down as unimportant by a large number. The significant difference between important and unimportant is, obviously, that basic qualifications are important while others, no matter how helpful in a subordinate way, can be dispensed with if not available or can be ultimately imparted. To the small firm there seems to be an indication that what must be looked for particularly is willingness to learn, willingness to work, some basic knowledge and a definite indication of potential capacities along required lines.

Often, reliable female office help is difficult to obtain. Whether or not this is the case, an enlightened employment policy will pay dividends. Office hours and vacation policy should conform to local practice.

In the past few years it has become increasingly difficult to obtain employees if Saturday morning work is in the schedule. So in most places

the typing department is closed on Saturdays, except for the first few months of the year.

Employee Relations

No deductions should be made for time lost as a result of minor illnesses; the office environment should be pleasant; employee relations should be affable and courteous; salary increases should be made at least annually; bonuses should be paid at least annually for length of service, for excessive overtime, for extra duties assumed, and so on. Not all of the latter provisions can be put into effect immediately in a small, new practice. But they should be as the practice grows and makes them possible, for they in turn contribute to the establishment of an enduring and expanding organization.

The employees should work steadily and should be willing to work a little longer when a rush assignment demands it. However, the day of the "slave-driver" or the constantly rushing type of supervisor is past and those tactics will not produce consistent or accurate work or help retain employees.

In the training of a stenographer or typist, it should be brought to her attention with considerable emphasis that an accountant supplies nothing except professional service, and that the quality of his service is reflected in the nature of his advice and in the form of the report his client receives. Also that since the report is the only tangible thing the client sees, he may estimate the worth of the accountant by the appearance and content of his report.

Where there is an office staff of more than one person, it is usually advisable to have the stenographers (other than personal secretaries in the case of larger firms) and the typists work in one room. The stenographers answer a bell or buzzer connected to the rooms of the members of the firm or members of the staff who dictate. The dictation usually consists of answering the mail, writing memos to clients and interoffice memos, and other types of work which under ordinary circumstances would not have to be reviewed by some other person except perhaps for final approval.

Usually comments pertaining to a report are not dictated. The accountant writes the report in longhand in draft form, which is reviewed by his senior, the chief of staff, or a member of the firm. Proficient accountants, however, may dictate their reports, sometimes in draft, and this may save expensive time at the lesser cost of some added clerical time. This is a practice which deserves encouragement because it is valuable in saving time for the firm when skilled accountants are in short supply.

UTILIZATION OF PERSONNEL

At the inception of a CPA's practice, the office girl is usually a combination typist, stenographer, file clerk, and receptionist. As the firm

grows and additional office help is required, departmentalization of operations may take place. One or more girls may take dictation and type correspondence and report comments, another girl or girls may type financial and statistical statements. Filing may be a full-time job for another employee.

The point in the firm's progress at which departmentalization becomes necessary must be decided separately by each firm. However, considering the problems of training office help and the salary costs involved, it is important that proper utilization be made of all available time.

For instance, many state tax returns require income or expense schedules or balance sheets, similar to those on the Federal income tax return. In those cases typing several extra copies at the time the client's Federal return is prepared may obviate later retyping for state tax purposes. During slow periods, typists might make pro-forma copies of financial statements and reports, omitting the current figures, which will be filled in at the conclusion of the audit. Giving the auditors these pro-forma copies will save staff time during the busy season. Also since these pro-formas are drawn up in the established form and are easy to read, it will also result in saving time when the girls finally type the report for the client.

CORRESPONDENCE

Letters and reports offer an opportunity to create a favorable impression of the firm in the minds of known and unknown readers. This public relations aspect, in addition to the usual reasons such as professional appearance and neatness, warrants that care be taken before sending out correspondence and reports.

Paper and Envelopes

The original letterhead sheets should preferably be engraved on 16- or 20-pound rag paper. The 8½ by 11 size is most commonly used. The letterhead may be set up in one of the following ways:

JOHN J. JONES
Certified Public Accountant
611 West Broadway
New York 22, N. Y.
Oregon 5-9122

JOHN J. JONES
Certified Public Accountant

611 West Broadway
New York 22, N. Y.
Oregon 5-9122

JOHN J. JONES
Certified Public Accountant

Member, American Institute
of Accountants

611 West Broadway
New York 22, N. Y.
Oregon 5-9122

It is not considered desirable to claim special proficiency or to specify classes of service on the letterhead; consequently, such wording as "income tax consultants," "systems experts" and similar descriptions should not be used. It is customary, however, for firms with more than one office to list the names of offices in an upper corner of the letterhead. Occasionally the names of partners of the firm are shown on the letterhead.

The special letterhead sheets used when extra copies of letters are sent out may be printed rather than engraved and may have the word "copy" printed in large thin letters across the center of the sheet or at its head. These sheets may be 12-pound stock or may be the same weight as the letterhead sheet, with the lighter weight preferred and in more common use. Envelopes should preferably be of the same paper stock as the letterhead, with the return address in the upper left-hand corner. Some firms use United States Post Office prestamped envelopes, printed to order; this saves time affixing stamps and is especially useful when getting out a volume of mail.

It is practical to use window envelopes $6\frac{1}{2}$ inches wide, or $9\frac{1}{2}$ inches wide, with the firm name printed in the upper left corner, for time-saving when mailing confirmation requests. These envelopes are not considered satisfactory or of sufficient dignity for use with correspondence.

Billheads usually are the same stock as letterheads, using half-size sheets. If it is the policy of the firm to render billings in detail or with considerable description of the services, the regular letterhead is used.

Procedures

Effort should be made to reply to correspondence the same day it is received, if its nature permits. This will prevent an accumulation of work and will also enhance the firm's reputation for efficiency and promptness.

Not many firms keep a record of each letter which comes in and requires a reply. But those that do find it useful where several persons answer mail, especially to follow up those men who have a tendency to accumulate papers on their desks. This record may be maintained by the person who opens the mail or by the office manager or partner who receives all mail.

A simple form of loose-leaf or bound copybook or blank book, ruled as follows, with a space or two between each day's entries, will suffice for this purpose:

INCOMING MAIL REPORT

Date _____

Name of Sender	General Subject of Letter	Person to Whom Given for Reply	Date Reply is Mailed

As all the items on a page are replied to a red line can be drawn diagonally across the page. Open items should be followed up perhaps twice weekly.

In other firms the name of the man who is to reply is written in pencil on the upper right-hand corner of the incoming letter and it is placed on his desk or in his mail folder for reply. This system is quite casual and usually works well only when all mail is signed by one person who has a good memory.

It does not seem advisable to allow too many persons to sign firm mail. The more signers the more difficult it is to achieve uniformity of language or practice and the more difficult to fix responsibility. There is no harm in staff men dictating or writing letters, but signing should be the prescribed and exclusive duty of a partner or manager. Where this is done it is usually the custom to place on the office copy only the initials of the staff member who prepared the letter. In some cases, though less frequently, the initials are also placed on the original letter.

In addition to restricting the signing of letters and reports to partners, some firms follow the practice of having the partners sign the firm name, and not as individuals.

Much of the correspondence in an accountant's office can be reduced to form letters not requiring individual typing or signature. For instance, letters accompanying tax returns sent to clients for signature and filing, confirmation requests, form letters advising clients of pertinent changes in Federal or state income, franchise or payroll tax requirements, and similar matter, may be mimeographed, offset, or printed to save typing and signing time. This is common practice.

File Copies

Not all firms file office copies of correspondence with clients in the same way. Some file them chronologically, some alphabetically by clients, some in a special correspondence folder for each client, and some in the client's audit file (where there is an auditing engagement).

Extra Copies

As a firm expands it will be found practical to type, in addition to the file copy, one or two or more copies of all correspondence dealing with client's problems, taxes, or fees. One copy could be placed in the front of the working paper folder for the information of the staff man at the time he next visits the client's office. Some firms circulate an extra copy of all such letters, on distinctively colored paper, among partners or managers for perusal and initialing. Some firms route a colored copy to the staff man usually serving the client so that he is currently informed on all matters affecting that client.

In one firm of medium size, four copies of all correspondence and memoranda are prepared, these being distributed as follows:

1. Original to the party addressed.
2. Duplicate white tissue to an alphabetical correspondence file, this being filed promptly.
3. Triplicate pink tissue to the accountant in charge of the client, this being initialed by him and then sent to the working paper files.
4. Quadruplicate blue tissue, this being circulated among the partners for information and also being used as a follow-up copy for an indicated person and date, when the subject requires follow-up.

In this procedure, additional white tissue copies marked "copy" in large, thin, red letters are used when others are to be informed.

As indicated, a copy of each letter should always be filed alphabetically by client. However, some firms also maintain a chronological letter file for reference purposes. Where several copies are made for different purposes, the use of different colored sheets aids the filing procedure.

Removal of Correspondence

Few firms are so small as to dispense with requiring that when correspondence is removed from the files, a written and informative record must be made of such removal. Usually this record identifies definitely the material taken, names the person removing it, and gives the date of removal. One firm requires that the record also show the purpose for which removal is made. The value of this addition lies in the fact that it is apt to suggest where the papers may be found if they are not readily located. One firm, asked whether it kept a removal record, replied thoughtfully and realistically, "We do not, but we should!" Examples of such a form are included in Appendix B to Chapter 7.

EQUIPMENT

Dictating Equipment

Some principals find it convenient to be at the office for only a short time in the morning or evening, spending the balance of the day at clients' places of business. In order not to conflict with the stenographer's program it has been found helpful to use dictating equipment (some accountants even carry a machine occasionally or have one at home). The records or tape can be dropped off at the office and the worked typed by the stenographer at her convenience.

How important dictaphone equipment is to the smaller firm, and particularly to the individual accountant who may have only a part-time office worker, is indicated by the fact that 50% of the small firms reporting on this point have such equipment; this equals the percentage of use by moderate-sized firms.

Typewriters

If the office has only one typewriter it should have a carriage at least 24 inches wide, in order that both correspondence and financial state-

ments may be typed thereon. The machine should be equipped with tabulator stops.

As the office grows it is practical to have one or two 15-inch carriage machines for correspondence and report comments and 30-inch carriage typewriters for financial and statistical statements.

In order to aid in typing a maximum number of copies of reports in one run, it is advisable to insist on a hard roller in each machine.

An electric typewriter costs approximately \$550 for the 30-inch size carriage but reduces typing fatigue, gives greater production in a day, has a uniform striking force and therefore uniform key impressions and turns out uniform carbon copies as well as a greater number of clear copies; this is especially worth while when making more than five copies of reports.

The standard pica type in most machines prints ten letters in an inch of space. For certain purposes elite type, printing a few more letters to the inch, may be practical. However, the smaller print is difficult to read when a number of carbon copies is required, especially in the case of figures and tabulations. Most firms use pica type for reports; many use elite type for correspondence. Some firms use specially designed type, which makes unauthorized alterations of reports by others easier to detect.

The type on the International Business Machine Electromatic "Executive" typewriter gives an impressive printed look to letters. However, it is not as suitable for statistical or report typing since corrections are more difficult to make and tabulations are more difficult to line up.

Since most firms use double underlining in statements it may be desirable to secure a special key for this purpose.

Reproduction Methods

It is often desirable to retain a copy of certain of the client's documents, minutes, or vouchers in the auditor's working papers. Rather than do laborious copying by hand with the attendant chances of error, it may be economical to use a photostating or similar machine. A simple photostat machine costs approximately \$250 and can be operated by office clerks after little instruction.

Reproduction also is used by some firms to copy certain pencil or working sheet schedules to be attached to tax returns. However, a poor or cheap process of reproduction is undesirable for reports to clients.

Certain audit programs and working paper schedule outlines can well be mimeographed at a far lower cost than printing or photo-offset. This is also true of form letters to clients and confirmation request letters.

In small offices numerous copies of a report are not usually required. When it does occur, the quantity needed is generally so limited that typing of several sets will suffice. This creates several difficulties, however, which will need attention. There is the matter of uniformity of appear-

ance of all copies when more than one typist and one typewriter are engaged. There is the need to make as many copies as possible at a time, which is limited by the need of having all copies legible and neat. There is the problem of comparing (proofreading) each set typed to insure that every set is identical and correct. And there is the important matter of retaining as an office copy one copy of *each* set typed and so marking each copy of every set for identification that every copy, including *each* office copy, can be related readily to the particular set or run to which it belongs.

Most firms find that where a large number of copies are required, typing in this way will usually take care of the matter. However, the cost of using other equipment may actually be less and a better result may be secured. Where the number needed is too great or too expensive to handle by typing, three other methods are used. The one favored by 50% is multilithing. About 30% employ offset printing, and around 20% use mimeographing.

REPORTS

It is important that the accountant's office carry out uniform and consistent procedures in processing the financial statements and reports from the time of completion by the accountant in charge.

For an office which handles numerous special and nonrecurring engagements, it has been found helpful to use a form which accompanies the report draft through checking, typing, and final delivery. This form indicates the client's name and address, the number of copies to be typed, the name and address of each person who is to receive a copy of the report and how many copies he is to receive. The form also provides spaces for the name or initials of the persons who prepared the report, reviewed it, typed it, checked it, and sent it out, together with the date each of these operations was performed. Some firms whose practices consist primarily of monthly or recurring audits provide a rubber stamp at the upper right-hand corner of the first report pencil sheet, for the name of the preparer and checker. A card file is maintained in the typing room, indicating, for each client, the name and address of those who are to receive copies, the number of copies to be typed and other pertinent data. These forms are discussed in Chapter 7.

Preparation and Review

The subjects of report writing and review are discussed in detail in Chapters 11 and 19.

The usual sequence of events in this connection is outlined in the following:

1. Preparation of the pencil draft of the financial statements, including footnotes and comments, by the accountant in charge or partner, usually at the client's premises.

2. Review of the pencil draft and the audit workpapers, and comparison with the prior report, if any, by a partner or supervisor either at the client's premises or at the accountant's office.
3. Discussion of salient points or of whole report with client.
4. Editing or amplification of the report.
5. Typing.
6. Checking of pencil report to typed sheets; proving footings and extensions.
7. Checking cross references and schedules within the report.
8. Correcting indicated typographical errors by the typist.
9. Review of corrected copy by manager or partner.
10. Binding of report and addressing of envelopes for delivery or mailing.
11. Affixing signature by partner (some firms do this step before the report is bound; it is easier to sign unbound sheets).
12. Delivery to client.

Some firms feel that as much as possible in connection with the report should be done at the client's office, so that the client can see how much time is spent on his engagement.

There is considerable difference in practice in timing the review of the report with the client (Step 3 in the foregoing list). Some accountants review the statements and report in detail with the client while the material is in pencil form, and this is the more common practice. Others review merely the adjusting entries with the client before the report is typed and then review the report itself after typing, when it is more readable and presents a better impression. Usually this choice is variable with the wishes of the client or the time schedules of the accountant, but it is generally believed that a review of the report with the client at one stage or other is highly desirable.

Before the report is reviewed with the client, it should be reviewed with the partner responsible for the engagement, unless it is much the same as previous reports for that client.

Stationery

Reports should be typewritten on rag-content bond paper of good quality, on which the accounting firm's name is suitably engraved, printed, or watermarked.

The great majority of firms use 100% rag paper, although some firms report the use of 50% or 75% rag content. The majority apparently use 13-pound stock for report purposes, with many using 16-pound paper. Some firms employ 20-pound sheets for important correspondence but not for reports.

The sizes of paper used for financial statement and report typing vary greatly. Some firms report the use of only three sizes while others report as many as ten sizes. The dimensions range from those based upon 8½ inches (such as 8½ x 14 and 8½ x 17) to those based upon 13 inches (such as 13 x 13½ — 13 x 17 — 13 x 18½ and 13 x 21), with many measurements in between these ranges. There is a trend toward the adoption of the 8½ x 11 inch report size, for the principal reason that clients

find that this more satisfactorily fits their files and those of their banker.

In order that wide sheets of schedules or tabulations will readily fold to a uniform report size, and keeping in mind the desire of banks and creditors for reports which will fit into standard files, the following sizes have proved satisfactory:

$8\frac{1}{2} \times 11$; 11×13 ; 11×17 ; $11 \times 19\frac{1}{2}$; 11×26

These are the best sizes for folding to $8\frac{1}{2} \times 11$ reports.

Each page following the letterhead sheet of the report should bear, in small type, the neatly printed or engraved firm name in the upper left-hand corner or at the bottom center of the sheet. Alternatively, some firms use paper watermarked in the center with the firm name. This increases the cost and also requires large stationery orders, usually a ton of paper at a time being the minimum quantity for a run, but larger firms consider it to be visually effective.

Paper of 16-pound stock is used for reports requiring not more than seven or eight copies. In order that twelve or even fourteen copies may be typewritten in one run, the same sizes are sometimes also purchased in onion skin paper.

It is important to test various types and grades of carbon paper on the firm's typewriters and report stationery. The quality of the work turned out by different carbon papers varies greatly, especially where numerous copies must be typewritten at one run. Cheap carbon paper is undesirable, and it is usually more satisfactory to use the more expensive types manufactured especially for statistical typing purposes.

If the accounting practice includes listed companies, it is necessary, in addition to the foregoing sizes of paper to carry an $8\frac{1}{2} \times 13$ inch sheet and a 17×13 sheet which folds to $8\frac{1}{2} \times 13$, for use in SEC registration statements or annual SEC 10K reports.

It also will usually be desirable to stock the $8\frac{1}{2} \times 11$ and 11×17 sizes in a plain unwatermarked and unprinted paper, for use in copying schedules to be attached to tax returns, or for statistical or financial data compiled for clients or others without audit.

Report Covers and Envelopes

The report may be bound in a cover of good pliable kraft (heavy paper) stock, light grey, buff or light blue in color. Returns from firms consulted on this question indicate a decided preference for cardboard covers with heavy paper as a second choice, and grey was favored over second choice brown as the color.

A cover of $9 \times 11\frac{1}{2}$ inches will fit the $8\frac{1}{2} \times 11$ sheet size; for other report sizes a cover one-half inch larger in each dimension than the folded sheet is adequate.

The cover should bear the firm's name, or name and address, followed by the title "Certified Public Accountants," (if proper) engraved or printed at the center bottom or bottom right.

The title of each report is shown either at the center top or in the center of the page. Some firms type the titles while others have them imprinted specially for each audit or special report. Each accounting firm should have a standard way of designating the title of a report. For audit reports a common form of title is as follows:

Auditors' Report
GREEN MANUFACTURING COMPANY
June 30, 1952

An alternative form sometimes used is this:

GREEN MANUFACTURING COMPANY
Report
as at June 30, 1952

Other styles may be used, but it is generally desirable to follow on the cover the order or format used in statement headings.

In the case of unaudited financial statements, on which no opinion is intended to be expressed by the accountant, care must be taken to see that the method of presentation is not such as to cause the reader to assume that the accountant intended to assume any responsibility. One way to do this is to use plain stationery and plain covers, without the name or watermark of the auditor appearing on them. A more common and preferable way, and the one stipulated by Revised Statement 23, of the AIA committee on auditing procedure,* is to designate on the cover and on each statement the fact that the data are "*Prepared From the Books Without Audit*"; in such case a cover style could be:

GREEN MANUFACTURING COMPANY
Financial Statements
(Prepared From the Books Without Audit)
June 30, 1952

Any similar style which conveys this information is permissible in such cases.

Some accounting firms use a flysheet immediately following the cover, bearing the same title as appears on the cover. Other firms omit the flysheet, but present an index as the first sheet. The index usually indicates the pages of comments and lists each financial statement and schedule in numbered sequence.

* This revised statement, entitled "Clarification of Report When Opinion is Omitted" is contained on page 14 in Appendix B of Chapter 13 of this Handbook.

Some firms bind lengthy survey or other special reports in cloth or leather covers. However, good quality engraved kraft or heavy paper covers will usually suffice, and the practice of using fancy covers is becoming uncommon.

The report will look best bound at the left-hand side, and reports are generally so bound, except that for monthly statements, tax protests, single sheets, short form and informal reports, SEC matters, and the like, binding at the top is preferred. Most firms bind reports with eyelets, and some use brass fasteners. Some draw ribbon through the eyelets, others use staples and a strip of gummed tape covering them. The plain eyelets or fasteners are most commonly used and the ribbon type is considered to be somewhat old-fashioned and unnecessary.

The mailing envelopes for reports may be 10 x 12½ inches in size, white, tan, or light grey, and of a reasonably heavy weight, since they must hold several copies of reports.

It has been found feasible when SEC work is done or in case of accountings for decedents' estates or other work for courts or attorneys which is typed on legal size (8½ x 13) sheets, to use 10 x 15 inch envelopes for mailing these items.

Typing

It is desirable that financial statements and reports be uniformly typed. The following matters should be standardized:

Spacing, indentation, capitalization, underscoring, punctuation, dollar signs, and double or single spacing.

A typing manual helps to keep reports uniform over the years, and also assures uniformity where there is more than one office.

An illustrative typing style manual entitled "Style Manual for Report Writers, Typists and Stenographers of a Public Accounting Office" is presented with this chapter, as Appendix A. While certain features of this manual may not appeal to some accountants, it is representative of the content of a typical manual and is readily adaptable for use in an accounting practice.

Schedule of Work

A simple schedule can be maintained to control the flow of work from the date an audit engagement is commenced to the date when the report is finally mailed to the client. This schedule would comprise the following items arranged in columnar form:

1. Client's name.
2. Audit date.
3. Senior in charge.
4. Usual audit time.
5. Date audit commenced.
6. Date audit completed.
7. Date report turned in for review.

8. Date review completed.
9. Date put into typing department.
10. Date put into checking department.
11. Date sent out to client.
12. Special comments (such as "rush," "date promised client," "hold for confirmation.").

The schedule would be kept by the office manager or other person in charge of staff assignments, who would fill in the information required for the foregoing items 1 through 9. Once a day the information could be completed as to items 10 and 11 by the person in charge of the typing or checking department. Examination of the information by the office manager would focus attention on an unusual amount of time required to complete an engagement, or to type a report, and would permit a follow-up through any stage of office procedure. Appendix B of Chapter 7 contains examples of different type of work-control records.

Some firms maintain a record in the typing department, either instead of, or as a supplement to, the foregoing record, accounting for each report from the time it is placed for typing to the time it is mailed or delivered to the client. Such a record may contain items 1, 2, 9, 10, and 11 of the foregoing listing, plus such information as the name of typist, number of copies typed, whether "mailed" or "delivered" to client, and number of typing department hours spent on the report.

If the record indicates any wide disparity between the date reports enter the typing room and the date typing is actually started, the matter should be looked into — it may either indicate an abnormal backlog of work or some fault in the way the work is being handled.

Typing Suggestions

In an office of medium size, with several girls, reports can be divided so that each girl types a few sheets, in that way cutting down the time that would be involved if only one girl were to do a large report by herself.

It should be borne in mind that, since the appearance of a report is important, the ribbons on each typewriter should have had about the same amount of usage. This is not as difficult as it sounds. It takes only a minute or two to change a ribbon if necessary and it does not mean that the ribbon taken off the machine must be thrown away. It should be saved and used for correspondence, reports which do not have to be matched, corrections, office matters, and similar work. A few ribbon spools should be saved. Having a number of spools on hand makes it easy to change a ribbon.

Reaching the bottom of a sheet while only two or three lines remain to be typed is one of the hazards of statistical typing. With experience a typist will have an idea of just how much she can put on one sheet without crowding. With a sample of a previous report before her she can tell whether any items have been added or eliminated. If there is no

sample obtainable, by counting the number of lines on the pencil copy, allowing for the handwriting, and comparing this with the writing space on the paper she plans to use, she should have an idea as to whether she can get the statement on one sheet or be forced to break it and continue on another. If she must break it, a good breaking point should be chosen, not one that will leave figures dangling without a total or one that carries over just one or two lines. If footnotes relate to a single statement and are intended to be portrayed with it, every effort should be made to put them on the same sheet as the items which they explain.

A pencil mark placed on the left-hand side of the sheet before typing, about an inch and one-half from the bottom, serves as a warning mark to the typist that she is nearing the end of a sheet. If a statement is being typed she is able to judge if it can be completed, or must be carried forward, and find a convenient line to break it.

If a pencil mark is also placed on the left-hand side of a sheet about one-quarter of an inch from the bottom, it will serve to indicate where the page number is to be placed so that all are uniform.

A spread balance sheet, one with assets on the left side and liabilities on the right side, will usually fit on an 11 x 17 sheet and make a better appearance than putting the assets on one sheet and the liabilities on another, since it allows for ready comparison and analysis. Putting assets on one page and liabilities on another is undesirable. On a spread balance sheet, an attempt should be made to space the current assets opposite the current liabilities; the totals of the two sides should likewise appear on the same bottom line, in order to give a neatly finished appearance to the statement.

In cases when there are not too many items, a balance sheet may be typed on a single 8½ x 11 sheet, by placing the assets at the top and the liabilities below the center, providing the figures do not require more than two columns. Crowding on a sheet makes it difficult to read and gives a jumbled appearance — on the other hand, too much space between columns gives a disjointed appearance and wastes the time of the reader attempting to make comparisons.

There should be a rigid rule for indentations — there may be a 3-space indentation for the first line and two spaces for the balance or an even two spaces for each indentation. The Style Manual, Appendix A, uses indentation to the 3rd, 5th, 7th et cetera.

Comparative profit-and-loss statements should be arranged with the figures for the current year in the first column reading from left to right, since the client is most interested in what happened this year and only for comparison purposes requires the figures for previous years. Forms of comparative statements are included in the Style Manual.

Sometimes an "increase and decrease" column is used on comparative statements. At one time it was fairly common practice to put the "decrease" figures in red, despite the fact that this required fitting the type-

writer with a 2-color ribbon and also required using red carbon paper, specially inserted, on the copies whenever a red figure appeared. This practice is becoming obsolete. "Decrease" figures are designated by placing an asterisk after the amount (with appropriate footnoting that "asterisks designate decreases") or by the use of parentheses enclosing the decreases.

Comment pages should not be crowded. They should be double-spaced and each sheet should be started on the same line, whether it be four lines down from the top or five or six. The writing should not extend any further down the sheet than about eight lines from the bottom, to allow for page numbering below the last line. Tabulations which appear in comments should not be broken, if it is possible to avoid it. This may be difficult at times but if the comments are scanned before the typist starts, she can usually determine about where a tabulation should start and end.

Erasures on Reports

The simplest way to avoid strike-overs in reports or correspondence is not to permit them at all. Strike-overs are unsightly and are evidence of careless typing. Corrections can be simplified by using highgrade paper, erasers, and shields. It is not necessary to "scrub" when an erasure is being made, as many light applications of the eraser will save the paper and assist in giving the appearance of a perfect report. Sometimes when erasing an original which is deeply imprinted, a little paper cement may be applied over the wording to be erased, then rubbed off with the finger; the dark smudge will come off with the cement, and reduce the amount of erasing required.

Corrections on carbon copies should be made in carbon. Typing corrections should be as nearly invisible as possible. Sometimes if a typist has been careful in the way she arranged her carbon initially, she can put all her sheets in at one time with carbon between each sheet and make her correction that way. However, in most instances, each sheet has to be corrected separately, and if when she places her sheet in the typewriter she arranges it exactly where she wants her keys to strike, and then places over the correction area a small piece of carbon and as many thicknesses of the same paper as is required, the fact that it is a correction will not be visible on the final copy. By thicknesses of paper is meant that for the first carbon copy she needs only one thickness, for the second, two thicknesses and so on. She can make this simple for herself by preparing some "correcting carbon" in her spare time. A small piece of carbon under one, two, or as many thicknesses of paper as are desired may be stapled together and used as the occasion arises. If the office practice is to show red figures in reports it is necessary to use typewriter ribbons with a combination of red and black. When red figures are being inserted the typist should endeavor to put in as many red figures

at one time as is convenient by placing pieces of red carbon under her black carbon in the area where the red figures are to appear; as she types, the figures will appear in red on all the copies.

An error, if caught while typing, can be corrected while the papers are still in the machine by erasing on all copies, after placing sheets of blank papers under the carbons to avoid smudging while erasing, and typing in the correction.

It is necessary that at least one typed copy of each report be retained in the office, and desirable that where there are several typed runs of a report, one office copy of each be retained and marked to identify the set to which it belongs. Some firms make an additional copy to be used as the working copy for next year's report, or to avoid retyping in case a need develops during the year for an extra copy for a bank or credit grantor. Firms which have branch offices usually require each branch office to prepare an extra copy of every report for scrutiny or post-review by the head office.

Review and Referencing

Before the pencil copy of the report or financial statements is typed, it is important that it be reviewed either by a principal or by a trained person assigned to this work. The person reviewing the work should initial it for typing and typists should not accept any work not so initialed.

The figures should be compared by the reviewer with those of the prior period, the percentages and ratios should be scanned, and the cross references between comments and schedules and between exhibits and schedules should be checked.

Also the source and accuracy of the report figures should be checked by reference to the working papers. This matter is amplified in Chapter 11.

Proofreading

Once a firm employs more than two or three staff men, it is desirable that reports be proofread by someone other than the typist.

In the larger firms specific personnel do this work on a full-time basis. The smaller firm may utilize early morning or late afternoon hours of its juniors or assistants. Some firms employ college students (accounting majors) on a part-time basis.

Proofreading may be done in several ways. It may be done by having one person alone compare the pencil copy line by line with the typed report. This is often the only method possible in the small office and in time one individual can acquire remarkable proficiency and speed. Some accountants consider that this is the best way. But it is more common, when personnel are available, to have two persons proofread. Where two persons are used, one may read the typed report aloud while the

other checks the reading with the original draft, or one may read the original draft aloud while the other checks the typed report. The last version is preferred by more than 80% of the firms reporting use of two persons in proofreading.

After comparing, the typed sheets should be footed and final totals cross-footed. Where red figures are put in by separate carbons, each copy should be scanned to see that the red came through.

Corrections should be marked on the office or file copy and made by the typist after all checking and referencing is completed. A designated person other than the typist who did the correcting should then review to see that all copies have been properly corrected. The office or proving copy should be a clear copy on which all figures and words are easily read.

The office copy of each typewritten page may be rubber-stamped in the upper right or left-hand corner as follows and initialed in order to establish responsibility for the respective work done:

Date typed _____
Typed by _____
Proofread by _____
Footed by _____
Cross referenced by _____

Final Review and Delivery

After the report has been reviewed, typed, proofread, and corrected it is usually submitted to the principal for signature and final scanning.

Some firms do not bind the report until after it is signed, as this saves unbinding in case the signing partner orders any revisions made. In offices where the reports have been sufficiently and systematically reviewed and referenced before or after typing, they are usually submitted to the principal for signature in final bound form. This saves time and additional handling.

The transmittal letters and addressed envelopes should be submitted to the principal with the reports. This gives him an opportunity to consider the mailing directions, so that reports are not likely to reach the wrong persons in the client's office.

Usually audit reports are considered by clients to be confidential documents. For this reason care is required to see that they are addressed to a responsible person, usually the treasurer or principal executive, in an envelope clearly marked "confidential" so that it is not opened in the usual mail handling. Where, in the case of a corporation, there is some question as to the person or persons to whom the report should be de-

livered, it is desirable to address it to the specific source of corporate authority authorizing the report.

In a majority of cases, especially for recurring engagements, the reports are mailed. However, some firms make it a practice to have a principal deliver the report personally and discuss it with the client.

Many of the larger firms deliver "rush" reports to nearby clients by messenger. Some firms send special or year-end reports by registered mail.

At least half of the firms which provided information for this chapter send a separate letter of transmittal with their reports (although this is usually an unnecessary duplication of effort). It appears advisable, however, to write a letter, accompanying all reports to be printed for security holders or others, requesting that a printer's proof be submitted to the accounting firm for review, before any printed reports are released by the client to stockholders or the public.

Distribution Record

A file should be maintained indicating on a card for each client, the client's name and address, the person to whom reports are addressed, the number of copies to be typed, the number of office or extra copies and whether reports are to be mailed or delivered.

By referring to the card before a report is typed, errors in number of copies or distribution may be avoided.

Some firms expand this record by adding two columns for "report period covered" and "date report sent out," so that the postings to these columns maintain a chronological record of all reports sent to each client.

Form Manual

For the guidance of the typists, and valuable to the staff man, it is helpful to maintain a book or folder containing model forms of letters, reports, financial statements, and schedules. This may be done by saving copies of good letters and reports, or by mounting model report paragraphs on sheets or cards by topic. A few illustrations are contained in the Style Manual (Appendix A). These can be supplemented by others selected from current work from time to time.

Thus if a staff man is called upon to write an opinion, a qualified opinion, a balance sheet footnote, detailed report comments, or a balance sheet for a client in a specialized industry, he can find a guide which will save his time and which will result in more uniform reports emanating from the accounting firm.

The "model" manual is also an easy method of training new typists to conform to the established margins, indentations, capitalizations, and other practices preferred by the firm.

For purposes of illustrating a suitable form of typing style and indentation, examples of financial statements are included in the Style

Manual. Examples prepared in a different style are included in an Appendix to Chapter 19. Illustrations of financial statement presentation are also contained in Chapter 18.

TAX RETURNS

Income tax returns are usually prepared by the principal or accountant who is familiar with the client's accounting and tax problems. However, in some firms, the required tax information is assembled in the working papers and the returns are then prepared by a person or persons in the firm's tax department.

It is desirable that the Federal income tax return be either prepared or reviewed by a person familiar with the client's affairs. The pencil copy should then be reviewed by a principal or by a trained member of the tax staff, for accuracy of computation, for completeness, and with a view towards suggestions for present or future tax savings.

In the tax departments of some firms, a list is maintained of all returns prepared by the firm, chronologically arranged by the date due at the various government offices. Persons responsible for their preparation are advised by the tax department at least three weeks before the due date, as a reminder, and so that extensions may be obtained in ample time, if necessary. This is important because of penalties and interest which may be incurred by the client if returns are filed late.

In a firm of any size, it will be found practical to rubber stamp, in the upper corner of the pencil return, the following information:

Prepared by _____
Date _____
Approved by _____
Date _____
Typed by _____
Typing checked by _____

The review of tax returns should include reference by the reviewer to the working papers, financial statements, or other supporting data obtained from the client or assembled by the accountant. References in the return should be cross-checked and all computations should be recomputed.

Some firms type an original and one copy of each return, one for the government and one for the client's files. The pencil copy is thus the accounting firm's only retained copy. It is well to consider the advisability of typing an original and two copies. It is no more work and results in a typed copy for the firm's files of each return which is sent out. In

case of subsequent dispute as to just what was sent out or in case the client's copy goes astray, an exact copy will be helpful.

Some firms bind the client's copy of the tax return in a regular report cover. This facilitates filing and handling by the client and in general offers a neater and more effective appearance.

Most firms send either a printed or typewritten letter of transmittal with each return, indicating the amount of tax due, date due, place of filing, and other information. Specimen letters of transmittal are submitted in the Style Manual at the end of this chapter.

It is usually unnecessary to type a special letter for each return. The use of forms can save much typing time, since only the name and address, amount of tax, date and place of filing need be filled in.

In order to avoid clients' misplacing or not filing returns mailed to them, some accounting firms have the client sign the return and mail it back to the accountant with the check to the tax collector. The accountant delivers the returns to the tax collector and obtains a receipt therefor. This is not wholly desirable as it places an added and unnecessary burden of follow-up on the accounting firm. Other accounting firms request the client to sign a copy of the letter of transmittal which accompanies the returns and to mail the letter back to the accountant's office at the time the tax return is filed.

Appendix A

STYLE MANUAL FOR REPORT WRITERS, TYPISTS AND STENOGRAPHERS OF A PUBLIC ACCOUNTING OFFICE

Compiled by Maurice H. Stans

This Style Manual has been compiled in instruction form so that any firm which wishes to do so may use it without change. Other firms may prefer to use it as a guide in drawing up a Style Manual of their own.
Editor

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American Institute of Accountants

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FOREWORD

This Manual is designed for the use of report writers, typists and stenographers to help them attain excellence in preparing the firm's correspondence and reports. Every writer, typist and stenographer should keep in mind that the letters and reports he or she writes become daily representatives from the firm to the clients, bringing to them, by their neatness and general appearance, a message of reliability and prestige. It should, therefore, be his or her constant endeavor to maintain high standards of performance.

It should always be the principal responsibility of the stenographer or typist to produce a neatly written letter or report, to observe the firm's rules for style, to adhere to the rules of grammatical correctness and to punctuate and spell properly.

The Manual is a compendium of the requirements of the office with reference to correspondence and report form, content and arrangement. The Manual presumes, naturally, a knowledge of the essentials of grammar, punctuation and spelling.

The Manual has been prepared as a practical reference book and, for convenience, is divided into the following sections:

- I. Audit reports--general comments
- II. Preparation of text of report
- III. Tabulations, outlines, lists, quotations and other indented material
- IV. Typing of statements and schedules
- V. Correspondence
- VI. Tax returns
- VII. Proofreading
- VIII. Illustrative list of stationery and supplies for an accounting firm
- IX. Books recommended for reference

The instructions are not designed as an exhaustive treatise on style but are intended merely to cover basic practices in report and letter writing. For pertinent information not contained herein the user is referred to any good current dictionary, preferably unabridged.

This Manual has been devised with the principal objective of presenting material as simply as possible and, thereby, providing for the maximum saving of time. It has eliminated, wherever possible, unnecessary flourishes such as underlining, extensive capitalization, and punctuation not required to make the meaning clear.

Acknowledgment is made to International Accountants Society, Inc. for permission to use, in the preparation of this Manual, some of the material appearing in its "Style Manual for Text Writers and Typists."

I. AUDIT REPORTS--GENERAL COMMENTS

A well-typed report is the result of careful and thoughtful work on the part of the typist. It should follow the form approved by the firm, but judgment should be exercised in planning the setup of the report as a whole. Each page should be well balanced; paragraphs should break in the right places; tables should be centered and not broken, except when it is necessary to break a table which is longer than a page; page numbers should be in the exact center and a uniform distance from the bottom of the sheet; type should be clean and alignment even; and there should be no "strike-overs" or visible erasures.

The typist should never be persuaded that there is not sufficient time to do a perfect piece of work. If a finished page is not up to standard, it should be retyped immediately, not after it has gone through the processes of proofreading, ruling and checking. The report represents the firm, and there should be no compromise with the standards which have been established.

If changes are made and it is necessary to erase after the report has been completed, each copy should be matched by inserting a small piece of paper and carbon between the ribbon and the typed sheet. A word should never be erased, leaving a blank space. A number of consecutive words or a whole line should never be erased, and erased words should never be replaced with a word more than one space longer or shorter.

Before beginning to type a report, instructions should be checked. These should be in writing. Instructions for covers should be checked. The entire draft should be reviewed and the spacing of headings and tables planned. If the report of the previous year is used as a guide, and a noticeable deviation is found in setup or in the spelling of proper names, the person in authority should be consulted. The names of persons, company names and subsidiaries and trade names should be checked and kept consistent throughout the report

and the accompanying statements. Particular attention should be given to this when more than one person is working on the report.

Number of Copies

The number of copies designated should be typed together with an office copy, if that has not been included in the number requested. Good carbons should be used for every page of the report and for each statement; after use a few times these carbons should be saved for report drafts or correspondence. Every copy of the first page should be typed on report head-sheets and all copies of the following pages on report second-sheets.

II. PREPARATION OF TEXT OF REPORT

Reports should be typed on one side of the paper only and should be double spaced except in the case of inserted tables, statements, classifications of accounts, lists and similar material, which should be single spaced. Spacing should be regular at all times; that is, there should be no extra space above or below a center heading, side heading or tabular matter.

Headings within the text are of two types:
(1) center headings and (2) side headings.

The center heading should be exactly centered on its line and typed in solid capitals. The center heading need not be underlined. Example:

SCOPE OF AUDIT

The side heading is a subordinate heading; it should be placed at the left-hand margin and solidly underlined. The first letter of each major word should be capitalized.

A side heading should not follow immediately after a center heading; there should be at least one paragraph of comments or instructions between the two.

Page Numbering

Every page of the report, except page 1, should be consecutively numbered at the bottom in the center between left and right margins.

Paragraphing

Paragraph indentations should be uniform. This Manual uses paragraph indentations of ten blank spaces.

Indented material within the body of a letter or report is set in five blank spaces from the left-hand margin, ends five blank spaces short of the right-hand margin, and the block style is used. (See section III of this Style Manual for detailed rules and illustrations of indented material.)

Capitalization

Capitalization should be avoided as far as possible. The names of accounts, statements and

departments, the titles of officers and department heads, et cetera, should be in lower-case letters. One exception is "Board of Directors," which is capitalized. When saying "the directors," however, there is no capitalization. The expression "the board" should not be used.

Any body of men or any government act which has some specific name should be capitalized when the full name is given. Example:

The Robinson-Patman Act. (After having been mentioned once by name, it should be referred to as "the act.")

Personal titles written with personal names should be capitalized only when part of an address or of a listing. Example:

Howard Jones, President
Atlas Steel Company

In the body of written material no capitalization of the title is required. Example:

Howard Jones, president of Atlas Steel Company

A few general rules of capitalization are also applicable to accountants' writing, these being:

1. Capitalize all proper nouns and proper adjectives, including the days of the week, the months and specific holidays, but not the seasons.
2. Capitalize the names of points of the compass when used for sections of a country, but not for mere directions.

Example:

He lives in the East.
He walked east on Madison Street.

3. Capitalize each important word in the title of a book, musical composition, magazine, et cetera. Prepositions, conjunctions and articles are not capitalized except at the beginning of the title.

Hyphens

Hyphens are a great aid to readability and understanding, but they should be used sparingly

and with discretion. A hyphen is used between words when the phrase will be more easily understood if so written. For instance, a hyphen should be used with compound adjectives and should always be used between a prefix and a proper name, such as pro-British. The hyphen also is used in joining an adjective with a noun used as an adjective, in joining two nouns used as an adjective, in expressing compound numerals, and in joining compounds made up of nouns and prepositional phrases. Examples:

We speak of "capital stock," but of
"capital-stock records."

Fifty-four; one-half year; day-to-day
transactions.

Consistency

The names of companies should be accurate and should be kept uniform. If the legal name is "The Black Company," for example, be sure that "The" is always used and always capitalized and that "Company" is always spelled out, not abbreviated. Always spell out "and" in a company name unless an ampersand (&) is part of the official name. If a statement has an item called "selling and administrative expense" that item should be called exactly that each time it appears.

Footnotes

Footnotes are seldom used in the text of reports. When used, the footnote is designated by a numeral (if there are more than two), or by asterisks (if there are only one or two), not by the word "Note." (See instructions on asterisks, page 35)

Dashes

Dashes are not found on typewriter keyboards; therefore, two hyphens should be substituted.

Example:

He does not know where he is going--or why.
(Note that there is no space before or after
the hyphens.)

The dash (two hyphens) is used in joining compound names of accounts, such as "allowance for depreciation--plant," and "allowance for depreciation--office." When names of such accounts appear

in the text, the sentence should be so worded that confusion is avoided. This may be done in one of two ways: (1) putting the exact name of the account in quotations, or (2) setting off the name with commas. Examples:

You should then debit "fixed assets--plant" and credit "notes payable."

You should then debit account 126, fixed assets--plant, and credit account 211, accounts payable.

Parentheses

When parenthetical material forms a part of the sentence, the period should be placed outside (as, for instance, here).

When the material within the parentheses is an independent imperative or declarative sentence, the period should be placed inside. Example:

He spent three years in France. (The exact dates are uncertain.) Later he returned to America.

A comma should not appear immediately preceding the parenthesis. If a comma is needed after a phrase written in parentheses, it should be typed outside. Example:

Here he gives a belated, though stilted (and somewhat obscure), exposition of the subject.

Underlining

In the text of a report or letter, underlining is occasionally used for emphasis. In such cases, each word should be underlined separately, not underlined solidly as in side headings. Example:

The popular method of arranging business figures is according to date.

Headings which appear in solid capitals should not be underlined.

Numerals

Numerals should not be used at the beginning of a sentence. Preferably, the sentence should be re-

arranged; and, if this is not possible, then the number should be spelled. If two related numbers occur at the beginning of a sentence, both should be spelled.

In any example or illustration the writing of amounts should be governed by whether any amounts in the illustration carry cents. Example:

If I buy something for \$2.00 on which I receive a 10% discount, my net bill is \$1.80. (The \$1.80 governs the writing of the \$2.00, which otherwise would be written "\$2.")

In the writing of cents only, such as twenty-five cents, the form "25¢" should be used in the text and "\$.25" in tabular matter. The only exception to the rule of using "25¢" in the text is in the case of a sentence which contains also an amount in both dollars and cents. Example:

... was priced at \$1.02, and the next units are priced at \$.95. (Here the \$1.02 governs the style of writing the \$.95.)

Numbers should not be split between lines. If only part of the number or amount can be put on one line, the entire amount should be carried to the next line. For example, this is improper:

Then we may calculate that the gross profit
on sales for the current year is
33-1/3%, which is one-third of \$105,-
000, or \$35,000.

It should be written as follows:

Then we may calculate that the gross profit
on sales for the current year is 33-1/3%,
which is one-third of \$105,000, or \$35,000.

In written material, numbers up to one hundred and round numbers over one hundred should be spelled out; figures should be used for numbers above one hundred, except the round numbers. However, if some numbers are under one hundred and some over one hundred in the same sentence, figures should be used for all of them. Examples:

There were 87 categories in the inventory;
these included approximately 3,100 items.

These are offered in groups of 60 and 120.

The company has 7,499 employees.

To avoid confusion, adjoining numbers should not be written in the body of a letter; the number requiring fewer words should be spelled out and figures should be used for the other. Example:

Between 1930 and 1940, ten thousand men were employed. Of the original ten thousand, 943 are still with us.

Figures should be used in the following cases:

1. In numbers representing money (\$1.19; \$6,000.00)
2. Market quotations (the stock sells at 6-1/2)
3. Dimensions (32" x 21")
4. Dates, street numbers, numbered objects, numbers containing decimals (89 Cedar Street; Room 4; Vol. 6; 9.17 yards)

The suffixes "th," "st," "nd," and "rd" are omitted from a date when the month precedes it. When the month is not named, or when the month follows the date, they should be added. Examples:

May 1
Your letter of the 1st
10th of the month
10th of May

Fractions

Regardless of the fact that there are typewriter keys for $\frac{1}{4}$, $\frac{1}{2}$, et cetera, fractions should be typed as follows for clearness on carbon copies: $\frac{1}{4}$, $\frac{1}{2}$, et cetera. A whole number and a fraction are joined with a hyphen, thus: 21-1/2. Simple fractions appearing in written material should be written out, as in "Two-thirds of those present voted for the resolution."

Numerals connected by symbols, such as in equations, paper sizes, et cetera, should be separated from symbols by one space.

Example:

$$8\text{-}1/2" \times 11"$$

$$2,534 \times 7,723 = 19,570,082$$

Zero Amounts

In tabular matter where zero amounts are to be shown, the following rules apply:

1. In a column where the amounts consist of dollars only, one hyphen should be placed in the "tens" column.
2. In a column where the amounts consist of dollars and cents, one hyphen should be placed in the decimal column. Examples:

a.	Cardboard	\$3,725
	Tissue	-
	Twine	2,842
b.	Cardboard	\$3,725.22
	Tissue	-
	Twine	2,842.80

Dates

When mentioning dates in the text material, the names of months should be spelled out, not abbreviated, such as December 1, 1949 (not Dec. 1, 1949). The only place where such an abbreviation is permissible is in journal entries. When only the month and the year are given, the comma is usually omitted.

The only places where a completely numerical abbreviation is permissible, such as 12/1/49, are (1) in "T" accounts, and (2) in columnar matter where one column of data consists entirely of dates, as in the example below:

<u>Policy</u>	<u>Kind of insurance</u>	<u>Amount</u>	<u>Date</u>	<u>Term</u>
212642	Building—fire	\$25,000	7/7/46	1 year
345618	Building—fire	20,000	7/1/46	1 year

Percentages

The percentage sign (%), not the words "per cent," should be used in the text when preceded by a number.

The words "per cent" should be used in columnar headings of tables and lists and in the text when not preceded by a number.

Journal Entries

A journal entry is composed of three parts: (1) the account and the amount debited, (2) the account and the amount credited, and (3) the explanation of the entry.

When a journal entry appears as an inserted item in a report or other textual matter, it should be indented five spaces. In other words, the account(s) debited should start at the sixth space; the account(s) credited, five blank spaces to the right of the debits; and the explanation, flush with the debits. The spacing of these three parts of the journal entry is invariable. Each entry should be single spaced, with double spacing between the entry and the explanation, and triple spacing between the entries. If the journal entries are numbered, the journal entry number is centered on the third line below the preceding entry and only double spacing is therefore required between journal entries.

The dollar sign in each isolated journal entry, that is, one journal entry standing alone, should be placed directly in front of the amount.

Example:

Cash	\$200	
Accounts receivable		\$200
John Jones paid his account in full.		

In a series of journal entries the spacing of the dollar sign for the entries is governed by the entry which carries the largest amount. Example:

Taxes	\$ 200	
Accrued real estate taxes		\$ 200
Tax accrual for July		
Accounts payable	1,000	
Accounts receivable		1,000
Transfer between contra accounts of Hall Company.		

The dollar signs should be shown only in the first entry of a series. Account names in a journal entry

should not be followed by the word "account." (Use "Cash," not "Cash account.")

Occasionally a journal entry will contain an account name which is so long that it will not fit into the available space, and a second line must be used. When this occurs, the second and succeeding lines of the account name should be indented two spaces from the first line. Example:

Factory expense	\$8,100	
Selling and administrative expense	1,000	
Mortgage expense	800	
Supplies		\$ 200
Unexpired insurance		1,200
Patents		5,400
Unamortized discount and expense on first mortgage note		800
Accrued personal property taxes		900
Accrued real estate taxes		1,400

To charge supplies, insurance, patent amortization, bond discount and expense, and taxes to expense accounts.

Although the second and succeeding lines of an account name are indented two spaces, the second and succeeding lines of the explanation section should be carried flush with the first line of that section. The right-hand margin of the explanation section should be as uniform as possible.

Sometimes the date and account number are included with journal entries. This requires starting the material at the left margin with no indentation. If only the date is used, it is placed at the left margin preceding the first account debited. (See first example following.)

If both the date and the account number are given, two alternatives are available:

1. The date may be centered above the journal entry, with the account number placed at the left margin. (See second example.)

2. The date may be placed at the left and the account numbers shown in parentheses following the names of the accounts. (See third example.)

Examples:

1952
Dec. 31 Factory ledger balancing
 account \$1,200
Lost profit on returned sales 800
 Accounts receivable \$2,000

First example, where only the date is given without giving the account numbers.

December 31, 1952
420 Factory ledger balancing
 account \$1,200
703 Lost profit on returned sales 800
403-01 Accounts receivable \$2,000

Second example, where both date and account numbers are given. Notice that the date is written out in full when it is centered above the entry.

1952
Dec. 31 Factory ledger balancing
 account (420) \$1,200
Lost profit on returned sales
 (703) 800
 Accounts receivable
 (403-01) \$2,000

Third example, where the ledger folio number is shown in parentheses.

If the journal entries are numbered, the number should be centered on the line above the entry, or below the date, whichever is appropriate.

Rarely, a list or table of figures appears as part of the explanation section of a journal entry. When this occurs, the list should be centered on the page.

Example:

1952			
Dec. 31	Common stock subscribed	\$81,000	
	Preferred stock subscribed	76,000	
	Common stock issued		\$81,000
	Preferred stock issued		76,000

To record issuance of capital stock:

<u>Issued to</u>	<u>Common</u>	<u>Preferred</u>
V. Larson	\$48,000	\$30,000
M. Olson	32,000	20,000
W. Marine	1,000	26,000
	<u>\$81,000</u>	<u>\$76,000</u>

Illustrative Report Cover and Report Letter

An example of a cover for an audit report and a letter showing the form of, and containing typing instructions for, the audit report letter follow:

THE BLANK CORPORATION

AUDITORS' REPORT

December 31, 1952

JOHN JONES & COMPANY
 Certified Public Accountants
 Cincinnati

(AUDIT REPORT LETTER)

BEVAN, BEMIS & COMPANY
1166 Edgewood Street
Dallas 4, Texas

February 8, 1953

The Blank Company
 11 Chestnut Street
 Ogden, Utah

Gentlemen:

This is a pattern for report typing, with some further instructions regarding spacing and setup. The report is double spaced throughout. Lists of exhibits and tables are centered and single spaced with a double space preceding and following, as illustrated below:

Exhibit I--Balance sheet, December 31,
 1952

II--Statement of income and retained
 earnings for the year ended
 December 31, 1952

III--Statement of cost of goods
 sold for the year ended
 December 31, 1952

Columnar headings are typed with only the first letter of the first word capitalized. It is expected that judgment will be used in spacing when it is necessary to avoid breaking a table. Some preliminary drafting is often helpful. A table should appear as follows:

	Year ended December 31,		Percentage to net sales	
	<u>1952</u>	<u>1951</u>	<u>1952</u>	<u>1951</u>
Cost of goods sold	\$1,111.11	\$1,111.11	10.00	10.00
Depreciation	<u>111.11</u>	<u>111.11</u>	<u>.00</u>	<u>.00</u>
Totals	<u><u>\$1,111.11</u></u>	<u><u>\$1,111.11</u></u>	<u><u>10.00</u></u>	<u><u>10.00</u></u>

The Blank Company

-2-

February 8, 1953

When a total of one column is carried to the next column, it appears on the same line as the last figure in the first column:

\$111,111.11	
11,111.11	
<u>111.11</u>	\$122,333.33

In all tables leave a minimum of two spaces between columns of figures. When calculating space for a column, always find the longest figure and be sure to include space for the dollar sign. Often it is necessary to base the calculation on the column heading if it is wider than the figures to be tabulated.

A new paragraph should not be started at the bottom of a page unless there is room for at least two lines, with two or more lines to carry over to the next page. Never break a word between pages. Try to keep the narrative introducing a table on the same page with the table.

THIS IS A SAMPLE OF A CENTER HEADING

The narrative begins two spaces below the heading with double spacing throughout the report.

A Side Heading in a Report

Commence the paragraph two spaces below a side heading and continue with double spacing; double space before typing the next side heading.

An example of a two-line side heading follows:

Advertising Expense Including Cost of Catalogs

The heading begins at the left-hand margin and the continuation line is indented two blank spaces. The entire heading is single spaced and underlined. No punctuation appears at the end of the heading.

The Blank Company

-3-

February 8, 1953

An example of a side heading with sub-headings follows:

Selling Expenses

Salaries

Traveling Expense

Advertising

The first subheading is dropped one line and indented five blank spaces. If text appears between the subheadings, double spacing should be used throughout. If no text appears between the subheadings they should be single spaced with a double space between the last subheading and the text.

Try to keep side headings within half the width of the page. If possible arrange the spacing of a report so that an important main heading will come at the top of the page.

Very truly yours,

BEVAN, BEMIS & COMPANY
(signed manually)

III. TABULATIONS, OUTLINES, LISTS, QUOTATIONS AND OTHER INDENTED MATERIAL

Tabular material should always be single spaced and should be centered on the page with equalized spacing between columns. Not less than two spaces should be left between any two columns of figures. Tabular material may, if necessary, extend to the left-hand and right-hand margins.

For example, a short inserted tabulation in textual matter would appear as follows:

<u>Accounts</u>	<u>Debits</u>	<u>Credits</u>
Cash	\$12,360	
Merchandise inventory	12,000	
Land	4,000	
Buildings	15,000	
Deferred charges	180	
Investment		\$25,000
Surplus		12,900
Sales		23,000
Purchase	17,000	
Operating expense	360	
Totals	<u>\$60,900</u>	<u>\$60,900</u>

Except for tabulations, the following general rule can be applied to all indented material:

1. If there are forty spaces or less in the longest line, the indented material should be centered on the page.
2. If there are more than forty spaces in a line, the indented material should be indented five blank spaces from the left-hand margin and should extend to not less than five blank spaces from the right-hand margin.

Classifications of Accounts

Classifications of accounts should be tabulated with indentations as follows:

CLASSIFICATION OF GENERAL LEDGER ACCOUNTS
(Blocked-Number System)

- 10 Cash and receivables
 - 11 Cash in banks
 - 12 Cashier's imprest cash fund
- 100 Stores inventories
 - 101 Supplies
 - 102 Materials
- 200 Unapportioned expense
 - Expense pools group
 - 201 Water expense
 - 202 Gas expense
 - General factory expense group
 - 231 Factory administration department
 - 232 Purchasing department

Two spaces should be left between the number and the following word. Each succeeding group of numbers should be indented flush with the first word in the preceding line. The placement of lower numbers is governed by the highest number in any column of numbers; for instance number 11 is indented an additional space in order to leave room for number 101.

Outlines

In some places it is necessary to present material in simple outline form. Sections in such outlines should be identified in the following order:

<u>Indentation</u>	<u>Identification</u>	<u>Example</u>
5	Arabic numerals	9.
9	Lower-case letters	a.
13	Arabic numerals in parentheses	(9)
18	Lower-case letters in parentheses	(a)

The numbers of the first section of such an outline should start at the sixth space in from the left-hand margin.

The identification number or letter of each successive section should be indented to a point exactly under the first letter in the first word of the preceding section.

All items in the outline are single spaced, except that double spacing should be used between the items of the first rank (Arabic numerals).

Example:

9. Accrued accounts
 - a. Prepare a subsidiary schedule for each class of tax to show:
 - (1) Amount accrued during year and charged to expense
 - (a) Reconcile with total tax expense
 - (b) Examine tax bills and supporting data
10. Debit balances
 - a. Determine nature of such transactions and validity of the items
 - b. If the amounts involved are material, confirm by direct correspondence

If an outline requires more than four sections, as listed above, the rules given here should be ignored and the rules on the presentation of complex outlines should be followed. (See below.)

Outlines (complex)

Some outlines, such as checklists, may be more complex and may require a more elaborate structure. In these cases, two new identifications series may be provided, these preceding the four given above, as follows:

<u>Section</u>	<u>Identification</u>	<u>Example</u>
1.	Roman numerals	XIV.
2.	Capital letters	A.
3.	Arabic numerals	9.
4.	Lower-case letters	a.
5.	Arabic numerals in parentheses	(9)
6.	Lower-case letter in parentheses	(a)

When this method of identification is used, the numbers of the first section of such a checklist should start at the left-hand margin of the page. The longest number governs the placement of all others.

The titles in the first section (Roman numerals) should be solidly underlined.

Double spacing should be used between the first and second sections (that is, between items

bearing Roman numerals and items bearing capital letters), and also between items of the second section (that is, between items bearing capital letters). Everything else in the checklist should be single spaced. Example:

CHECKLIST OF AUDIT SUGGESTIONS

I. General suggestions for beginning the audit

- A. Assuming that books are in balance and that balances and footings have been inked in, compare trial balances at beginning and end of period, et cetera
- B. Prepare working trial balance

XXIII. General

- A. With respect to every phase of the work, check for consistency and for compliance with..., et cetera
- B. Audit by inspection
 - 1. Make comparisons of sales volume in relation to:
 - a. Receivables (aged)
 - (1) Current
 - (2) Delinquent
 - b. Sales commissions
 - (1) Domestic
 - (2) Foreign
 - c. Returns and allowances
 - 12. Compare fixed overhead costs by years

Lists

The two rules previously given govern the placement of lists on the page, as follows:

- 1. If a list consists of items no one of which is longer than forty spaces pica type (including the highest number), the list should be exactly centered on page and singled spaced. (See Example 1 on the following page.)
- 2. If a list consists of items longer than forty spaces pica type, the numbers should start at the paragraph indentation for inserted material and the items should extend to five spaces short of the right-hand margin. If any item consists of more than one line the sec-

ond and succeeding lines should be carried flush with the first line; the items should be single spaced with double spacing between the items. (See Example 2 below and Example 3 on the following page.)

The highest number in any list governs the placement of the lower numbers. For example, a list of 121 items requiring two lines each should be set up as follows:

1. This is indented to the eighth space because the highest number takes two more spaces.
12. This is indented to the seventh space because the highest number takes one more space.
121. This is the highest number in the list and therefore is indented to the sixth space (paragraph indentation for inserted material).

In any list two spaces, and only two, should be inserted between the number and the following word.

If any item in a list contains tabular matter, such tabular matter should start flush with the first word of the item. Count the spaces from the left margin of the page to the first word in the item. The tabular matter should end exactly that many spaces from the right margin regardless of the width of the item itself. This centers the tabulation on the page. (Example 4, page 28.) In rare instances it may be impossible to follow this rule, the tabular matter being too wide to fit into such space. Where this happens, the tabular matter should end exactly at the right-hand margin of the page. (See Example 5.) Examples:

Example 1

1. Saving of daily time
2. Neat, legible records
3. Automatic date printing
4. Mechanical computation

Example 2

1. Each item may be transferred to a card.
2. Instead of cards, slips may be used.

3. When cards are prepared, copies may be made.

Example 3

1. Each item called for by a multiple form requisition may be transferred to a new slip or card.
2. Instead of preparing slips or cards for the requisition, individual tabulating cards may be prepared.
3. At the time the multiple requisition is prepared, carbon copies may be made.

Example 4

1. Additional provision for depreciation of fixed assets as follows:

Buildings	2% of cost
Furniture and fixtures	10% of cost
Delivery equipment	20% of cost
2. Accounts receivable amounting to \$1,700 are known to be uncollectible and should be charged off.
3. Additional provision for doubtful items amounting to 1% of net sales should be recorded.

Example 5

1. An invoice for insurance premiums which should have been charged to prepaid expenses has been charged as follows:

Manufacturing expense	\$1,500
Selling, general and administrative expense	<u>500</u>
Total	<u>\$2,000</u>
2. The prepaid expenses expire at the rate of \$300 per month. These items are chargeable as follows:

Manufacturing expense	75%
Selling, general and administrative expense	25%

Quotations

A short quotation should form part of a sentence of the text.

Example:

He said that he "would favor the concept without approving its adoption."

A long quotation should be single spaced and set forth separately, starting at the paragraph indentation for inserted material (five blank spaces) and continuing to the same number of spaces from the right-hand margin. The first quotation mark in this instance should come at the fifth space, and the first word should start at the sixth space. The second and succeeding lines are flush with the first word of the first line. Two examples follow:

"These are measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping."

"...measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping."

If several paragraphs from one source are quoted, the quotation marks should appear at the beginning of each paragraph and at the end of the last paragraph only.

All quoted material should be exactly quoted. The only permissible changes in a quotation are (1) a spelling error, (2) alignment on the page, and (3) omission of parts, which should be indicated by a series of three periods as in the following example:

"These are measures adopted . . . to check the clerical accuracy of the bookkeeping."

Periods and commas always precede the quotation mark at the end of a quotation. All other punctuation marks are placed inside the quotation marks only when they belong to the quoted material; when they belong to the entire sentence, they are placed outside.

IV. TYPING OF STATEMENTS AND SCHEDULES

Statements and schedules should be single spaced and should always be centered on the page unless they are to be bound on the left-hand side, in which case they should be one-half inch off center to allow for binding.

Ordinarily, a statement or schedule should not be split between pages. However, occasionally a long statement, such as a trial balance or list of expenses, will extend beyond one page. In this case it should be carried forward without subtotals or other designation. The title of the second page should be the same as the first with the word "continued" added in parentheses.

Abbreviations should never be used in the body of a statement or report. For example, use "depreciation," not "depr."; use "inventory" not "inv."; et cetera. It is also preferable not to use abbreviations in headings, but sometimes it is unavoidable.

The word "account" is never used within a statement; for example, use "Cash in bank," not "Cash in bank account."

If the amounts in a statement are all dollar amounts, the zero cents should not be shown; for example, an amount would be typed \$20,000, not \$20,000.00.

In a series of columnar figures the "total" column should ordinarily appear as the last column to the right. However, in instances where the total is of much greater significance than the individual items, the total should appear in the first column from the left.

In presenting comparative statements in columnar form for two or more years, the latest year's figures should be shown in the first column from the left.

Oversized Statements

When it is necessary to use a sheet of paper larger than the standard report size, such sheet should be folded to the standard size after typing.

Headings

Ordinarily, the heading of a statement or schedule consists of three parts: (1) the name of the corporation or person (in capitals and lower case), (2) the title of the statement (in solid capitals), and (3) the date or period (in capitals and lower case). There should be double spacing between each of these lines.

Columnar headings should be typed with only the first letter of the first word capitalized.

Spacing

Two or more spaces, depending on the size of the body of the statement, should be used between the last line of the heading and the first line of the body of the statement. In the case of the balance sheet, double spacing is used between the centered word "ASSETS" and the side heading "CURRENT ASSETS."

Statements divided into sections should have double spacing between the sections.

Indentation

Indentation on statements and schedules should be to the 3rd, 5th, 7th, 9th, 11th, 13th and 15th spaces progressively from left to right. (Paragraph indentations in this Manual are to the 11th space as are the "Total" designations after a column of figures.)

The second line of a descriptive passage in the body of a statement or schedule should be indented to the third space. Example:

Common stock, authorized 500 shares of \$10 par value; issued and out- standing, 456 shares	\$4,560
---	---------

Items listed under a group heading should be indented to the third space under the preceding line. No punctuation is used to indicate sub-items. Examples:

CURRENT ASSETS
Cash
Accounts receivable
Inventories
Raw materials
Work in progress
Finished goods

Capitalization

The center caption and the main side captions of the balance sheet and the main side captions of the statement of income should be solidly capitalized with no punctuation following. Otherwise, capitalization should never be used in the body of the statement except for the first word in the line or sentence or for proper nouns. Example:

ASSETS

CURRENT ASSETS
Cash in bank
Cash on hand
Accounts receivable

Underlining

Except for columnar headings and rulings for subtotals and totals, underlining in statements should not be used.

In any statement or ruled table the figures should be centered under each columnar heading, and the heading underlined.

If the heading is longer than any amount beneath it, the entire heading should be underlined. Example:

Accounts
receivable
\$375.25
264.16

If the heading is shorter than the figures beneath it, the underlining should be typed the full

length of the largest amount beneath it, including the dollar sign. Example.

<u>Cash</u>
\$ 1,000.25
3,500,000.75

When statements contain reference numbers following the dollar amounts, the underlining of the heading should be extended over that reference number. Example:

<u>Debits</u>
\$110,000 (12)

Headings over columns of descriptive material (not amounts) should be underlined only to the extent of their own length. Example:

<u>Items</u>
Cash
Accounts receivable
Inventories

Rulings within tabular matter, before and after totals, should not be carried over or under the dollar signs. Example:

\$1,475,000
250
67,000
<u>\$1,542,250</u>

In the body of financial statements and other schedules, single rulings are used only where necessary to indicate the point of subtraction or addition. Double rulings are used at the end of a column or tabulation. For examples, see the illustrative financial statements beginning on page 60 of this Style Manual.

When double rulings are required, the two lines should be typed with sufficient spacing between them that there is no possibility of mistaking the two as being one line. Example:

Not: \$1,542,250	But: <u>\$1,542,250</u>
------------------	-------------------------

Typewriters can be fitted with double underscore keys.

Dollar Signs

In any list of money amounts the dollar sign should be typed at the head of each column and repeated only before and after a double ruling.

Examples:

\$2,300	
<u>2,300</u>	\$ 4,600
2,400	
<u>2,400</u>	
<u>2,400</u>	<u>7,200</u>
	<u>\$11,800</u>
	\$ 9,000
	<u>3,000</u>
	<u>5,500</u>
	17,500
\$3,000	
<u>2,000</u>	
<u>1,500</u>	<u>6,500</u>
	<u>\$11,000</u>

Percentages

In statements and schedules the percentage sign (%) should not be used alone as a columnar heading. The words "per cent" should be used instead. When this is done, no sign is typed after the figures in the column. If a columnar heading should be "Increase" or "Decrease" or some other designation, and the figures under the heading are percentages, the sign is typed after the first figure in the column and also before and after a double ruling. Example:

<u>Per cent</u>	<u>Increase</u>
10	12.5%
25	7.1
<u>5</u>	<u>10.0</u>
<u>40</u>	<u>29.6%</u>
5	5.5%
1	1.0
<u>6</u>	<u>5.6</u>
<u>12</u>	<u>12.1%</u>

Asterisks

The asterisk indicating a loss, a deficit or a "red" figure follows the figure to which it refers. It should not be enclosed in parentheses. The column in which that figure appears may be headed:

Profit
or Loss*

The asterisk also is used sometimes as a footnote reference in statements (unless it already has been used to indicate a loss), but only when there are one or two footnotes on a page; if more than two, numerals are used. When the asterisk is used, it should be typed after the figure or word to which it refers and before the footnote itself. The footnote is placed at the close of the statement on a vertical line with the left-hand margin of the statement, thus:

*See statement showing correction of net profits.

**See analysis of earned surplus.

If a footnote is so long that it requires more than one line, the second and following lines should be indented two spaces.

Group Headings

A balance sheet may contain items of equal rank, but some of the items may represent group headings. This fact is distinguished by indenting the subsidiary group items two spaces, without punctuation. Example:

Cash		\$100.25
Receivables		
Accounts receivable	\$50.00	
Notes receivable	<u>60.00</u>	110.00
Inventory		<u>80.00</u>
Total		<u><u>\$290.25</u></u>

When one deduction appears on a statement with the word "less" preceding it, the word "less" should form part of the phrase and should not be followed by punctuation. Example:

Accounts receivable	\$100	
Less allowance for doubtful accounts	<u>10</u>	\$90

When a deduction consisting of more than one item is made, the word "less" should be followed by the items listed thereunder, indented two spaces.

Example:

Total liabilities		\$100,000
Less		
Notes payable, due 1950	\$10,000	
Debentures, due 1956	<u>40,000</u>	<u>50,000</u>
Net amount		<u>\$ 50,000</u>

Designation of Exhibits

The exhibits of tabular material in the next section are indexed according to page number rather than by designation as "Exhibit" or "Schedule." In certain instances, however, it may be desirable to designate the material according to exhibit number. Where this additional designation is made it should be shown in the upper right-hand corner of the statement or schedule as in the following example:

Exhibit I

The Filler Corporation
BALANCE SHEET
December 31, 1952

Syllabification

The general rules of syllabification in typing material are important and should be observed in accountants' reports and correspondence:

1. Divide only between syllables; words of one syllable should not be divided.
2. Prefixes and suffixes usually may be divided from the root. (ex-pand; con-clude; work-ing)
NOTE: Rules 3 and 4 take precedence over this rule.
3. A single consonant goes with the preceding or the following vowel, according

to the pronunciation. (pro-duce;
prod-uct; va-por; vap-id)

4. Two adjoining consonants are usually divided (dic-tion; col-lision; pater-nal; lan-tern; com-mis-sion). But two letters which make a single sound, such as "sh," "ck," "ph," or "th" are not divided. (preach-ing)
5. Suffixes such as "cial," "sion," and "tion" should not be divided. (cru-cial; commis-sion; composi-tion)
6. Do not divide names of persons or other proper nouns.
7. Do not divide initials preceding a name, or such combinations as 55 B.C., 2:20 a.m., Y.M.C.A., or Lieut. Col.
8. Do not divide a word at the end of a page.
9. Do not divide a word already hyphenated, such as "self-control."
10. Do not carry less than three letters to another line.
11. Do not separate figures at the end of a line: \$1,425.35.
12. Do not divide words at the ends of more than two consecutive sentences.

Illustrative Statements

Financial statements using these rules are illustrated on pages 60 to 63 inclusive.

V. CORRESPONDENCE

The following material relates specifically to correspondence. The general rules regarding the form, paragraphing, capitalization, quotations, underlining, numerals, and other material appearing in the portions of this Manual dealing with report writing are equally applicable to correspondence.

There are two types of letters in an accounting firm's correspondence, these being:

1. A formal letter
2. An informal letter

Formal Letter

A formal letter is frequently used in the following circumstances and other situations where formality is deemed desirable:

1. A letter pertaining to working arrangements, fees or other business matters.
2. A letter of opinion on an accounting or tax matter.
3. A letter covering transmittal of a report, a tax return or other documents.

Such a letter carries the singular person throughout when written by a sole practitioner and the plural person throughout when written by a firm.

Formal correspondence should always be addressed to or for the attention of an individual, in order that it may have confidential treatment at the receiving end. This is particularly true in the case of letters transmitting reports, tax returns, and other documents.

A formal letter may be addressed in either one of the following two fashions:

Mr. John A. Jones, President
Jones Manufacturing Company
321 West Erie Street
Chicago 6, Illinois

or

Jones Manufacturing Company
321 West Erie Street
Chicago 6, Illinois

Attention: Mr. John A. Jones, President

The title of the addressee should be stated.

Formal letters must always be signed by a principal (partner or practitioner). The closing may take either one of the following two forms:

Very truly yours,

(manually) John Smith & Company

or

Very truly yours,

JOHN SMITH & COMPANY

By

John Smith
Partner

Informal Letter

An informal letter is one addressed to an individual and considered more or less in the nature of a personal communication. It is signed by the writer with his own name. All such letters written by anyone but a principal (partner or practitioner) must be cleared with a principal if they relate to the firm's business in any way. An informal letter carries the singular person throughout.

Names

It is a good practice to have the name of the writer typed beneath the written signature in order to insure correct deciphering. The stenographer should do this in all cases unless requested not to do so.

As in the case of reports, names and addresses should always be exact. The proper legal names of all organizations should be used. Abbreviations in names, addresses and other matter should be avoided.

Date Line

The date line should be typed three lines below the printed head of the letter, its position corresponding as nearly as possible to the right-hand margin of the letter.

Address

The address should be single spaced. The title of the person addressed should appear on the same line as the name, if possible. If any part of the address is too long to look well on one line, a second line should be used. City and state should not be abbreviated.

The address should be at least two lines below the date line, the exact distance varying with the length of the letter. The block form should be used, with open punctuation (no commas at ends of the lines).

References

Certain communications may require reference to previous correspondence or to the subject matter. This may be done by a reference line immediately following the address, in this form:

Re: Your file No. 1219

or

Re: Federal income tax return for 1952

In cases where both a "reference" line and "attention" line appear in the same letter, they should be placed in the following manner:

Doe, Doe & Doe
135 South LaSalle Street
Chicago 2, Illinois

Attention: Mr. William Doe
Re: Federal income tax return for 1952

Neither line should be underscored.

Salutation

The salutation should be typed two lines

below the address or the last line of any inserted reference.

In a letter addressed to a firm or corporation, the salutation should be "Gentlemen:", even though the letter is marked for the attention of an individual. In informal correspondence, the salutation should be provided by the dictator.

Body of Letter

The letter should begin two lines below the salutation. All letters should be single spaced regardless of number of lines. A letter should never have only one paragraph unless it contains only one sentence.

Double spacing should be used between paragraphs. Paragraphs should be indented ten spaces from the left margin.

All lines should be as uniform as possible, without too many divisions of words.

A new paragraph should not be started at the bottom of a page unless there is room for at least two lines. Not less than two lines should ever be carried to another page.

Complimentary Close

For formal letters the complimentary close should be "Very truly yours." For informal letters it should be "Sincerely," unless some other expression is dictated. The complimentary close should be placed two lines below the last line of the letter and to the right of center.

Reference Initials

Each letter and memorandum should carry the initials of the dictator in the lower left-hand corner, followed by a colon and the stenographer's initials, thus: AVC:TE

Enclosures

When enclosures are transmitted, that fact should be indicated in the lower left-hand corner,

appearing below the reference initials as, for instance: Enclosures 4

Continuation Pages

Continuation pages of a letter should have only the name of the addressee at the top of each page, at the left-hand margin. The number of each continuation page should be inserted at the top of the page in the center, and the date should be placed at the right. Spacing should be equalized.

Number of Copies

In the case of all correspondence and memorandums, the number of copies required by firm practice should be made. These should be handled and filed in accordance with the established system of the office. Copies for persons outside the firm should be made on special "COPY" tissue sheets.

Envelopes

Envelopes should be addressed in block style, without indentations.

Appearance

Accounting firms maintain high standards of workmanship and appearance in reports and correspondence. Strike-overs are not acceptable, nor are crowded words. Erasures must be neat without tearing the paper, and they should be practically undetectable. The material should be balanced attractively on the page, with equal margins. Typewriters, ribbons and carbon paper must be clean and in good condition.

Telegrams

In preparing Western Union blanks for transmission, the same number of copies should be made as is required for letters and office memorandums.

In the proper spaces on the blank, the type of service desired and the account to be charged should be indicated on all copies.

The date, time and place from which sent should be typed in the upper right-hand corner. The

address and signature should be shown in full. The entire telegram should be typed in capitals with necessary punctuation, using numerals for dates and amounts.

The copies are distributed in the same manner as copies of other correspondence.

Illustrative Letters and Memorandums

Specimen formal and informal letters and specimen office memorandums follow this portion of the Manual. These illustrate the form used in the date line, the address, the salutation, the paragraphing, the complimentary close, the signature and other features.

Also included are completed examples of Western Union telegram forms and of journal entries as the latter would be transmitted to a client.

FORMAL LETTER

BEVAN, BEMIS & COMPANY
1166 Edgewood Street
Dallas 4, Texas

July 1, 1952

American Institute of Accountants
270 Madison Avenue
New York 16, New York

Re: Correspondence

Gentlemen:

This is a standard form to be used when typing a letter.

The address should begin at least two spaces below the date line and the margin should be set so that the letter will be well balanced on the page. The width of the margin is determined by the length of the letter.

Indent paragraphs ten spaces from the left-hand margin. The lines should be approximately uniform in length and a dictionary should be consulted when in doubt as to the proper division of a word. All letters are to be single spaced with a double space between paragraphs. Follow each period with two spaces before commencing the next sentence.

Never release a letter with a visible erasure. If words are to be deleted or changes are made after a letter has been completed ALWAYS retype. A letter reflects the firm's standard and a letter with untidy erasures, uneven margins, fuzzy type or poorly balanced setup should not be released for signature.

The complimentary close should be written two spaces below the last line of the letter. Leave a margin of at least an inch at the bottom of the page.

Very truly yours,

BEVAN, BEMIS & COMPANY

REC:SD

By
Robert E. Carter
Partner

(FORMAL LETTER)

BEVAN, BEMIS & COMPANY
1166 Edgewood Street
Dallas 4, Texas

July 1, 1952

Mr. David A. Matthews, President
The Winslow National Bank
Winslow, Maine

Dear Mr. Matthews:

This is the form to be used in writing letters of more than one page in length.

Before typing a letter be sure that the type and platen are clean. Keep a reliable type cleaner at hand and use it frequently. Watch the alignment of type and have defective type bars repaired. Use a lightly inked black ribbon in order to produce a clear, sharp impression.

"When quotations are set out separately, place the quotation marks four blank spaces from the margin of the letter. Single space the lines irrespective of the spacing of the letter proper. There should be a double space preceding and following the quotation and between quotation paragraphs.

"In an indented quotation place quotation marks at the beginning of each paragraph of the matter quoted and at the end of the concluding paragraph.

"Errors associated with the use of quotation marks generally arise in connection with the position of other punctuation marks which happen to be used with them. (See page 28.)"

Registered mail or air mail should be clearly marked in capitals at the upper right-hand corner of the letter, also on all file copies and the envelope. A notation should be made at the foot of the letter when there are enclosures. This notation should clearly indicate the number of enclosures.

Mr. David A. Matthews

-2-

July 1, 1952

Leave a margin of at least one inch at the bottom of the page. Never carry a single line of a paragraph to the second page. Try to break a paragraph so that there are two or more lines on the first page and as many on the second. If this is not feasible, carry the entire paragraph to the second page.

On the second and following pages the name of the addressee is to be typed from the upper left-hand margin, the number of the page in the center and the date in the upper right-hand corner. It is not necessary to repeat the entire address; if the letter is addressed to a company write the company name on the second page but if it is addressed to an officer of the company, type only his name.

The spacing will be determined by the number of lines on the page but the margins must match those on the first page. If there are only a few lines to be carried over, the first paragraph should be dropped well below the date line but never to the middle of the page.

A letter second sheet should be used for all pages following the first, with the same number of copies throughout. Always check the number of copies after you have inserted the paper in the typewriter.

Very truly yours,

BEVAN, BEMIS & COMPANY

By

Robert E. Carter
Partner

REC:SD

Enclosures 5

FORMAL LETTER

BEVAN, BEMIS & COMPANY
1166 Edgewood Street
Dallas 4, Texas

July 1, 1952

American Institute of Accountants
270 Madison Avenue
New York 16, New York

Attention: Mr. John L. Carey, Executive
Director

Gentlemen:

Letters consisting of two or more short paragraphs should follow the proportions laid down for the full-page letter, using wider margins to secure a harmonious appearance on the letterhead.

The initials of the dictator and the stenographer appear at the lower left.

Carbon paper which has been used for reports may be used again for the file copies of letters. However, if the letter is to be sent out in duplicate, be sure that carbon paper is in good condition.

Very truly yours,

(manually) Bevan, Bemis & Company

REK:SD

INFORMAL LETTER

December 31, 1952

Mr. Robert White
150 North Lake Avenue
Upstate, Illinois

Dear Bob:

Pursuant to our meeting yesterday, I enclose drafts of two office memorandums concerning The ABC Company. These were prepared as a result of our discussions of the problems involved. Will you please review them and let me have your comments so that I can forward them to Bill Jones, indicating that they are the result of our joint discussions?

I will also advise Bill that you and I are considering an alternative procedure. This will be the one suggested by you of transferring the buildings to a building corporation. In order to visualize the results, I will proceed to make some computations which will be submitted to you and we will then jointly inform Bill as to the result of our considerations.

Sincerely,

(Space for manual signature)

John Smith

JS:L
Enclosures 2

INFORMAL LETTER

February 27, 1953

Mr. Louis R. Ajax, Controller
Ajax Printing Company
600 North Park Avenue
Chicago, Illinois

Dear Louis:

I find that it will be convenient for me to meet with you this coming Monday, March 2. However, I suggest that you come to my office because the papers will be more readily available for our use in connection with the work we are planning to do.

The forms have been received so we should have no difficulty in getting started.

Sincerely,

(Space for manual signature)

John Smith

JS:L

BEVAN, BEMIS & COMPANY

OFFICE MEMORANDUM

Date July 15, 1952
To J. C. Adams From Fred Smith
Client Jones Manufacturing Company
Subject Annual Audit

Fred Williams, the treasurer of this client, phoned today and asked that we prepare eleven copies of the annual audit report hereafter instead of six.

Please make appropriate notations on your records.

FS:LMC

DOMESTIC SERVICE		WESTERN UNION		1206	INTERNATIONAL SERVICE	
Check the class of service desired; otherwise this message will be sent as a full rate telegram					Check the class of service desired; otherwise this message will be sent at the full rate	
FULL RATE TELEGRAM	SERIAL				FULL RATE	LETTER TELEGRAM
DAY LETTER	NIGHT LETTER				VICTORY LETTER	SHIP RADIOGRAM
NO. WDS.-CL. OF SVC.		PD. OR COLL.	CASH NO.	CHARGE TO THE ACCOUNT OF	TIME FILED	
				BEVAN, BEMIS & COMPANY		
Send the following message, subject to the terms on back hereof, which are hereby agreed to						
<div style="text-align: right; margin-right: 100px;"> NEW YORK AUGUST 8, 1952 </div> <div style="margin-top: 20px;"> BEVAN, BEMIS & COMPANY 1166 EDGEWOOD STREET DALLAS 4, TEXAS </div> <div style="margin-top: 20px;"> PUNCTUATION MAY BE USED IN TELEGRAMS. WHEN TYPING DATES AND AMOUNTS USE NUMERALS. (THE BALANCE AT JANUARY 31, 1949 WAS \$697,324.56) SIGN FULL NAME </div> <div style="text-align: right; margin-top: 20px;"> BEVAN, BEMIS & COMPANY </div>						

DOMESTIC SERVICE		WESTERN UNION		1206	INTERNATIONAL SERVICE	
Check the class of service desired; otherwise this message will be sent as a full rate telegram					Check the class of service desired; otherwise this message will be sent at the full rate	
FULL RATE TELEGRAM	SERIAL				FULL RATE	LETTER TELEGRAM
DAY LETTER	NIGHT LETTER				VICTORY LETTER	SHIP RADIOGRAM
NO. WDS.-CL. OF SVC.		PD. OR COLL.	CASH NO.	CHARGE TO THE ACCOUNT OF	TIME FILED	
				BEVAN, BEMIS & COMPANY		
Send the following message, subject to the terms on back hereof, which are hereby agreed to						
<div style="margin-top: 20px;"> (FILE COPY) </div> <div style="text-align: right; margin-right: 100px; margin-top: 20px;"> 10:30 AM NEW YORK AUGUST 8, 1952 </div> <div style="text-align: center; margin-top: 20px;"> FWL:TJM </div> <div style="margin-top: 20px;"> BEVAN, BEMIS & COMPANY 1166 EDGEWOOD STREET DALLAS 4, TEXAS </div> <div style="margin-top: 20px;"> PUNCTUATION MAY BE USED IN TELEGRAMS. WHEN TYPING DATES AND AMOUNTS USE NUMERALS. (THE BALANCE AT JANUARY 31, 1949 WAS \$697,324.56) SIGN FULL NAME </div> <div style="text-align: right; margin-top: 20px;"> BEVAN, BEMIS & COMPANY </div> <div style="margin-top: 20px;"> CHARGE - THE BLANK COMPANY </div>						

The Blank Corporation

JOURNAL ENTRIES

June 30, 1952

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 5,000	
Buildings	160,000	
Land	25,000	
Machinery and equipment	224,000	
Capital stock, 1,000 shares common		\$100,000
Capital stock, 1,000 shares preferred		100,000
Paid-in surplus		214,000
	<u>\$414,000</u>	<u>\$414,000</u>

To record acquisition of assets as
authorized by directors' minutes,
April 30, 1952

Accounts receivable	\$ 1,639	
Accounts payable		\$ 1,639

To transfer credit balances in accounts
receivable to accounts payable as follows:
Williams Ship Co. \$1,039
Jones Steel Co. 600

Accrued interest receivable	2,630	
Interest income		2,630

To record interest on debit balances
for June 1952

Machinery and equipment	2,600	
Repairs		2,600

To remove from repairs account cost of
a new pump, erroneously charged

VI. TAX RETURNS

Tax returns must be typed carefully. To obtain the best results, a wide-carriage typewriter with elite type should be used. Two-fold and three-fold tax forms should be opened, and carbon sheets wide enough to cover the entire typing surface should be used. When the forms have been inserted into the typewriter, the copies should be checked to see that they are in perfect alignment. This can be done by sticking a sharp pin through all of the forms. If this "pin check" is made frequently and the tax forms are adjusted as the typing progresses, all of the copies will register perfectly.

Number of Copies

Three copies should be typed, unless more are requested. The third copy should be stamped with the checking stamp and should be used as an office copy for the firm's files. The first carbon copy should be the client's file copy.

Schedules

Tax schedules should be typed on regular weight paper and the totals should be double underscored on the typewriter. The headings should not be underscored. A checking stamp should be placed on the third copy of every schedule. Occasionally the instructions call for enough copies to be used with several tax returns. In that case, the proper schedule numbers should be typed on the various copies, and an office copy should be retained for each set of returns.

Schedule Numbers

Schedule numbers should be written in the upper right-hand corner of the page and should conform to the numbers on the tax return.

Tax Forms

Since tax forms are printed on fairly heavy paper, two typings should be made if more than five copies are requested. When there is more than one typing, only one office copy should be stamped, but there should be a checking stamp for each typing.

Proofreading

All tax-work must be comptometer-checked and proofread in the proofreading department. Corrections must be made neatly and checked carefully. Since it is difficult to make neat corrections on tax forms, any tax returns requiring major changes should be retyped.

Illustrative Tax Transmittal Letters

Examples of form letters for use in forwarding tax forms follow. These illustrations lack dates, addresses, salutations, et cetera, which should be filled in by the typist.

FORM LETTER FOR DECLARATION OF ESTIMATED FEDERAL INCOME TAX
(Alternative items shown in parentheses)

We enclose, in duplicate, your (amended) 1952 declaration of estimated Federal income tax.

The original should be signed by you (and your wife), dated, and forwarded to the Director of Internal Revenue for your district in time to be received on or before March 15, 1952.

A check in the amount of \$, payable to the Director of Internal Revenue, should accompany the declaration.

The duplicate copy of this declaration should be retained in your files.

(This declaration is based upon an estimated taxable income equal to or greater than that indicated on your final return for 1951. Accordingly, no amendment of this declaration will be required regardless of any increase in your 1952 income. In the event your income decreases substantially, you should consider amending this declaration. In either case, a final return for 1952 will be due March 15, 1953.)

(This declaration is based upon an estimated taxable income of \$, which is less than the amount shown on your 1951 return. If it should become apparent during the year that your 1952 income will exceed the amount estimated, it may become necessary to file an amended declaration on the appropriate due date of installments. Penalties will be avoided if this is done or if a final 1952 income tax return is filed on or before January 15, 1953.)

FORM LETTER FOR INDIVIDUAL FEDERAL INCOME TAX RETURN
(Alternative items shown in parentheses)

We enclose, in duplicate, your 1951 Federal individual income tax return.

The original of this return should be properly signed by you (and your wife), dated, and forwarded to the Director of Internal Revenue for your district in time to be received on or before March 15, 1952. (The original of Form W-2 issued by your employer must accompany the signed return when filed.)

An overpayment of tax in the amount of \$ is indicated at Item 8 on the first page of the return, and the treatment to be accorded such overpayment is also indicated.

The duplicate copy of this return should be retained in your files.

FORM LETTER FOR INDIVIDUAL INCOME TAX RETURN
(Alternative items shown in parentheses)

We are enclosing, in duplicate, your 1951 Federal individual income tax return.

The original should be signed by you (and your wife), dated, and forwarded to the Director of Internal Revenue for your district in time to be received on or before March 15, 1952. (The original of Form W-2 issued by your employer must accompany the signed return when filed.)

A check for the tax due in the amount of \$, payable to the Director of Internal Revenue, should accompany the return.

The duplicate copy of this return should be retained in your files.

FORM LETTER FOR FEDERAL PARTNERSHIP INCOME TAX RETURN

We enclose, in duplicate, your Federal partnership return of income for the year ended

The original should be signed and dated by a partner and forwarded to the Director of Internal Revenue for your district in time to be received on or before

No tax payment is due in connection with this return as each partner's share of the net income and credits of the partnership is reportable by him individually in his personal Federal income tax return.

The duplicate copy of this return should be retained in your files.

FORM LETTER FOR FEDERAL CORPORATION INCOME TAX RETURN

We enclose, in duplicate, your Federal corporation income tax return for the year ended

The original should be impressed with the corporate seal, signed by two principal officers, dated, and forwarded to the Director of Internal Revenue for your district in time to be received on or before

The tax in the amount of \$ may be paid, by check to the Director of Internal Revenue, either in full at the time of filing the return or in four installments as follows:

1st installment due with return . . . . .	.35%
2nd installment due three months from due date of return . . . . .	.35%
3rd installment due six months from due date of return . . . . .	.15%
4th installment due nine months from due date of return . . . . .	.15%

The duplicate copy of this return should be retained in your files.

VII. PROOFREADING

All accounting work must be compared by two persons, one who reads from the draft and one who holds the finished copy. Some work may require a second reading which may be done by a single proof-reader.

Editing is the dictator's responsibility; and, while proofreaders should question grammatical construction, no changes should be made in the text unless approved by the dictator.

The proofreader must be trained to read clearly at a fairly rapid, but even, pace. She should read spacing, capitalization, and punctuation as well as text and should spell all proper names. She should stop immediately when the copyholder marks a correction, and should watch her place so that she may continue promptly.

The copyholder must learn to concentrate and should never allow her attention to wander or to be distracted. She must be alert and must follow the text letter by letter. She should watch for

- Errors in setup
- Typographical errors
- Transposed letters and figures
- Misspelled words
- Spelling of proper words
- Consistent spelling
- Capitalization
- Punctuation
- Proper division of words between lines
- Grammatical construction
- Bad erasures

Proofreaders should use a red pencil and should make all correction marks in the left-hand margin, placing a light mark under the word or letter to be corrected. Standard proofreader's symbols should be used. All typists and readers should familiarize themselves with these marks. (See Hints to Proofreaders (page 221), MANUAL OF STYLE, UNIVERSITY OF CHICAGO PRESS.)

VIII. ILLUSTRATIVE LIST OF STATIONERY AND SUPPLIES
FOR AN ACCOUNTING FIRM

	<u>Description</u>	<u>Use</u>
<u>Letters</u>	Engraved bond letter- heads, 8-1/2 x 11	All correspondence
	Second (continuing) sheets	All correspondence
	Tissue sheets printed "copy"	Copies to parties outside firm
	White tissue	Correspondence file
	Blue tissue	Review by partners; follow-up file
	Pink tissue	Supervising account- ant; working papers
<u>Billing</u>	Engraved bond letter- head - 5 x 8-1/2	Bills to clients
<u>Memorandums</u>	4-part memorandum form (copies same colors as correspondence copies)	Interoffice and in- traoffice corre- spondence and file memorandums
<u>Envelopes</u>	No. 6-3/4 size	Bills and one-page letters
	No. 10 size	Letters of more than one page
	No. 6-1/4 size (printed return envelope)	Return correspondence
	Large manila (8-1/2 x 11)	Unfolded long letters
	Large manila (10 x 15)	Mailing reports
<u>Telegrams</u>	Western Union telegram blanks (short and long sizes)	All telegrams
<u>Reports</u>	Report letterheads - 8-1/2 x 11 13-pound paper	First page of reports
	Report second sheets (name imprinted or watermarked) 13-pound paper	Continuing pages of reports
	Wide statement sheets - 11 x 14 and 11 x 17	Schedules and state- ments
	Office copy sheets (plain) 8-1/2 x 11, 11 x 14, and 11 x 17	Retained copies of reports

<u>Plain Paper</u>	Plain 13-pound sheets, 8-1/2 x 11 and 11 x 17	Tax schedules; tax protests; drafts of letters; memorandums and reports; financial statements without opinion
<u>Legal Size Paper</u>	Watermarked or engraved, 8-1/2 x 13 and 13 x 17	Estate accounts, SEC reports, and other special reports
<u>Covers</u>	Buff covers with firm's name White covers, plain Blue office copy covers White backing sheets	Opinion reports Nonopinion reports Office copies of reports Tax protests, court papers
<u>Binding Materials</u>	Eyelets, washers and machine	Binding reports
<u>Carbon Paper</u>	Hard-finished black carbon paper, lightweight (sizes needed for all paper sizes)	All typing work
<u>Supplies</u>	Black typewriter ribbons, erasers, erasing shields, time reports, typewriter brushes and cleaning fluid, file folders and dividers, paper clips, pencils (black and red), scratch pads, and mimeograph and multi-lith paper	

IX. BOOKS RECOMMENDED FOR REFERENCE

The following books will prove helpful in supplementing and in applying the rules included in this Manual.

Webster's New International Dictionary, Unabridged,
G. & C. Merriam Co.

A Manual of Style, The University of Chicago Press

Complete Secretary's Handbook, Davis and Miller,
Prentice-Hall

English for Secretaries, Monroe, The Gregg Publishing
Company

Standard Handbook for Secretaries, Hutchinson,
Whittlesey House

United States Government Printing Office Style
Manual

The Secretary's Handbook, Tainter and Monroe, The
Gregg Publishing Company

The Filler Corporation

STATEMENT OF INCOME

Year ended December 31, 1952

SALES

Gross sales, less returns, allowances and discounts		\$1,385,624.76
--	--	----------------

COST OF GOODS SOLD

1,056,614.22

Gross profit

329,010.54

SELLING AND ADMINISTRATIVE EXPENSES

Selling expenses	\$124,373.62	
------------------	--------------	--

Administrative expenses	<u>131,817.10</u>	<u>256,190.72</u>
-------------------------	-------------------	-------------------

Operating profit

72,819.82

OTHER INCOME

Interest and dividends	725.01	
------------------------	--------	--

Gain on sale of fixed assets	<u>1,050.00</u>	<u>1,775.01</u>
		<u>74,594.83</u>

OTHER DEDUCTIONS

Interest	6,700.00	
----------	----------	--

Amortization of discount and expense on first mortgage note	<u>983.42</u>	<u>7,683.42</u>
--	---------------	-----------------

Net income (before income taxes)

66,911.41

INCOME TAXES

Federal normal tax and surtax		<u>22,316.48</u>
-------------------------------	--	------------------

NET INCOME

\$ 44,594.93

The Filler Corporation

COMPARATIVE STATEMENT OF INCOME

Years ended December 31, 1952 and 1951

	Year ended December 31,		Increase decrease*
	1952	1951	
SALES			
Gross sales, less returns, allowances and discounts	\$1,385,624.76	\$1,039,561.99	\$346,062.77
COST OF GOODS SOLD	<u>1,056,614.22</u>	<u>752,744.62</u>	<u>303,869.60</u>
Gross profit	329,010.54	286,817.37	42,193.17
SELLING AND ADMINISTRATIVE EXPENSES			
Selling expenses	124,373.62	107,385.02	16,988.60
Administrative expenses	<u>131,817.10</u>	<u>125,132.62</u>	<u>6,684.48</u>
	<u>256,190.72</u>	<u>232,517.64</u>	<u>23,673.08</u>
Operating profit	72,819.82	54,299.73	18,520.09
OTHER INCOME			
Interest and dividends	725.01	793.00	67.99*
Gain on sale of fixed assets	<u>1,050.00</u>	<u>-</u>	<u>1,050.00</u>
	<u>1,775.01</u>	<u>793.00</u>	<u>982.01</u>
	<u>74,594.83</u>	<u>55,092.73</u>	<u>19,502.10</u>
OTHER DEDUCTIONS			
Interest	6,700.00	6,700.00	-
Amortization of discount and expense on first mortgage note	<u>983.42</u>	<u>983.42</u>	<u>-</u>
	<u>7,683.42</u>	<u>7,683.42</u>	<u>-</u>
Net income (before income taxes)	66,911.41	47,409.31	19,502.10
INCOME TAXES			
Federal normal tax and surtax	<u>22,316.48</u>	<u>17,473.94</u>	<u>4,842.54</u>
NET INCOME	<u>\$ 44,594.93</u>	<u>\$ 29,935.37</u>	<u>\$ 14,659.56</u>

The Filler Corporation

BALANCE SHEET

March 31, 1952

ASSETS

CURRENT ASSETS

Cash		\$ 5,269.92	
Accounts receivable			
Customers	\$25,673.63		
Officers and employees	<u>3,816.49</u>		
	29,490.12		
Less allowance for doubtful accounts	<u>2,700.00</u>	26,790.12	
Inventories--at the lower of cost (determined by the first-in-first-out method) or market			
Raw materials	21,642.79		
Work in process	10,749.62		
Finished goods	<u>5,253.13</u>	37,645.54	
Insurance premiums unexpired		<u>837.15</u>	\$70,542.73

FIXED ASSETS

Machinery and other equipment--at cost		26,895.92	
Less accumulated depreciation		<u>4,956.18</u>	<u>21,939.74</u>
			<u>\$92,482.47</u>

LIABILITIES

CURRENT LIABILITIES

Accounts payable--trade		\$41,482.69	
Income taxes for the year ended December 31, 1951--unpaid portion		2,348.16	
Accrued liabilities			
Income taxes for the three months ended March 31, 1952--estimated	\$ 700.00		
Salaries and wages	693.00		
Taxes (other than income taxes)	<u>277.24</u>	<u>1,670.24</u>	\$45,501.09

CAPITAL

Capital stock--authorized, 5,000 shares of \$10.00 par value; issued and outstanding, 1,000 shares		10,000.00	
Retained earnings		<u>36,981.38</u>	<u>46,981.38</u>
			<u>\$92,482.47</u>

The Filler Corporation

BALANCE SHEET

December 31, 1952

ASSETS			LIABILITIES		
CURRENT ASSETS			CURRENT LIABILITIES		
Cash		\$ 20,296.29	Notes payable to bank (unsecured)		\$ 25,000.00
United States Government securities--at cost, plus accrued interest (principal amount, \$25,000.00; quoted market price, \$26,593.20)		25,692.47	Current maturities of first mortgage note		20,000.00
Accounts receivable			Accounts payable		
Customers	\$255,673.63		Trade	\$148,069.73	
Officers, employees and other	<u>14,816.49</u>		Employees and other	<u>6,066.35</u>	154,136.08
	270,490.12		Income taxes for the year ended December 31, 1952		22,316.48
Less allowance for doubtful accounts	<u>9,500.00</u>	260,990.12	Accrued liabilities		
Inventories--at the lower of cost (determined by the first-in-first-out method) or market			Salaries and wages	8,692.00	
Raw materials and supplies	121,642.79		Taxes (other than income taxes)	<u>7,277.24</u>	<u>15,969.24</u> \$237,421.80
Work in process	43,749.26				
Finished goods	<u>17,356.30</u>	182,748.35			
Prepaid expenses and sundry deposits		<u>8,120.41</u> \$497,847.64			
INVESTMENTS			FUNDED DEBT		
Investment in subsidiary			First mortgage 4% note, payable in quarterly installments of \$5,000		155,000.00
500 shares (100%) of the capital stock of Justin, Inc.--at cost	56,289.72		Less current maturities		<u>20,000.00</u> 135,000.00
Advances to Justin, Inc.	<u>20,000.00</u>	76,289.72			
Other securities--at cost		<u>10,264.89</u> 86,554.61			
FIXED ASSETS			CAPITAL		
Land--at cost		20,000.00	Contributed capital		
Buildings, machinery and equipment, furniture and fixtures--at cost	421,693.72		6% cumulative preferred stock--authorized, 1,500 shares of \$100 par value; issued and outstanding, 1,450 shares	145,000.00	
Less accumulated depreciation	<u>149,262.73</u>	272,430.99	Common stock--authorized, 4,000 shares of \$100 par value; issued and outstanding, 2,000 shares	200,000.00	
Leasehold improvements--at cost, less \$7,969.47 amortization		<u>15,692.74</u> 308,123.73	Capital contributed in excess of par value of common stock	<u>50,000.00</u>	395,000.00
DEFERRED CHARGES AND OTHER ASSETS			Retained earnings		
Cash surrender value of life insurance		3,692.78	Appropriated for possible future decline in inventories	20,000.00	
Patents--at cost, less \$5,269.72 amortization		6,169.72	Unappropriated	<u>119,146.16</u>	<u>139,146.16</u> 534,146.16
Unamortized discount and expense on first mortgage note		<u>4,179.48</u> <u>14,041.98</u>			
		<u>\$906,567.96</u>			<u>\$906,567.96</u>

Appendix B

SELECTED BIBLIOGRAPHY

(The Bibliography for Chapter 7 also includes a number of items which deal with aspects of the subject matter of this chapter.)

- ROCKEY, CHARLES S., "Accountant's Office Manual," Prentice-Hall, Inc., New York, 1952.
- BACAS, PAUL E., "The Successful Practice of Accountancy," Prentice-Hall, Inc., New York, 1951.
- OEHLEF, CHRISTIAN, "Audits and Examinations," American Book Company, New York, 1949. (Chapter 23: The Report)
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- HARRINGTON, JOHN J., Office Procedures in "New Developments in Accounting," American Institute of Accountants, 1946, page 88.
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- PRIESTER, GERTRUDE, "Typing and Filing Procedures," *New York Certified Public Accountant*, November 1940, page 93.
- DUNCOMBE, FRED J., "Organization of Work" in Papers on Auditing Procedure and other Accounting Subjects, American Institute of Accountants, 1939, page 188.
- POWELL, WELDON, "Accountants' Report Procedure," *Pathfinder Service Bulletin*, September 1939, page 1.
- EGGLESTON, D. C., "Mechanical Features of Accountants' Reports and Working Papers," *New York Certified Public Accountant*, October 1934, page 10.
- SQUIRES, FREDERIC W., "The Internal Organization of an Accountant's Office," *New York Certified Public Accountant*, October 1934, page 19.
- GLUICK, L., "The Accountant's Typist," *The Certified Public Accountant*, January 1928, page 9.

Note: Page 59 of Appendix A lists several references pertinent to the material in that appendix. These references are not repeated in this Bibliography.

CHAPTER 9

STAFF SELECTION AND TRAINING

ORGANIZATION OF AN ACCOUNTING FIRM

Organization Chart. Classification of the Staff.

EMPLOYMENT POLICIES

Contracts of Employment. Noncompetition Agreements. Personnel Records. State Laws on Fair Employment Practices.

SELECTING A STAFF MEMBER

Basic Requirements. Sources From Which to Obtain Staff Members. Employment Application Forms. The American Institute's Testing Program. Psychological Testing. Procedure for Interviewing Applicants. Internship Programs. Co-operative Educational Plans.

STAFF DEVELOPMENT

Staff Training Programs. On-The-Job Training. Formal Staff Training Programs. What Should Be Included in the Class Training? A Suggested Class Program (Staff Manual; Preparation of Audit Working Papers; Audit Procedures; Report Writing and the Preparation of Financial Statements). Co-operative Training Programs. Teaching Methods. Informal Training Procedures. Development of Specialists. Developing Staff Morale. Creating Staff Loyalty. Staff Meetings and Social Activities. Staff Manuals (Appearance and Behavior; General Conduct; Relations with Clients; Secrecy Regarding Firm's Business).

APPRAISING THE PROGRESS OF THE STAFF

Rating and Reporting upon Performance. Discussions of Progress with Staff Members. Remuneration and Progress.

APPENDIXES

Personnel Forms. Personnel Manual. Staff Manual.

CHAPTER 9

Staff Selection and Training

BY IRA N. FRISBEE

ORGANIZATION OF AN ACCOUNTING FIRM

Organization Chart

The size of an accounting firm often determines the degree to which a definite organization chart and outline of the functions of the personnel has been perfected. Nevertheless, a classifying of personnel and an outlining of the duties of each member of the staff are found in many small firms. The need for an organization chart or some similar outline of the duties and relationships of staff members is particularly evident in large firms having several offices. Even in a medium-sized firm, a chart of the organization will be particularly useful, especially if more than one office is maintained.

A chart, or other form of organization outline, is important chiefly as an aid to efficient management. Obviously, the majority of the staff members must be engaged mostly in carrying on the accounting work — making audits, preparing tax returns, assisting with systems and special problems, et cetera. But time must be spent by some one or more persons in administrative functions. For example, the extent and terms of engagements must be arranged with the clients. Assignments of staff to jobs must be made and the supervision of these jobs may need to be delegated. Working papers must be reviewed, as must the audit reports, tax returns and other reports of the engagements. Responsibility for the prompt typing and preparing of the accounting reports for delivery cannot be entirely delegated to the typing department; even in this work the final decisions and responsibility for efficient results rest upon an administrative executive or executives of the accounting firm. Also, the authority and responsibility for many other duties of management must be assigned, such as: determining the fee to be charged for each completed engagement; purchasing supplies, equipment, books, tax and other services; hiring staff and office assistants; developing staff training methods and programs; engaging in research in accounting theory and auditing techniques in order to improve the practices and procedures of the firm. In an office having several partners, each partner undertakes part of the administrative functions. However, individual abilities will vary and it may be that there are partners who should be engaged chiefly

in the accounting work rather than in administrative functions. Sometimes there are partners who are most able in supervising effectively the accounting engagements but who lack the ability and the desire to undertake any of the office work or the staff-management functions.

Even the sole practitioner operating without any permanent staff will find that he has both the functions of conducting his practice (that is, doing the work) and of administering his practice (making decisions not related to the work on individual engagements). Perhaps the administrative functions will be so intermingled with his work functions that he will fail to recognize and devote enough time to them. But, if his practice is to grow and if a staff of accountants and office people is to be acquired, he will find that more and more time must be spent in administrative work. In presenting this subject the author has written principally from the viewpoint of the medium-sized firm. It is believed that smaller firms should be able to find suggestions which will be applicable and helpful to them in their selection and training process.

Classification of the Staff

In classifying the accounting personnel of a public accounting office, five main groups or classes are usually recognized.^{1,2} These are: partners or principals; managers or supervisors; senior or in-charge accountants; semi-senior accountants; junior accountants. In small firms and sometimes in medium-sized firms if there are many partners or principals there may be no need for "managers" or "supervisors." However, if there is only one principal (a sole practitioner) with a large staff, many managers and/or supervisors may be needed.

Within each main class there may be several grades. Often there are one or more senior partners, with junior partners varying in rank and in duties and authority. The sole practitioner and the partners are usually referred to as "principals," but some large firms have principals who are not partners. These principals have authority and internal responsibilities similar to partners. Although lacking ownership and the liabilities of partners, they usually share in profits under contractual arrangements, they are authorized to sign reports and other documents for the firm, and they act for and in place of the partners on many occasions.

Usually the majority of the functions of management are performed by the partners or principals, but some may be delegated to the managers or supervisors,* such as interviewing and hiring staff assistants, making job assignments, and conducting staff training programs. For the most part the managers and supervisors are in charge of engagements in the case of audits, or are in charge of separate departments such as the tax

¹ See references at end of this chapter.

* In some firms, persons in this classification are called "managers," in others they are "supervisors" and in some cases they may be termed "supervising seniors."

department or the systems department if separate departments are maintained for these services. In supervising engagements they usually plan the work to be performed and direct it either by calling frequently at the client's office during the engagement, or by staying on the job in the case of large audits, or by contacting frequently (by telephone or otherwise) the senior accountant who is in charge on the job. Also, they review the working papers and the report to determine that the work is complete and up to standard.

Seniors, semi-seniors and juniors are the three customary classes of staff accountants who work under the managers, partners and other principals in carrying out the audit engagements, preparing tax returns, et cetera. Actually there may be several grades in each classification, such as "top" senior, "medium" senior, "light" senior, and similar classifications for juniors and sometimes for semi-seniors. Inasmuch as continual advancement in position and responsibility is expected by both the employee and employer, there may be many more grades or stages of development within each group, particularly in the minds of their associates and superiors. These multiple or refined classifications are not usually formalized by a salary adjustment for each upgrading while the young man progresses. However, in a few instances, firms have formally classified their staff members as A, B or C within each of these three major groups and apparently maintain these classes for salary purposes. Discussion of the duties of juniors and the duties of seniors will be found in Chapters 26 and 27.

From the standpoint of management, an important reason for a chart or outline of the staff is the avoidance of situations that are embarrassing or discouraging to the individuals. Whether or not a formal chart exists, each staff member constantly makes his own mental chart and places himself on it, and each staff member is likely to have strong feelings of pride and jealousy. For instance, to assign a senior to work under another senior, unless the latter is recognized as being well above the former, is likely to result in mental anguish for the senior so assigned and may also give the second senior a false feeling of importance. This might be overcome in most instances if the reason for such assignment is explained to those involved at the time of making the assignment.

EMPLOYMENT POLICIES

Contracts of Employment

In employing staff members one of the first questions which arise concerns whether or not written agreements covering the terms of employment are advisable. Such written contracts are not usually made with staff assistants who are in the lower grades of staff classification.* An

* Sometimes an exchange of letters, or the signature of acceptance on the employer's letter, is used. If a formal contract is adopted, its provisions will be similar to those for employees of higher rank except as to compensation, particularly for overtime work.

employee with the rank of manager or principal, however, should always be covered by a contract of employment which sets forth his authority, duties, basis of compensation, profit-sharing plan, if any, and the period of the contract. Where contracts are used, it is customary to specify that the employee is to give his full time and attention to his employment and is not to engage in competitive practice during the period of the contract. Also, the provision may be made that for a period of two (or more) years after termination of employment he will not do work for any of the firm's clients, either on his own account or as an employee of another, and that he will not solicit such work from the clients.

A clause also may be used to specify that the employee will not offer employment to any other employee of the firm during a period of perhaps two years after termination of employment. Two examples of employment contracts are given in Appendix B.

In hiring juniors or seniors an accounting organization ordinarily is taking persons on trial and, therefore, the period of service may be terminated upon giving notice. Nevertheless, usually the best results will be obtained if the staff members understand that while employment continues their full time and attention is to be devoted to the employer's work so that conflicts of interests do not arise. The employing firm always should make its policy as to outside employment clearly known to the staff members so that a mutual understanding exists.

Noncompetition Agreements

As suggested above, some employers have attempted to regulate the conduct of their employees after they have left the employ of the firm by having them, upon initial employment, sign an agreement not to seek accounting engagements from any of the firm's clients after they leave the employ of the firm or while they are contemplating leaving. Sometimes an agreement of this sort includes a statement that the employee will not reveal or use information which he has obtained concerning the affairs of the firm's clients in order to obtain engagements from other sources. A further prohibition which may be included in agreements is that the accountant will not hold himself out as "formerly with" or "late of" the firm which has employed him. Obviously, such clauses as these will not be necessary if the employer is fortunate in obtaining employees of character, integrity and high moral and ethical standards. It is doubtful that employees lacking those characteristics will avoid all actions that are damaging to their former employer no matter how careful the employer has been in attempting to prohibit the competitive activities. The professional code of ethics will be sufficient deterrent against unethical acts by those of high ethical standards. The chief value of such contract provisions would seem to be that they call to the attention of the employee the proprieties of his relationship with his employer.

Undoubtedly, too, they have a strong deterring effect on those who would otherwise be guilty of flagrant violations.

Personnel Records

Some firms have made the mistake of neglecting their personnel records. Ultimately these accountants will have occasion to regret their negligence because much time will be wasted if they do not have a permanent file showing the essential facts about all persons who have been in their employ. Adequate social security records should be obtained and filled out completely to show not only the record of earnings and the deductions therefrom, but also to keep up to date the residence address, telephone number, names of relatives and similar personal information. Then, by keeping a permanent file of these social security records for all former employees as well as those currently employed, the employer will be in a position to answer quickly questions on the terms and nature of employment of all persons whom he has employed.

The personnel records should include the letters of application from all persons who have applied. Also, the files should include all correspondence that relates to persons who have not been hired as well as to those who were hired. Such a file would include the filled-in application form, if any, and any correspondence with the applicant, with his references, with credit bureaus, with schools he has attended, and with his former employers.

Another desirable file is one in which data are collected on persons applying for positions with clients of the firm and persons who have applied to the accounting firm for placement elsewhere. Many accountants find that their clients rely upon them to a considerable extent to assist them with their personnel problems and not only expect the accounting firm to interview accounting personnel but also expect their public accountant to find the personnel to be interviewed. Although the accountant may be tempted to throw away applications when no job is immediately in sight, he should resist such an impulse because he cannot know when a client will request assistance in obtaining an accounting or other office employee.

Under wage and salary stabilization rules all employers have found it necessary to have in their files a complete record of promotions and the reasons for promotions. During the period when such rules are in existence, the accountant should be particularly careful to see that his own employment records are in order and that he has adhered to the regulations for salary or wage increases. This usually requires an explanation of each increase stating the reason (merit, regular promotion, general cost-of-living increase, et cetera) with references to the salary stabilization rules allowing the increase. Staff members holding CPA certificates are exempt at present (November 1952) from salary stabilization regulations. Complete personnel records should be maintained, however, showing advancement within the firm.

State Laws on Fair Employment Practices

Accounting firms are not subject to many of the restrictions upon hiring imposed by Federal or state laws. Problems arising from union membership, closed shops, and use of child labor should never arise in hiring professional employees. But all employers, including accounting firms, should plan their employment and personnel policies to avoid charges of discrimination because of race, creed, or color.

In 1952 ten states had antidiscrimination laws.* In eight of these, the laws were substantially the same. Such laws specify that it is unlawful for the employer to refuse to hire, or to discriminate in hiring, any individual because of his race, creed, color or national origin. In some states the law forbids an employer to ask questions that express, either directly or indirectly, any discrimination as to these characteristics. Under such conditions the employer should be careful in wording employment application blanks to avoid reference to such items as place of birth of the applicant and of his parents, nativity, lineage or ancestry, maiden name of wife or mother, and his religion.

Even in states not having discriminatory laws, the interviewer should exercise care to avoid any suggestion of discrimination. Careless remarks which indicate prejudice may be interpreted as evidencing policies of discrimination.

In employing people for public accounting, the employer must consider the personal attributes of the applicant, including his appearance, behavior, cleanliness, tact, aggressiveness, dignity, culture and compatibility. The record of the rejections of applicants, showing the disposal of every application, should be clear as to the reasons for rejection so as to provide defense against charges of discrimination.

A number of states have laws that specify the maximum hours for which it is permissible for women to work. Usually, certain exceptions are specified or may be granted. In California, for example, there is a maximum of eight hours a day and forty-eight hours a week except that the law does not apply to women in executive, administrative or professional capacities. This exemption applies to licensed accountants and also those in creative, managerial or intellectual work earning at least \$350 per month.

SELECTING A STAFF MEMBER**Basic Requirements**

Public accounting practitioners readily admit that a firm is no better than its staff. In a large measure success depends upon the ability of the persons who make up the accountant's staff. Yet it is surprising how

* These states are: Connecticut, Indiana, Massachusetts, New Jersey, New Mexico, New York, Oregon, Rhode Island, Washington and Wisconsin. See "Labor Guide," Prentice-Hall, Inc., New York, volume VII, page 203.

little attention is given to the problems of selecting and training these employees.

That the staff employee must be a superior person rather than just a good person or an able person may not have occurred to some practitioners. This superiority must be present in his personal attributes such as his honesty, character, integrity, dignity, personality and adaptability.* But, also, he should have a broad general education together with a specialized training in accounting. In addition to all this, to go far in public accounting, he must obtain a wide experience in business matters and develop skill in auditing methods and techniques.

What is the minimum educational background considered necessary for public accounting? The majority of firms employ only those having college degrees. Many of them set up as a minimum educational requirement not only the college degree but also a "major" or specialization in accounting. Some firms have indicated that they will consider only applicants who have graduated with high scholastic rank. Admittedly, the possession of a college degree does not necessarily indicate that the holder is a well educated person. Some people without college degrees have far more education than some with degrees have. However, statistics on successful candidates at CPA examinations indicate that a far larger percentage of the candidates who have college degrees pass the examination than those without, such percentages being determined in relation to the entire respective class taking the examination. This conclusion is substantiated by a study prepared for the Board of Examiners of the American Institute of Accountants by the Institute's educational department.³ It states:

"College graduates, as a group, were 17% more successful and noncollege graduates 26% less successful than the average. The relative performance of each group increased consistently from a low for the "High School Only" group of 55% less successful to a high of 103% more successful than average for the Graduate School Group. The only subgroup among the college graduates which was less successful than average was the Nonaccounting Major Group."

In some professions, such as law and medicine, prescribed courses have been agreed upon to train the students and prepare them for their professional examinations. Many in public accounting believe that ultimately similar requirements will be set up for this profession.

Some accountants have found that college-trained juniors are not willing to complete a period of training as a junior which firms believe to be desirable. Apparently some college graduates have been misin-

* A splendid statement of the qualifications for a professional career in accounting is given by Edward B. Wilcox in "Qualifications for a Professional Career," *The Accounting Review*, January 1944, pages 1-6. In summarizing he says: "One has only to be an intellectual giant, adaptable, gifted with insight and imagination, the possessor of infinite knowledge, tact, diplomacy, courage, and a winning personality, an idealistic paragon of all the virtues, and a demon for work."

formed and led to expect more rapid success than is likely to be achieved. Also some may have failed to acquire habits of work and may be surprised to find that they have only a thin veneer of knowledge.

Sometimes the employer is at fault in making promises and describing a career which he cannot make available to employees. Every prospective employee has the right to know what he may reasonably expect to find as an opportunity and no employer should mislead a prospect by enticing him with unjustified hopes or dreams of an improbable future. Otherwise both parties will waste time, the relationship will be only temporary, and the profession may lose a valuable but disillusioned prospect.

In the past some accounting firms have recruited junior accountants from private industry after they have had some bookkeeping or other clerical experience. Currently there is a tendency among a majority of the firms to take candidates directly from college without any experience in accounting. In a questionnaire recently sent to a number of accounting firms, 69% indicated that they had no minimum experience requirement and 10% stated that they required a specified period in their own office with duties other than those of junior accountant such as checking reports, filing, comparing, and other checking. Out of the total responding, only 10% required bookkeeping experience for a year or more as a minimum experience requirement, and most of these were small firms.

Sources From Which to Obtain Staff Members

As to the source of obtaining staff members, the most satisfactory is likely to be colleges. The success with any individual college may depend upon (1) whether its graduates are well trained, and (2) whether the public accounting firm has a contact or contacts with persons who are adept at placing graduates in the most suitable positions. In the questionnaire sent to the firms mentioned above, 95% of those replying stated that they used college and universities as one of their sources. The various sources used are tabulated below, together with the per cent of the firms reporting that they used the source:

	<i>% of Firms</i>
Colleges and universities	95
Unsolicited applications	83
Recommendations of friends	62
Recommendations of clients	53
Private employment agencies	52
Newspaper advertising	48
Former temporary staff personnel	40
Business schools — commercial	33
Recommendations of other accounting firms	31
Professional accounting organizations (national, state and local)	26
Former members of permanent staff	21
Federal and state employment services	14

As to the frequency of use of these sources, the colleges and universities were rated highest and the unsolicited applications were next in order, followed closely by newspaper advertising and private employment agencies. In using newspaper advertising, nearly all of the firms inserted their own "Help-Wanted" advertisements; those answering the "Situation-Wanted" advertisements reported only occasional success.

Employment Application Forms

Frequently insufficient attention has been given to the obtaining of adequate information concerning prospective staff accountants. Only 71% of the firms surveyed (see above) were found to be using application forms in the selection of staff personnel, and 80% of these used short forms which provided for basic data only rather than long forms that requested data for use in evaluating the applicant's abilities and qualifications. Some employers believe the application form should provide a rather full coverage of the personal history and background of the applicant. The most important questions relate to the applicant's life history, business experience, physical strength or weakness, family life and financial responsibilities. Such information is basic in judging the applicant's character, honesty, integrity, ability and ambition. Examples of application forms are included in Appendix B to Chapter 7 and in Appendix A of this chapter.

The best time to have the candidates fill out the application form usually is considered to be before an interview. This enables the interviewer to study the applicant's record in advance, thereby eliminating certain questions at the interview, and revealing others that require further elucidation, thus giving the interviewer the opportunity to direct the interview to the most important items. In conducting interviews at colleges, the interviewer may find a considerable amount of well organized personal data about each student which can be studied either before or after the interview.

The following questions are often included in the application form, in addition to the name of the applicant, his home address, telephone number, date of application and present business address, if any:

Are you an American citizen?

Lineage (American, English, Irish, Scotch, French, German, Russian, Polish, et cetera.)*

Religion.*

Date and place * of birth.

Are you single, married, widowed or divorced?

Number and relations of persons dependent on you for support.

Give particulars respecting nearest living relatives:

<i>Name</i>	<i>Address</i>	<i>Relation</i>	<i>Occupation and Employer</i>
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* These questions must be omitted in states that forbid an employer to ask questions that express any discrimination as to race, color or creed, and are omitted voluntarily by some employers in states which have no such prohibition.

Are you a CPA? If so, in what state? When did you receive your certificate?

Are you related to any partner or employee of this firm?

Name acquaintances in our employ.

How do you spend your spare time?

Are you now attending or do you plan to attend high school?

Do you or your wife have an income besides your salary? (Specify)

Do you own your home, rent, or live with relatives?

Do you own an automobile and, if so, what make and model?

Are you in debt and, if so, to what extent and for what reason?

Have you ever gone through bankruptcy or made an assignment?

Have you ever been bonded by a surety company?

If so, state latest bond and to whom given.

Have you ever been refused a surety bond?

If so, why?

Is your health good?

Have you ever been refused life insurance?

Have you any physical defects? (Explain)

How much time have you lost from work through illness during the past two years?

Have you ever been dismissed or suspended from any position?

If so, state when, where and the cause.

Are you interested or engaged in any business? (Give particulars)

Are you willing to accept out of town engagements?

Are you willing to work overtime?

For what position are you applying?

When can you begin work?

In addition to these questions, the application forms should include schedules to be filled in covering the education of the applicant, a complete record of all of his previous employment, and a list of responsible persons submitted as references. The schedule for educational qualifications should provide for a showing of the number of years of completed work in each of the secondary schools, the colleges or universities, and the other institutions listed by the applicant. The name of the school and the city in which it is located should be given, the years of attendance, the degrees obtained, if any, and the major course or subject studied in college. Some employers find it beneficial to have applicants furnish a transcript of their collegiate record of courses and grades or to have the applicant request their colleges to send these records to the prospective employer.

Space may well be provided in the application form for the applicant to state any honors he received in school, such as prizes, membership in honorary and/or professional fraternities, and scholarships, teaching assistantships, and fellowships. Another important type of data, for which a line or more should be provided, is that of extracurricular offices, on which suggestions may be made to the candidate that he list the organizations to which he belonged, the offices held, and any athletic, dramatic, literary or forensic activities in which he engaged.

A useful schedule of the applicant's previous employment is also recommended and it may require considerable space. Columns may be

provided with the following headings: name and address of employer; dates of beginning and leaving; starting monthly salary; monthly salary when leaving; nature of employer's business; nature of your work; reason for leaving. Space should also be provided for listing the periods of inactivity between employment and an opportunity should be given for the applicant to state the reason for this inactivity. If the applicant is presently employed, an inquiry should not be directed to that employer without the applicant's permission. Other prior employers should be requested to confirm the employment and state whether the employment was satisfactory.

The schedule of responsible persons given as references may be relatively simple but it is reasonable to request from three to five references who have known the candidate for at least three years, and to specify that no former employers or relatives be included in the list. In addition to the name and address of the reference, his occupation may be requested and also the number of years of acquaintanceship. Letters of inquiry should then be sent to all references.

Small practitioners may question the time and expense required to prepare the type of application form suggested above, and in using it for each applicant. Surely the few hours required to prepare such a questionnaire will be well repaid and the expense of providing the forms need not be large if mimeographed sheets are used. The practitioner should remember that the most important consideration in hiring is to avoid mistakes, both because of the resulting waste of time and delay in doing jobs, and because of the effect upon the quality of work and upon the relationships with clients.

The American Institute's Testing Program

To assist in the evaluation of staff candidates, the American Institute of Accountants has developed two types of tests. One type is the orientation test and the other is the achievement test. The latter has been prepared for two levels of ability: Achievement Test, Level I, designed for use during the period of college training; and Achievement Test, Level II, designed for use with college seniors, applicants for employment and staff members. These tests are available from the Educational Records Bureau, 21 Audubon Avenue, New York 32, N. Y. and may be given by the employer or by colleges or universities. The cost, including a grading service, is reasonable. In many of the colleges these tests are given each year, and for each test each student's percentile rank, among all those in the country who took the test with similar amounts of formal education, is determined. Each student may obtain an official record of his own test results for use in applying for employment.

The orientation test is basically an intelligence test, requiring no accounting education or experience. This test measures knowledge of

vocabulary, ability to read business material, and skill in solving arithmetical problems based on business situations. Success in the test indicates that the candidate has an aptitude for work of the nature of accounting.

The American Institute also furnishes and grades the well-known "Strong Interest Blank." This is a vocational test designed to ascertain the occupational group or groups whose members have interests most nearly parallel to those of the person tested. As interests are factors in occupational success, the results of this test provide additional data in evaluating an applicant's chances for success in the profession.

Psychological Testing

In addition to the orientation and achievement tests prepared by the American Institute, there is a more specialized field of psychological testing in which not only the aptitude of the candidate is measured but also an evaluation is obtained of personality factors that indicate probable success or failure. This type of testing requires the services of industrial psychologists trained in preparing such tests and in evaluating the results.

Not many accounting firms have availed themselves of the services of these professional psychologists. Nevertheless, the experience of those who have done so appears very encouraging. In the few cases that have come to the attention of the writer, the results reported have indicated that the respective accounting firms plan to continue the service. For example, one firm reports that, in every case when it has hired an applicant upon which its consulting psychologist gave an unfavorable report, it has found that its own decision was wrong. This firm now requires a report from its consulting psychologist on applicants for all positions in its office, including nonaccounting personnel.

Space in this Handbook does not permit a description of the methods or techniques of the consulting psychologists. It is to be noted, however, that personal interviews are not necessary under one of the methods used; the entire analysis is made from the application blank alone. In this case the organization of psychologists has prepared an application blank covering the personal history of the applicant. Although this application blank appears to be an ordinary application form, the questions are worded in such a way that the answers permit the drawing of most useful deductions concerning the applicant's personality structure and the probability of his success or failure in the position. The fact that no personal interview is needed makes this method of psychological testing available to accountants far distant from the testing organization. This approach to the appraisal of applicants is promising, but it probably should not be regarded as an entirely adequate substitute for an interview between the applicant and a psychologist, where such an interview can

be arranged conveniently. (For an illustration of the Personal History blank, see Appendix B to Chapter 7.)

Psychological testing for business positions is a relatively new development in American business. No doubt the greatest development has been in studying the psychological factors making for success in the sales field, but some psychologists have made studies of the personality characteristics making for success in the general area of finance, including accounting. It is to be emphasized that psychological testing must be done only by qualified persons and that the accountant must be careful in selecting a consultant, because there are said to be many incompetent persons invading the field. A suggested starting point in locating a consultant is The American Psychological Association, 1515 Massachusetts Avenue, N.W., Washington 5, D. C., which lists one hundred fifty industrial psychologists who have been designated diplomates by the American Board of Examiners in Professional Psychology.

Psychologists recognize that people with certain key personality characteristics tend to be successful in certain fields but are misfits in other vocations. People succeed because their jobs give them emotional satisfaction and because they enjoy doing what the particular job requires. Psychological testing appraises the characteristics needed for the vocation and sorts out the people who have those characteristics.

Procedure for Interviewing Applicants

In the absence of psychological tests, and even with them, a personal interview with the applicant is an important means of evaluating his personality. The interview also may develop information as to the aptitude of the candidate, although it is to be noted that the testimony of the applicant seldom will erase the evidence of his scholastic attainment or the results of an orientation or other aptitude-testing procedure.

Over 90% of the firms answering a questionnaire on staff selection replied that they accomplished the personality evaluation of applicants through interviews based on informal "sizing-up" of applicants. It is interesting to note that nearly all of the firms considered personality evaluation to be just as important and significant as aptitude testing.

Too few accountants realize that the interview should be planned carefully in advance and that considerable skill can be attained in conducting an interview.⁴ Interviews should be held upon appointment only and adequate time should be budgeted for the interview. Probably no interview with a candidate who has any possibility of qualifying for a position should be less than one-half hour. Also, the interviews should be dignified by promptness in meeting the applicant and he should be given every opportunity to present himself at his best. Interruptions should be avoided during the interview because they are certain to disturb one or both parties.

It has been suggested previously that it is well to have the application

form in advance of the interview. This enables the interviewer to plan the questions and to acquaint himself with information about the applicant to a considerable extent before the interview.

In the actual conduct of the interview, the employer should recognize as a primary purpose the obtaining of the confidence and co-operation of the party being interviewed. The interviewer himself must not be in a state of emotional upset and at no time should he betray disapproval of, or an adverse reaction to, the applicant. He must be natural and friendly in his attitude and seek to put the applicant at ease early in the interview. He should remember that his purpose is to get the party interviewed to do his share of the talking rather than spend the time in instructing the applicant.

A few suggestions as to the questions to be asked may be helpful. These are: questions evidencing interest in the applicant's home and family; questions about the school attended and how the applicant happened to choose the school and the course of study that he completed; questions as to the most valuable courses and why they were valuable; comments on the employment experiences of the applicant, if any, with particular questions as to how the applicant felt about a certain job, his reason for leaving employment with a certain company, et cetera. In asking about a specific job which the applicant has held it may be well to ask him just what he did on that job. Sometimes a discussion of hobbies, athletic activities or similar items is particularly revealing.

An additional duty of the interviewer usually is to describe the position for which the applicant is being interviewed. Sometimes this subject can be introduced by asking the applicant just why he has applied, and why he believes he can be successful. Then, if the interviewer believes that the candidate is a good prospect, he should describe the position and the policies of the firm, particularly as to rates of pay, promotions, hours of work, requirements as to overtime, and opportunities for training. As a guide to the interviewer and as a record of the interview many employment interviewers have a form which they utilize. Examples of such forms are given in Appendix A.

At the end of an interview the interviewer should know certain definite things about the applicant. He should have learned important and precise facts about the latter's accomplishments in the past, what his hopes and expectations are, why he is seeking the position, the real reasons for leaving past employment, how he regarded the working conditions and his immediate superiors on his former jobs, whether he has a happy family life, and whether his health is equal to the strain of public accounting. These are all fields in which the applicant's answers will reveal his personal qualifications and to some extent his aptitude for public accounting. Too often the interviewer relies only, or almost entirely, upon such matters as the appearance, dress, cleanliness, poise, self-assurance, and expressiveness of the candidate. Yet it is far more

important for the interviewer to ascertain whether the applicant has qualities of initiative, imagination, leadership and perseverance and whether he is capable of assuming responsibility. Also, evidence of his ambition and his comprehension of professional service standards and aspirations will need to be observed. If the interviewer has been successful in drawing out the applicant, he will have some concept of the latter's outlook on life, his general culture, and seriousness of purpose.

In closing the interview, the applicant should be informed as to when the final employment decision will be made and when notification can be expected. Rarely can a decision be made by the interviewer as to the desirability of employing the applicant until after the close of the interview. Where such a decision is reached, the employment can be arranged for at that time. If the applicant has other prospects he should be given a reasonable time to come to a decision as to which position he will accept. Courtesy and respect for goodwill suggest that all unsuccessful applicants be notified promptly and tactfully, usually by letter.

Internship Programs

Recently there has been a growing movement to recruit junior accountants from the colleges of business administration by hiring them temporarily before they have completed their college work. Over thirty schools that are members of the American Collegiate Schools of Business now have accounting internship programs. These programs give students an introduction to actual public accounting experience and an opportunity to blend practical experience with classroom study. They also give accounting firms an opportunity to preview the individual candidate. Discussions of the benefits to the students, the accounting firms, the schools, and even the teachers are set forth in several publications.^{5, 6}

Internship programs have been found most readily adaptable to colleges operating on the "quarter" system but a number of schools operating on a semester basis have recently made arrangements whereby their students are permitted to take part in such programs. Most public accounting firms experience a peak season; * and the quarter system, upon which a few colleges operate, best allows the internship program to operate in this busy season. Under that system the students may be available following the Fall quarter, which ends before Christmas, and are engaged for full-time work for the entire Winter quarter until late March or early April when the Spring quarter begins.

From a long-range point of view, the recruiting of students for the permanent staff by hiring them in the Winter quarter under the internship program may not always provide the best training that might be given. If the accounting firm is extremely busy and does not make a conscious effort to provide varied and selected experience for the interns,

* Several of the firms replying to the questionnaire, however, indicated that they no longer have a peak season.

the students may receive very little attention and may be used almost entirely on clerical and routine work. On the other hand, if students attending college on a semester basis are hired for a semester under an internship program, it is easier to give more attention to training them and thus their capabilities and progress can be appraised more adequately. Also, the period of training can be much longer under the semester internship plan as it may be started about July 1 and extend until early February.

In a few cases a summer internship program, in which only the three summer months are used for the training, has been followed. This is usually the most convenient for the students but it requires that the co-operating firms have sufficient summer work to give the trainees valuable experience. Obviously, the internship program must fit the needs of the accounting firm and some firms will be able to contribute more to the student's training at one time than at another. Whereas some accounting firms may be able to offer a very satisfactory period of internship in the summer months, in other firms there may not be enough work at that time to keep the permanent staff occupied. Although 76% of firms questioned stated that the best time for the internship experience (for both the student and the employer) is during the winter, 14% of such firms did not agree and 45% considered summer internship "satisfactory" as compared with 40% who voted that summer internship is unsatisfactory.

Accounting firms situated favorably in the vicinity of colleges where accounting students are trained often find that they can obtain some students during the entire year, or a portion thereof, on a part-time basis. Although this may be beneficial to both parties, at least temporarily, it can hardly be considered a substitute for an internship program on a full-time basis. Usually, the part-time employee is not available for many of the larger or out-of-town engagements and he may be used best in office work or on small engagements, often of a bookkeeping type.

Co-operative Educational Plans

There are some schools which operate on the work-study plan. The details of their operation vary but usually provide for alternate six months periods of full-time work followed by periods of class attendance for all students, starting with their sophomore year. Among the colleges using this plan are Antioch, Cincinnati, Drexel and Northeastern.

STAFF DEVELOPMENT

Staff Training Programs

The careful selection of personnel must be recognized as only the first step in developing a competent staff. A young accounting graduate and also a seasoned accountant recruited from private industry will need

training in the fundamental phases of public accounting practice. In fact, they are only embarking upon a period of further study of accounting, auditing, and business problems when they enter public accounting. Ultimately, their studies may lead them into the most difficult of auditing problems, or it may lead them into specialized fields such as tax accounting, cost analysis work, and the installation of accounting systems. The successful practitioner must plan for and assist his staff in the attainment of the best training possible.

A complete program will include three types of staff training. These are: (1) on-the-job training, (2) organized classes or group discussions, and (3) individual study. Each will now be considered.

On-The-Job Training

• Theoretically "on-the-job training" offers the best opportunity for training juniors, particularly in the basic phases of auditing practice. For the beginner, working on an actual job under the instruction and supervision of a competent superior who makes a real effort to teach (or preferably to assist his pupil to learn) all that can be learned from the job offers an ideal relationship. One might even visualize this as a class with one student or an example of the tutorial system of instruction installed in the practice of public accounting. Actually, this ideal is not often achieved. Too often the seniors, managing supervisors, and partners are too intent upon accomplishing the work to the best of their own ability, and within the least possible time, and lose sight of their obligation to give training to the juniors on the job. In fact, it is difficult for a senior on a rush job to spread his efforts so as to give the junior all the training and help which he might give him if they were working on a less hurried type of engagement. Then, too, many able accountants may feel that they have little ability or aptitude for teaching, even as a tutor rather than as a lecturer, and that it is not reasonable to expect them to do much instructing while concentrating on turning out the job.

Nevertheless, some very important steps can be taken in all offices and by all types of persons to obtain better training on the job. One which has been adopted by some firms is to have the senior sit down with the junior staff assistant or assistants before beginning an engagement and review the working papers of the previous year together with the audit program proposed for the current year. This gives the assistants a picture of the entire engagement and affords them an opportunity to anticipate problems peculiar to the audit. To expedite this review, it is helpful if each assistant has the opportunity to look through the papers before meeting with the senior in charge for the discussion of the engagement. Obviously, the effectiveness of this procedure of previewing the job will depend upon the co-operation and skill of the in-charge accountant and upon his ability to give his assistants a worthwhile participation in the work. If skillfully handled, such a review in advance of the actual work in

the client's office will stimulate interest and enthusiasm in the staff men. Furthermore, the time spent should be more than offset by time saved later in the engagement. Also, without this required program of review, the senior himself often may neglect to study adequately the papers and the audit program from the prior year, and may enter upon the job without sufficiently planning the work.

There are other ways in which the man in charge of an audit can assist in training the men under him much as a matter of course and as a regular procedure. One is to let the assistant learn by doing rather than by memorizing what he is told to do. Unfortunately some people seem to think that teaching involves a lot of talking and explaining and itemizing of every step to be taken. The best teaching is done by giving juniors problems which are almost beyond their grasp and at the same time instilling in them the interest needed to work the problems through to successful solutions. When a senior has a difficult problem, or even problems that are not very difficult for him but which require care and attention, he may well pass them on to his assistants. This can be done on the job or informally at lunch or while traveling to or from the job. Sometimes a better answer or a new approach may result, either because the senior has clarified his problem in explaining it or because the junior has found a new approach to a solution.

Even in making assignments to junior assistants, a certain amount of training technique is essential. Merely to assign a detailed list of things to be done on one part of the engagement without giving any indication of why they are to be done is to invite inefficiency in the accomplishment of the tasks. A list or detailed schedule of work accompanied by suggestions as to why the work is being done usually will accomplish better results. Staff men cannot be taught to think if they are given little opportunity and encouragement to think out the purposes of their work assignments. By giving them a few reasons why the procedures are useful they will be encouraged to make their work more effective.

To summarize briefly, we may say that effective but practical on-the-job training can be obtained in all accounting offices if the accountant in charge of the job will give some attention to "sharing" the engagements with his assistants. Even a little sharing of the planning, the programming, the problems, and the peculiar questions that arise not only will give valuable training but will result in better work. Regardless of the size of the accounting office, on-the-job training by sharing the engagement is an available method of staff training.

Formal Staff Training Programs

Only 21% of the accounting firms interrogated by means of a questionnaire replied that they held regular staff-training classes. Such classes would not be necessary if the on-the-job training were completely effective and not too costly. But, for medium-sized and large firms it is likely to

be more efficient to train several people in a group, particularly if a skilled person is in charge and if an effective program has been worked out. For such firms it should be less expensive to train the beginners directly by means of formal classes than to train the senior "in-charge" accountants to give their assistants the proper instruction and the maximum in opportunities for learning while on the job.

There can be no doubt that a formal training program puts an emphasis on training which affects the entire organization. Many of the seniors have attended the training classes while they were juniors and some will be assisting with the current classes. Therefore, they are more cognizant of their responsibility to the beginners because they have been, or still are, a part of the program. With this awareness, on-the-job training is stimulated. Also, the need for self-improvement and for the development of new methods and techniques is emphasized. In fact, the fundamental purpose in conducting training classes, named by more persons answering the questionnaire than for any other purpose, was to "keep all staff members growing and developing in ability to handle current and new problems."

Training classes may be held during office hours, on Saturday mornings, or in the evenings, but some firms prefer a short intensive period lasting from a few days to a few weeks. Small firms probably will have difficulty in devoting a period of weeks to an extensive program, although some might be able to pick a time of the year when a few days could be given over completely to the training of beginners or to classes in specialized fields. As an initial step, it may be well to adopt a modest program designed entirely for juniors and semi-seniors, with the classes held once a week for a period of two hours over perhaps eight or ten weeks. For this type of class, the time might be set for four to six o'clock, which is suggested principally to enable staff men to come in from jobs and yet not be delayed too long in getting home after the class. Some may prefer to start the class an hour earlier so that the entire class period is during office hours. Others may find it preferable to hold the class at the beginning of the day.

If this type of training program is set up, it is essential that a regular schedule be fixed in advance and adhered to throughout the period. If that is not done, the program is almost certain to fail of its purpose since it is impossible to fit in such a program in such a way as to be convenient at all times to all employees and not to require some readjustment of assignments. Firms that wait until there is a "good" time to hold such training sessions never start them.

What Should be Included in the Class Training?

One approach to a decision as to the content of staff-training programs is to decide what not to include. Surely, it is not desirable to attempt to compete with college courses in principles of accounting, auditing,

income taxes and other subjects if these courses are available in classroom form or by correspondence. Such classes might be undertaken if it seemed advisable to stimulate the interest and effort of the staff members in self-education or perhaps in a correspondence course in which they have enrolled. A class of this type should be supplementary only and would differ materially from the usual classroom instruction. Review courses to prepare candidates for the CPA examination also should be excluded ordinarily, although this does not mean that the employer should fail to encourage and even to assist the staff members to prepare for the examination. These suggestions are made upon the premise that the best results from CPA review and other collegiate courses can be obtained by specialists whose chief occupation is in the field of preparing and teaching such courses.

Too often, when it is found that several of the beginning staff members are deficient in accounting principles or auditing theory, it is decided to include coverage of rather primary matters in the staff training class. In such cases it would appear preferable to have the laggard staff members catch up with the others by individual study or by taking specific college or correspondence courses, rather than to retard the speed of class instruction to the level of the lowest beginner.

A Suggested Class Program

As a suggestion of subject matters to be included in a class for staff beginners, the following are submitted:

Staff Manual

A staff manual may have been prepared covering thoroughly such matters as behavior and appearance; instructions for conduct in the staff office, in clients' offices, and when off duty; relationships with clients; secrecy regarding the firm's business and clients' affairs; and the necessary details of timesheets, vacations, sick leave, overtime pay, expense sheets, et cetera. Nevertheless, the new staff members should have these matters impressed upon them in a class meeting with an opportunity for discussion and for questions as to just what is expected.

Discussion can well be expanded to include consideration of the article by Edward B. Wilcox on "Qualifications for a Professional Career" referred to earlier in this chapter. Also, it might well include the attributes previously mentioned as important in evaluating the personality of candidates to be selected for the staff. An additional subject closely affiliated with staff manual material is that of auditing standards. A short discussion of the general or personal standards, the standards of field work and those of reporting will provide an excellent introduction to auditing. All class members should read carefully the "Tentative Statement of Auditing Standards" which was adopted at the annual meeting of the

American Institute of Accountants in September 1948 (included as Appendix A to Chapter 13).

One class meeting may be adequate for the subjects included in this part of the program.

Preparation of Audit Working Papers

In this part of the course, the general plan of preparing working papers, their indexing, the organization of certain papers for the permanent file, the control of papers while on the job, and the general nature of the material to be included in a set of working papers should be discussed. Questions as to what is to be included in the permanent file papers rather than in the current-year set of papers should be considered. Also, the methods prescribed by the firm for filing tax return working papers and audit program papers should be explained. Particular attention should be given to the indexing system used by the firm and to listing on the working paper schedules exactly the work done in each part of the audit.

The subject matter for this part of the course should be available in the filed working papers within the office of the accounting firm. It is less confusing for the beginners if not more than two or three sets of papers are used for study. Often a thorough study of one set of papers will accomplish more than references to many sets. The papers chosen for study should evidence thoroughness and be representative of what is expected in form and content. These papers should be examined by all class members before the class meets, and the instructor must be well acquainted with the model papers. Otherwise, the questions which the beginners will bring to class may not be answered readily or sufficiently.

In this discussion it is assumed that the firm uses a "standard index" system wherein the same letter refers to the same asset or other account in all sets of papers (see Chapter 15 for an illustration). Also, each firm should teach its own method⁷ of filing the summary and control schedules, the rough draft of the audit report and statements, the adjusting journal entries and trial balances, and the detailed papers evidencing the confirmation of accounts receivable and those for details of the physical inventories. Perhaps some help in developing the best arrangement and details of papers can be obtained from textbooks or from published model sets, but for staff instruction purposes it is suggested that the study be confined almost entirely to the methods used by the particular firm conducting the class.

One or two meetings should be assigned to this subject of general instructions for preparing working papers.

Audit Procedures

A few firms have developed what may be called an Audit Procedure Manual or an Auditing Instruction Book in which the usual procedures

and techniques to be employed in each part of the auditing work are listed. (An illustration of such a manual is included in Chapter 14.) Such a book, together with the set or sets of working papers previously studied (including the related audit programs for the respective engagements), will provide the basic material for this portion of the course. It is probable that most small and many medium-sized firms will not have prepared a formal auditing instruction book or manual, although it is advisable to do so. For these firms the working papers and audit programs will need to be the basic materials until such a manual has been developed. There should be reference books available. Comparisons should be made particularly with the "Case Studies in Auditing Procedure"⁸ and the Codification of Statements on Auditing Procedure" of the American Institute of Accountants (included as Appendix B to Chapter 13) and with material in the recent textbooks, such as the seventh edition of "Montgomery's Auditing."⁹

It may be that an entire meeting, or more, will be needed for the subject of auditing the cash accounts. The starting point should be the most usual or standard method of the firm, and the student should see how the audit program and the working papers record the procedures followed and what evidences of the verification work are accumulated. In other words, it is suggested that the class be shown just what has been done on a job as the first step in their study. It is important that they be encouraged to think out the reasons why the different steps have been taken and to develop an understanding of the objectives of the entire procedure and of each part. Next, the class should be given variations in the cash audit procedures which are sometimes used. The reasons for variations and the adequacy of the methods should be discussed. As a final step, the members of the class should compare the methods followed by the firm with those in the "Case Studies in Auditing Procedure," particularly for similar types of engagements, and with the three general methods specified in "Montgomery's Auditing."⁹

It may be well to emphasize that the most important part of the training in audit procedures is the development of reasons for the procedures.

Many persons can memorize a list of things to be done but, unless they understand why they are doing these things, their work may be deficient. Only when there is an understanding of the significance of each step and of the over-all procedure will the auditors be likely to recognize errors and deficiencies in the accounts. Furthermore, this realization of the "why" of each step is necessary in determining the extent to which each verification procedure is to be carried.

Many helpful suggestions may be made to the beginner in connection with the Instruction Manual, Audit Manual or other list of procedures for verifying cash. For example, how to sort checks rapidly, what to scrutinize on each check, how to count and stack coins, bills, rolls, et

cetera, and many other details may be discussed profitably. One senior with several years of experience recently made the comment that he had never seen a beginning junior who knew that he should place a tick mark on the checks he examined. An interesting general discussion might be developed on the subject: "What and what not to tick."

The verification procedures and techniques for each of the major portions of the audit should then be studied according to the same type of plan as has been described for cash. Thus, one entire meeting might be required for the consideration of the usual procedures in verifying accounts and notes receivable. The actual practices of the firm, illustrated by the particular audit working papers used for illustrative purposes, would be the starting point. This would be followed by variations in the practice of the firm and by comparisons with the practices of others as indicated in the sources suggested above.

Considerable time may be needed in studying the inventory verification methods, particularly if many types of problems have been encountered by the firm and if the class is given an opportunity to consider various manufacturing processes with the accompanying problems of costing the goods in process and the finished jobs. If the auditing firm does not have many engagements involving manufacturing inventories it may be well to limit this part of the course to inventories of only one manufacturer in addition to those of one retailer or wholesaler.

It is not suggested that the study of audit programs be treated as a separate subject. The beginner needs to concentrate on the *usual* procedures and only the audit programs of the particular jobs which serve as basic material need be considered for illustrative purposes. The related parts of the programs should be taken up while the audit procedures are being studied for each of the major phases of the audit.

The auditing procedure portion of the staff training course can be expanded easily to require many meetings. It is probable that four or five meetings may be very successful the first time the course is planned and given. This may not allow for a program in which the students actually do many of the procedures. That type of a class is possible only when much more time is allotted to the training course than is contemplated in this suggested minimum. In the intensive and extended training courses, sets of books and records obtained from defunct corporations occasionally may be used to give the students actual work in the procedures.

Even in the shortened course here contemplated, some materials may be collected for illustrative purposes, such as checks, certificates of common and preferred stock, bonds, a trust indenture covering a bond issue, capital stock certificate books, documents evidencing loans and the security pledged for the loans (such as the notes, mortgages, trust deeds, insurance policies, title insurance policies, or abstracts-of-title papers).

Report Writing and the Preparation of Financial Statements

Although the beginner will not be faced immediately with the problems of preparing financial statements and writing audit reports, he should be instructed in the practices of his employer early in his accounting experience. Preferably, the matters to be covered should be formalized in a "Standard Statement Presentation Manual." (For an illustrative manual of this type see Chapter 18. Also see Chapter 19). This manual should state the usual classifications of items and the terminology to be used in financial statements and should give a standard wording for unqualified opinions, for qualified opinions, and for denials of opinions on financial statements.

If an accounting firm has not formalized all of its policies relative to the preparation of financial statements and the phraseology for opinions and denials of opinions thereon, it may be that staff bulletins or memoranda have been issued from time to time explaining and setting forth some of these policies. In the absence of written instructions on these matters, the instructor will find it necessary to review typical audit reports and summarize for the class the policies and procedures evidenced therein. Even better than this, assignments to members of the class to ascertain the standard practices of the firm will stimulate their interest and thinking. A few of the matters to be investigated are: standard titles for the usual financial statements, titles used for main headings of assets and of liabilities, order of arrangement of assets and liabilities, extent to which details are presented in various sections of the balance sheet, wording of so-called "reserve" accounts (such as allowance for depreciation, allowance for doubtful accounts, or estimated depreciation to date, estimated bad accounts, et cetera), extent of the description of the capital stock accounts, use of "retained earnings" instead of earned surplus, details ordinarily included in the statements, use of footnotes to the balance sheet, a determination of the matters most commonly requiring footnote comments, and the ascertaining of standard phraseology for the opinions for short-form reports.

Some attention can be given profitably to the long-form report, because a knowledge of the subject matter usually covered helps in explaining the reasons for collecting certain data and for making certain investigations during the audit examination. The instructor may summarize the standard policies of the firm relative to long-form reports or, preferably, he may assign to the class members the task of ascertaining these policies from typical reports. For example, he may have the members of the class determine the main divisions of the usual report, the usual wording and coverage of the introductory paragraphs, the manner of listing or indexing the exhibits, and the type of material covered, together with the manner of presenting it in each section of the report. Some attention should be given to the style of the report, including the length of sentences, the extent to which introductory phrases or sentences are used,

methods of varying the words and phrases in making comparisons of the data for two or more periods, and methods of avoiding hackneyed expressions or phrases. If staff members are used for the comparing and proving of typed reports, they will have had the opportunity to observe the customary physical set-up of the reports of their employer. If a separate comparing and proving department is maintained, this opportunity may not have been given to the staff members. In that event, some consideration of the physical setup of reports is particularly needed so that, when members of the class are given opportunities to assist in preparing statements and other portions of the long-form report, they will be able to conform with the proper physical setups for the data.

One or two class meetings may be assigned to this final part of the class training. It is suggested that an intensive study of financial reports and statements will be more beneficial to semi-seniors and seniors than to beginning juniors and, therefore, an extended consideration of report writing may be undertaken for advanced personnel. Reference material to be used, especially in an advanced course of study, would include published reports of companies and the latest edition of "Accounting Trends and Techniques," published by the American Institute of Accountants and based upon a survey of the annual corporate reports of more than eleven hundred companies.

The program for training beginners which has been outlined herein does not include a concentrated study of questionnaires on internal control. It is believed that this subject may be omitted from the class for junior accountants except as specific parts of a questionnaire are to be considered in studying auditing procedures. Questionnaires relating to internal control are best understood after the auditor has had a wide experience in auditing work because there is a wide variance in the accounting systems and in the requirements of different enterprises. The writer has found that juniors lacking in experience do not grasp easily the significance of many of the questions. Then, too, they are discouraged to find that there are far too many questions to permit memorizing.

Co-operative Training Programs

Firms which are not large enough to institute their own formal training program may be interested in co-operating with other, similar firms. When this is done, the work of planning and directing the programs can be divided among them, so that all share the burdens and views are exchanged. In at least two state societies of certified public accountants, a committee on education has promoted and assisted in the development of training courses which are given by a college or university for accounting staff members only.

In California, the state society's committee on continuing education has developed several courses and has obtained competent instructors to give the courses under the management of the Extension Division of the

state university. Classes offered to CPAs and members of their staffs have included: "Report Writing," "Auditing Procedures," and "Current Financial Statements." Other courses are planned and are in preparation on "Staff Training at the Junior Level" and "Service to Small Clients." Materials needed for each course, such as a syllabus, a case study, or a problem have been prepared under the supervision of the committee and adequate funds for the work were obtained from the fees collected for the courses. Classes have been successfully held in four of the largest cities in the state.

Two courses under the auspices of Rutgers University Extension Division have been planned by the committee on education of the New Jersey Society of CPAs. These courses are "Work of the Junior" and "School Board Audits." Other courses are planned to cover the work of the senior, report writing, and report contents.

Courses of the type described above are particularly important, because they are planned and supervised in part by practicing certified public accountants and are designed to meet the requirements of staff training in a very practical manner. For example, the course content and the syllabus for the class in auditing procedures in California was prepared by a competent writer after spending many days in the offices of leading accounting firms investigating these procedures. Also, the class in report writing utilized the material (and the instructor) developed by one of the accounting firms and used in their staff training program for several years.

Teaching Methods

The subject matter, the size of the class, and the abilities of the instructor must be considered in choosing the teaching methods. For example, some teachers who are excellent in small classes are not at all effective in handling large groups. The "discussion" method of teaching can be used very effectively in small groups, provided the group is not too small, but this method requires a great deal of skill in directing the discussion if it is used in large groups of forty or more people. Some subjects require the "exposition" (lecture) method of teaching, at least in part, in order to establish a starting point for a discussion period or for the use of illustrations and practice problems.

As indicated previously in this chapter, the writer believes that the discussion method should be used in preference to the exposition method whenever possible. Care must be taken, however, to avoid lengthy and inappropriate discussions. The key to a good discussion group lies in the selection of an imaginative leader who will devote time prior to the meeting to developing techniques for guiding the discussion. Not every person who lectures ably has the temperament or ability required of one who must tactfully turn aside an unprofitable line of thought and immediately stimulate a more profitable one.

The leader must direct the discussion by inserting questions and obser-

vations which develop the best thinking and which interest the students in seeking and arriving at the best solutions. For this purpose, a class of about ten persons usually is best. It is desirable that the class be limited to a maximum of twenty. However, in the co-operative staff training courses given under the auspices of the Extension Division of the University of California, it was found necessary to allow a maximum of forty students in a section to finance the program and to satisfy the large demand for enrollment. This greatly curtailed the use of the discussion method.

Ideally, the discussion method should be supplemented by the use of illustrative material and of practice problems. Usually, practice problems comprise an important part of an intensive course; whereas, in a short course, meeting one afternoon or evening in a week for six, eight or ten weeks, the problem material necessarily is restricted to very few, if any, problems. Instead, a great deal of illustrative material will be used in the form of working papers, audit programs, questionnaires on internal control, and audit reports. In all cases the object should be to have the students find out the answers (with assistance) in as many cases as possible, rather than to "stuff" them with many answers, conclusions, procedures, and other expository material without allowing them the opportunity to analyze questions and to formulate conclusions themselves.

Sometimes it is necessary to plan for an examination in writing at the end of the course. A short course calls for a short examination only and a one-hour period may be found to be adequate. There are both advantages and disadvantages in having an examination. Students usually apply themselves more diligently to the course when they know they must sit for an examination. On the other hand, the thought of the examination may cause them to spend too much of the class hours in writing down bits of knowledge and in memorizing specific procedures in order to make a good grade on the examination. Consequently, the class discussion may suffer because of too much writing and too little thinking, and because of a detached point of view rather than an intensive interest in exploring an interesting subject. It may be advisable to abolish examinations in a staff training course in order to emphasize and train the students to do some intensive and original thinking.

Some beliefs are held that tests and examinations indicate the effectiveness of the training program. In opposition to this, it may be observed that a truly successful program will be evident by the extent of the discussion and the intensity of the arguments stimulated in the classes.

Informal Training Procedures

When an accountant stops learning he should be retired immediately. Throughout his professional career the accountant must ever be continuing his education. He may do this by engaging in professional

activities in accounting organizations, by attending technical meetings, by taking college courses in residence or by correspondence, and by reading accounting literature. Thus a staff training course for beginners is just a start in obtaining a practical accounting education. Juniors, seniors, managers and partners all must keep up to date in their profession.

Each staff member, when eligible, should be encouraged to join the state and local society of certified public accountants and the national societies such as the American Institute of Accountants, the National Association of Cost Accountants, and the American Accounting Association. Some firms pay the dues of their staff members and most allow a reasonable amount of time for engaging in committee work and executive activities in such societies. Some firms also pay the costs of monthly dinners, and the registration fees and convention expenses for any members of the staff who will attend these meetings. Other accountants feel that all or a part of these expenses, particularly the payment of dues, should be undertaken by the member himself so that he may take more pride and more interest in his affiliation.

In addition to the technical meetings provided through accounting societies, the individual accounting firm may hold very profitable meetings. The success of such meetings will depend upon the manner in which they are planned and conducted. Unless the meetings are made to cover interesting and worthwhile subjects in a profitable manner, they will soon become a duty rather than a privilege.

Technical meetings of the staff may best be held either during office hours or in connection with dinner meetings. Some firms of fifteen to forty employees have found that a dinner meeting followed by one or two technical papers prepared by staff members is very successful. The papers presented * should be the result of extensive research on the part of the staff member. Very fine papers have been written by semi-senior and even junior staff members. Discussions should be encouraged and the writers of the papers may be the best persons to conduct the discussion period. Some firms have regular staff meetings for this purpose once each month during most of the year. It is important to have a suitable room for such meetings. The cost of the dinner should be paid by the accounting firm.

In most large cities and in many smaller places, evening and summer courses in accounting subjects are available in colleges or other schools. Some firms pay all or a part of the tuition for such courses for all members of the staff who enroll and complete the course. In the field of income taxes, in particular, it is worthwhile to encourage staff members to take and to retake scheduled courses, particularly after major changes have

* A few interesting subjects are: Current Regulations on Salary and Wage Stabilization — Experiences with Renegotiation of Government Contracts — Accounting for Stock Options — What is a Depletable Interest in Oil for Income Tax Purposes — Words and Phrases Commonly Misused in Accounting — Internal Control in a Department Store.

occurred in the tax laws. The writer has observed cases of staff accountants who take a tax course (the same course) regularly every year for many years.

In many states, a Graduate Study Conference, annual clinic, or similar event, is scheduled each year by the local society of certified public accountants. The number allowed to enroll for the 2- or 3-day meeting necessarily may be restricted, but each firm should arrange to send as many of its staff as can be accommodated. These conferences have been very beneficial to those attending.

Every accounting office, no matter how small, should have a library even if it is no larger than one bookshelf. Books should be selected with care and should be available to staff members to read in the office or to borrow upon signing a properly controlled receipt. Much assistance in choosing the proper books and periodicals will be found in Chapter 4 of this Handbook.

Periodicals and books received by the accounting firm on special subjects should be routed to the staff member or members who are particularly interested or who are working in the field covered by the book or periodical. For example, publications relating to the oil industry should be routed regularly to all assistants, including juniors as well as seniors, who are engaged on, or who have been engaged on, jobs involving problems of oil accounting. Also, a memorandum note to members of the staff who should be interested can be written by the partner or principal when he observes articles in accounting magazines that should be of particular interest to the staff members.

Staff training should include a reasonable amount of rotation of employees in assignments to engagements. Junior assistants should be assigned to different superiors rather than working always under the same senior. They also should receive assignments on varied types of engagements. As to senior assistants, repeated assignments to the same jobs year after year will "make Jack a dull boy." Both the job and the man will benefit in many cases by having an occasional change in the "in-charge" accountant as well as in the assistants under him. When assistants are again assigned to a large job, some changes in their duties and responsibilities may be effected.

If the staff manager keeps the rotation of employees in mind and if he makes definite and obvious efforts to accomplish intelligent changes in assignments, the staff itself will be increasingly aware of the need for training. Often a senior accountant will expect too much of beginners, particularly if he himself has worked on the same engagement for so many years that he has forgotten the unusual features that once troubled him.

New assignments with new problems may make the senior more tolerant of his assistants. Furthermore, if the staff manager will take a few moments to describe to the senior the previous training of the be-

ginner and if he will mention any particular fields in which the junior is lacking, the senior (and the beginner) can profit accordingly. This may even encourage the senior to be increasingly tolerant, because he has been coached in the training and deficiencies of the particular man.

Development of Specialists

Many accounting firms believe there are important advantages of specialization in accounting work. One of the most important advantages is considered to be the opportunity to increase one's general practice because of the reputation and achievement attained in a special field. Next in importance is considered the opportunity to do what the practitioner prefers to do. Then too, the opportunity to command higher fees often is considered important, particularly if the special practice is developed in a relatively untouched or undeveloped field.

On the contrary, many feel that specialization may cause an accountant to lose touch with the field of general practice and his clients may tend to refer to him only those engagements which fall within the special field or fields for which he is best known. There also may be too great a dependence upon the continued development or success of the industries or the activities which are related to the specialized skills. Usually there is some danger in restricting the sources of fees to a speciality, and yet a somewhat complex organization may be needed to combine the speciality with general practice.

Most frequently specialization is found in the field of income tax and in that of system work. Among the large accounting firms it is common for a separate department to be set up for tax work and sometimes for system work. Also, departments may be maintained for that portion of the staff which is engaged in municipal and other governmental audits, for staff members engaged entirely in college and university audits, et cetera.

The needs of the individual firms may vary but in general specialization by staff members should not be encouraged until a broad training has been obtained. Certainly, at least two years of general training, and preferably as much as five years, should be obtained before embarking upon a specialized practice. Also, this writer believes that specialization by establishing separate departments should not be overdone to the extent that general staff members are excluded from such fields as tax work and system work. Tax problems are fundamental in nearly all of the public accountant's work and no auditor can readily avoid problems of modernizing and improving accounting systems. In fact, almost every audit affords opportunities for suggestions in this area and a complete knowledge of the system in use must be obtained.

Developing Staff Morale

Staff morale may be described as the confidence, pride and enthusiasm which members of the staff have in the firm with which they are asso-

ciated. Needless to say, the maintenance of high ethical and technical performance by the firm is essential in obtaining this pride and confidence. If a firm is to be regarded highly by its employees, they must have reason to believe fervently that the best of work is being performed and that their employers are highly regarded in the profession.

Continued technical training of staff personnel through programs of training and by the informal methods discussed above are important factors in developing this morale. The accounting firm that performs the best work must have workers who are trained in the best of techniques and standards. This is basic for good morale.

Nevertheless, something more is needed. An inherent and continuing enthusiasm for his job and for the success of his firm must be felt by each person who is a part of the organization. Such an enthusiasm, to the extent it permeates the entire staff, helps to knit the organization together and to make a loyal working team. And it is reasonable to expect a staff to develop this loyalty and enthusiasm for the organization of which each member is a part. Certainly, staff members have a common interest in furthering the reputation and success of the firm. Whether they remain permanently with the employer or ultimately leave to enter private employment or to open up their own accounting practice, they will always want to believe that they have been working for the best firm in the profession.

Creating Staff Loyalty

This satisfaction in his job and in his employer which, when sufficiently developed, may be described as "loyalty" can and must be encouraged by intelligent methods. For instance, when a job is well done is a word of praise ever given? Is bad work likely to receive a reprimand in public? Are juniors ever made to feel that they have a little recognition for their part in an assignment?

Loyalty is not a one-way street. Employers must evidence interest in their employees if they are to expect loyalty from them. In some firms the partners and principals make no attempt to know even the names of the men. This indicates a lack of interest in the welfare or even the existence of staff members whom they do not recognize as belonging to the staff. Whether the staff is large or small, each member will appreciate the feeling that he "belongs" which is given by friendly greetings from "higher-ups" who recognize him and call him by name. In small firms, particularly, if a real interest in the employees exists, it will be evidenced frequently by a friendly concern for the personal welfare of the employees and their families.

Under conditions of keen competition among staff members for advancement and for "heavy" assignments, disappointments are certain to occur. While these cannot be avoided, they may be kept at a minimum if appropriate explanations are made. It is better to acquaint the party

who has failed to advance as fast as he has expected, or who has not received a coveted assignment, of the reasons for such treatment rather than to have his disappointment affect his loyalty and his work. Too often, postponement of a simple but satisfactory explanation causes not only a heartache but a disgruntled employee.

Of course, adequate compensation must be paid if the firm wants loyal employees. If salaries are not up to the rates prevalent in the profession, enthusiasm for the job and the firm will be rare unless there are compensating factors, which is unlikely. A junior accountant may recognize that he is learning a profession, but if other juniors are paid more while enjoying equal opportunities for learning, explanations will be sought or the junior will be lost.

Keeping staff members busy is very important for morale. Long periods of idle time are particularly difficult. On the other hand, busy periods in which considerable overtime may be necessary and the occasion of a rush job usually give a boost to morale. Unless so overdone as to injure health, or otherwise imposed unreasonably, the busy season experienced by many accountants usually gives a sense of accomplishment to the entire organization which makes them respect themselves, their jobs and their employers. Likewise, the assignment of a difficult task may revive the enthusiasm of a senior who is stagnating. During slack seasons, special efforts should be made to utilize the time with training classes, professional reading, research and the improvement of the auditing procedures of the firm.

Staff Meetings and Social Activities

Unless technical meetings of the staff are made interesting as well as helpful they will discourage rather than improve the loyalty of workers. If the meetings become dull it is better to discontinue them temporarily and concentrate on obtaining better, although fewer meetings.

As previously mentioned, some firms have been quite successful in having their staff meetings combined with a dinner once each month during most of the year. Usually the partners or managers will try to keep out of the discussion, at least in the early stages. Such meetings obviously require a suitable private dining room where a good meal can be had — at the expense of the firm. In some cases other staff meetings are held after working hours; sometimes they are before office hours; most often they are likely to be during the scheduled work-day, either at the beginning or late in the day. Meetings of this sort may deal with special instructions to the staff, a discussion of actual audit cases or circumstances that have been encountered, consideration of the extension of certain audit procedures, discussion of special questions on internal control, and the study of income tax laws, salary and wage stabilization regulations, price stabilization rulings, regulations for the renegotiation of government contracts, et cetera.

Social meetings for the entire organization are useful in developing loyalty, if they are properly planned and conducted. These occasions should be shared by all; sometimes — as at a picnic or beach party — the spouses and families may be included. Even though they are not held more often than once or twice a year (at Christmas and perhaps in early or late summer), they will bring better acquaintance and more friendliness to the staff.

Staff Manuals

Staff manuals may be of two types. One is an administrative manual explaining the firm's personal practices and policies. This type of manual is not for general distribution to members of the staff but is distributed to partners and supervisors who have responsibility for personnel policies and practices of various offices. An example of this kind of manual is given in Appendix B.

The second type of manual is prepared for distribution to all staff members. This type of manual covers not only firm practices and procedures but may deal with such matters as appearance and behavior of staff men. An example of such a manual is included as Appendix C of this chapter.* In other cases written rules may not have been prepared and too little attention may have been given to such instruction. Lack of attention to the proper conduct of staff members is likely to affect adversely the appearance and actions, and therefore the self-respect, of these employees. Some of the most important instructions which affect staff morale are given below:

Appearance and Behavior

Even a master's degree from a college does not insure that the recipient has learned the importance of neatness and propriety of dress, cleanliness in the care of his person, and a reasonable amount of dignity and decorum in his behavior. Some beginners need these matters called to their attention several times. Others have difficulty in learning that the importance of appearance and behavior is not limited to the working hours of the firm

General Conduct

Although the employer cannot entirely prescribe the employee's conduct while away from work, the reflection upon the firm of inappropriate behavior and poor appearance, particularly in public places, can be suggested. Also, the importance of his general conduct to his own career and to the accounting profession should be pointed out. He should be

* Appendix B and Appendix C are used by different accounting firms and are therefore not integrated or complementary. However, any practitioner or firm adopting or modifying one of these documents for its own use could readily prepare the other to correspond.

encouraged to participate in worthy community and professional activities.

Relations with Clients

Junior assistants should be informed that they are not to discuss their findings with, or direct their questions to, the client. The accountant in charge of the engagement will take up with the client all matters relating to the engagement, or will have a partner do so. Discussions by junior assistants with the client's employees regarding irregularities and loose methods are to be avoided. Courteous and friendly relations are to be maintained with these employees but only on a professional basis; the attitude should be one of dignified friendliness. The client's records should not be removed from his office except with his permission and a dated receipt must be given in such instances when removal is necessary. All assistants (and principals as well) must maintain independence in their mental attitude and must avoid relationships which might create an assumption of lack of independence. No staff member should have any financial interest in any of the firm's clients. Personal checks and salary checks should not be cashed in the client's offices and any rules of the client as to smoking during working hours should be observed. Fraternizing with employees of a client should be taboo.

Secrecy Regarding Firm's Business

The affairs of the firm and of its clients are confidential matters. The accountant's work is undertaken in strict confidence and with an understanding of privacy. Therefore, the utmost care must be taken not to discuss or mention any of the affairs or even the name of a client outside of the office of the firm or that of the client. If the assistant needs to be reached by telephone from his home, the office of the firm should be called; the operator will then call the assistant and have him call his home.

APPRAISING THE PROGRESS OF THE STAFF

Rating and Reporting upon Performance

Most firms check and evaluate the progress of each staff member periodically. Usually this is done when promotions are being considered. However, it should be done more often than at promotion time, both for the benefit of the party or parties who make the staff assignments and to assist the employees.

In a small firm, it may be possible to watch the progress of each employee without written reports. For example, in one small firm, meetings of the four partners are held once each week, at lunch, and a

frequent topic of discussion is the progress and performance of the staff members on their jobs. Where the ratio of partners to staff is 1:3 or 1:4 (or even somewhat lower), this method may be adequate.

In large firms and where there are relatively many staff members in proportion to the number of partners or principals, a formal report on each assistant may be filed with the personnel director by the accountant in charge of each engagement at the close of the engagement. A very useful form for this is appended to this chapter, together with the instructions for rating (see Appendix A). It should be noted that definite grades are required as to several items evidencing auditing ability, and as to professional qualifications, self-expression qualifications, and personal qualifications, respectively. A careful study of the factors listed in the "instructions" for consideration in making the ratings should be very helpful in checking the progress of any practitioner's staff members.

How does the client react to the staff members assigned to the job? Usually any comments obtained will be casual or spontaneous. They cannot very well be solicited. Not much criticism can be expected from this source unless the assistant is poor — or very good. But it should be recorded on the man's progress sheet with adequate explanation of the circumstances.

Discussions of Progress with Staff Members

Reports on staff members afford an excellent opportunity for staff training. Interviews should be held with each employee periodically to discuss his weak points, particularly, but also his good points. Specific references to reports on engagements should be made in a frank and friendly manner for his personal benefit. The suggestions given by such an interview may be more useful than many hours of class training.

Remuneration and Progress

Changes in remuneration usually are dependent on the progress indicated by the ratings given each employee. If there have been many individual ratings, a tabulation of the progress made on each item rated on successive assignments will be needed. But care must be exercised in comparing the ratings given by different persons. To make the grading comparable, an index of the severity of the grader may be needed. Thus, the graders may be rated as "very severe," "severe," "average," "lenient," and "very lenient." Letters may be used for this rating of graders and these can be affixed to the grades given by them to the other employees. A tabulation of successive grades received by an employee from various graders will give a better indication of the progress, or lack of it, when the severity of the grading is measured with the grades.

If there are many employees, a "ladder" showing the positions and particularly the salaries may be used. First, a ladder, which is a chart of

the possible salaries for all employees, is made. Then the employees are all listed on the ladder and their relative positions and progress studied.

Employees consider the real measure of their attainment to be their salary. The size of the increase at promotion time, and the fact that there is an increase, is of great significance particularly to juniors. Actions speak louder than words. Unusual progress should be rewarded with adequate remuneration.

Regular dates for promotion increases are customary. Although many firms ordinarily promote only once each year, there is much to be said for semiannual appraisals of progress with corresponding adjustments of salaries.

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Appendix A

PERSONNEL FORMS



Staff Training Report

Employee Progress Report

Progress Report on Junior Accountant

Report on Staff Performance

Application for Employment

Record of Interview

Interviewer's Guide

STAFF TRAINING REPORT

A good staff accountant must have more than a knowledge of subject matter. He needs (a) ability to "follow through," (b) ability to transmit to supervisor the unusual points arising in an engagement, (c) initiative to check with supervisor the firm policy with regard to nonroutine matters, and (d) ability to write concisely and clearly. To assist in development of these abilities and to promote a well rounded knowledge of subject matter, each staff member shall **upon completion** of an assignment, submit this report including all data which may be applicable.

STAFF MEMBER _____ CLIENT _____

NATURE OF BUSINESS _____ TYPE OF ASSIGNMENT _____

DATE STARTED AND COMPLETED _____ WORKED UNDER SUPERVISION OF _____

DESCRIBE BRIEFLY PHASES OF WORK PERFORMED BY YOU _____

SUMMARIZE NEW EXPERIENCES OR PROCEDURES LEARNED _____

STATE YOUR OPINION ON FOLLOWING MATTERS:

- (1) To what extent did client deviate from generally accepted accounting principles? Why was such deviation important or unimportant in this assignment?
- (2) Internal Control: What are the strong points and the weak points? How could weakness be strengthened? How could defalcation occur?
- (3) Audit program: What portion of program performed by you appears unsatisfactory either because it actually fails to verify or because time required is excessive for objective? What changes in program would you recommend?
- (4) Other suggestions or comments:

Do not volunteer business or tax advice to client. Refer questions to a partner.

EMPLOYEE PROGRESS REPORT

Name _____ Date of Reports _____

SEE REVERSE SIDE FOR INSTRUCTIONS

	Assistant		Senior		Other	
	Junior	Semi-Senior	Light	Medium	Heavy	Designate
What level of work did this employee perform as the basis for your rating?	_____	_____	_____	_____	_____	_____
1. Technical knowledge (its adequacy for level of work indicated).	60 Deficient in working knowledge of fundamentals.	70 Needs more basic information to become productive.	80 Has sufficient knowledge to do good work.	90	100	Excellently prepared for duties.
2. On-the-job performance (see reverse side for definition.)	60 Unsatisfactory.	70 Occasionally satisfactory.	80 Quite consistently satisfactory.	90	100	High grade performance at all times.
3. Capacity for future growth (leadership).	60 Lacks qualifications to make headway.	70 Ability limited to intermediate assignments.	80 Is able to handle increasingly responsible assignments.	90	100	Should progress to high level of responsibility.
4. Ability to write reports, notes to financial statements, etc. (if applicable).	60 Incapable of original reporting; careless with facts.	70 Can follow previous routine reports. Original work not good.	80 Fair, but requires editing.	90	100	English and presentation good; facts carefully stated.
5. Development of assistants (if applicable).	60 Lacks ability to instruct less experienced men.	70 Sometimes does not get assistants to understand what is expected of them.	80 Generally successful in transmitting knowledge to his assistants.	90	100	Does excellent job of training assistants.

If you were discussing his rating with this employee, what would you consider the most constructive thing to tell him with respect to his performance and preparation for future responsibility? (BE SURE TO ANSWER THIS QUESTION) _____

Date _____

Signed _____

INSTRUCTIONS FOR COMPLETING EMPLOYEE PROGRESS REPORT

(REVERSE SIDE)

When completing an Employee Progress Report for a given individual it should be borne in mind that the making of this rating has a two-fold purpose. First, it is to help the management in selecting logical persons for promotion and in administering a sound salary policy. Second, a frank discussion with the employee so rated will keep him posted with respect to his progress and point out ways in which he might be able to improve his record.

In rating a person be sure you do not compare the record of a beginner with the performance you expect from a more experienced person. For instance, if you are rating a junior accountant on technical knowledge, be sure to evaluate this characteristic on the basis of what a junior accountant must know about auditing procedure and do not give him a low rating because he does not happen to know as much as the senior for whom he is working. Acquirement of further knowledge will come with additional training. Attached are specifications covering the responsibilities of junior, semi-senior and senior accountants to serve as a guide in rating staff members.

If a rating is discussed by the management with an employee, the identification of the rater will be kept anonymous at all times. A rating would not be discussed with an employee, usually, unless there were two or three ratings by different individuals which could be consolidated into a composite rating, thus affording the individual a more valid rating and protecting the identity of the raters to an even greater extent.

2. **On-the-job performance**—This is a broad category and the rating should be made carefully. It should take into consideration the amount of work performed, the degree of accuracy and neatness, dependability as to attendance and industry, success in getting along with associates and with members of the client's organization, analytical ability in understanding assignments, and resourcefulness in planning and executing the work. It is an omnibus rating but by giving the man you consider best the highest rating and the man you consider poorest the lowest rating, you will have a man-to-man comparison which will give an accurate picture of the relative abilities of the persons you rate. Cover any specific weaknesses by your answer to the question at the bottom of the report.

PROGRESS REPORT ON JUNIOR ACCOUNTANT

On Mr. Date:

By Mr.

Work done at:

Dates:

	GOOD	FAIR	POOR
Ability to grasp a situation.....			
Ability to follow instructions.....			
Ability to work with others.....			
Ability to work without supervision.....			
Ability to command respect.....			
Ability to direct others.....			
Accuracy and freedom from errors.....			
Adaptability			
Conduct in client's office			
Constructive thinking.....			
Liking for his work.....			
Legibility of writing.....			
Mathematical ability.....			
Neatness of work.....			
Neatness of appearance.....			
Originality in work.....			
Personality			
Punctuality			
Receptiveness to criticism.....			
Speed in covering assigned tasks.....			
Technical knowledge.....			

REMARKS:

.....

.....

.....

NOTE TO SENIOR: Try to answer all questions, but do not answer a question unless you have had an opportunity to form a fair opinion, taking into consideration the junior accountant's previous experience and technical training.

PERSONNEL REPORT

CONFIDENTIAL

To Mr.

Date Re: Mr. Assignment

(Before preparing this report read carefully the instructions on the reverse.)

- Auditing Ability**
 - Working papers
 - Technical ability
 - Application to work
 - Sense of responsibility
- Qualifications for self-expression**
- Personal qualifications**
- How do you classify him** (indicate by "x")

	E	G	F	P
(a) Senior				
(b) Light Senior				
(c) Semi-senior				
(d) Junior				
- Ability to assume more responsible assignments**

Immediately Yes () No ()

Eventually Yes () No ()

Nature of work:

Comments:

INSTRUCTIONS

These reports are **confidential** and should not be returned in a self-addressed envelope. Either deliver them to Mr. ... or mail them in a regular envelope with this attention. The completed report should be returned promptly upon releasing the staff member from this assignment.

The purpose of these reports is to aid the firm in making the most effective use of the services of its staff members. Therefore, it is essential that the information furnished for the check list on the reverse side be **complete, accurate, and frank**. Do not attempt to make a **favorable appraisal of the man** in a regular envelope. The completed report should be returned promptly upon releasing the staff member from this assignment.

Each item listed in the first four questions, make a check in the appropriate column bearing in mind his classification as staff member as: excellent (E), good (G), fair (F), or poor (P). (Question 5). Comments should be made in the space provided. If the man has any **outstanding favorable qualifications** they should be mentioned. If, in your opinion, any **qualifications** are **lacking**, they should be mentioned. In the latter case, it is desirable that you suggest what action might be taken to eliminate or reduce such shortcomings.

The following factors are suggested for consideration in making the required ratings:

Auditing Ability

- Working papers**
Complete (adequate)
Excessive information
Neat
Clear (easy to follow)
Adequate cross references
- Technical ability**
Application of auditing procedures
Knowledge of accounting principles
Inquiries of accounting systems, internal control, etc.
Preparation of financial statements and schedules
Preparation of reports
- Application to work**
Conscientious
Careful
Imaginative (originality)
Speed of performance
- Sense of responsibility**
Self-reliance
Progressive (makes constructive suggestions, etc.)

Qualifications for self-expression

Ability to speak
Ability to write
General personality
Qualities of leadership
Appearance
Respect for superior
Conduct (moral character)
Outside interests
Ambition
Reasoning ability
Perseverance
Diligence

Signed:

Date:

Signed:

Date:

APPLICATION FOR EMPLOYMENT

The following questions to be answered in applicant's handwriting:

ATTACH FULL FACE
PHOTOGRAPH HERE

Date.....

Name in full.....

Address

Telephone—Business

Home

Are you an American citizen?.....

Date of Birth.....Place of Birth.....

Height.....Weight.....

Are you single, married, widowed or divorced?.....

Is anyone dependent on you for support?.....If so, who?.....

Give particulars respecting nearest living relatives:

NAME	RELATION	ADDRESS	OCCUPATION and EMPLOYER
.....
.....
.....
.....
.....

Are you related to any partner or employee of this firm?.....

Name acquaintances in our employ.....

What are your hobbies or interests?.....

How do you spend your spare time?.....

Have you or does your wife have.....Do you own your home, rent or

an income besides your salary?.....live with relatives?.....

Do you own an automobile?.....

Are you in debt?.....If so, to what extent and for what reason?.....

Have you ever gone through bankruptcy or made an assignment?.....

Have you ever been bonded by a Surety Company?.....If so, state latest bond

and to whom given?.....

Have you ever been refused a Surety Bond?.....If so, why?.....

Is your health good?.....Have you ever been refused for insurance?.....

Have you any physical defects? (Explain).....

Do you use liquor in any form?.....

How much time have you lost through illness during the last two years?.....

RECORD OF EMPLOYMENT:

The fact that you have filed this application will be **KEPT STRICTLY CONFIDENTIAL**, and will not in any way be State how you have been previously employed or engaged since leaving school, accounting fully for your occupied or

NAMES AND ADDRESSES OF FORMER EMPLOYERS	Nature of Employer's Business	Under whom did you work?
NOTE: State reason for and length of inactivity between present application date and last employer.		
Name of Last Employer.....		
Address		
City State		
NOTE: State reason for and length of inactivity between last employer and second last employer.		
Name of Second Last Employer.....		
Address		
City State		
NOTE: State reason for and length of inactivity between second last employer and third last employer.		
Name of Third Last Employer.....		
Address		
City State		
NOTE: State reason for and length of inactivity between third last employer and fourth last employer.		
Name of Fourth Last Employer.....		
Address		
City State		
NOTE: State reason for and length of inactivity between fourth last employer and fifth last employer.		
Name of Fifth Last Employer.....		
Address		
City State		

Have you ever been dismissed or suspended from any position?

If so, state when, where and the cause.....

Are you interested or engaged in any business?.....Give particulars

Education	Number of years	Name of School	City	Year of leaving	Did you graduate?	Major Course or Subject	SCHOLARSHIP
Secondary School							Average..... Above av..... Below av.....
College or University					(Degree)		Average..... Above av..... Below av.....
Other—give type							Average..... Above av..... Below av.....

Academic or Professional Honors
(List honor or professional fraternalities, prizes, teaching scholarships, special recognitions or designations, etc.)

Extra-curricular or Social Activities
(List elective offices, organizations memberships, athletic, literary, dramatic, artistic or favorite activities, etc.)

brought to the attention of your PRESENT employer without your permission.
unoccupied time.

Nature of your work	Date Beginning	Starting Monthly Salary	Date Left	Monthly Salary When Leaving	Why Did You Leave? Give Details
	Month Year		Month Year		
	Month Year		Month Year		
	Month Year		Month Year		
	Month Year		Month Year		
	Month Year		Month Year		

REFERENCES:

Give names and addresses of five responsible persons, three of whom must be in a business or profession. All such persons must have known you for at least three years and one for five years. (Do not give names of former employers or relatives.)

NAME	ADDRESS	OCCUPATION and EMPLOYER	NUMBER OF YEARS ACQUAINTED
1.			
2.			
3.			
4.			
5.			

For what position are you applying?.....When could you begin?.....

Present SalaryMinimum Salary acceptable.....

SUMMARIZATION:

Furnish herewith, in narrative form, a statement in which you attempt to show through your educational background, and experience, why you believe you are qualified to accept the responsibilities involved in the position for which you are applying.

Unless excused for particular reasons, applicants will be required to take an examination as to their qualifications.

All employees are required to furnish a fidelity bond in a Surety Company designated by this organization for such an amount as is deemed sufficient; the premium for such bond will be paid for by us.

Applicants will be required to undergo a medical examination by a physician designated by this organization; if the report is unsatisfactory, the applicant will not receive further consideration.

Employment is also contingent upon execution of an employment agreement with us.

All persons selected for positions in this organization are on trial, and if at any time it is found that the employee is not adapted to the work, or not likely to prove successful, the engagement may be terminated without further reason, and without prejudice to the employee's reputation, the firm's obligation ending with the payment of salary through the last day of employment.

Social Security Number.....

.....
Signature of Applicant.

(This space NOT to be filled in by applicant)

DateInterviewed by.....

Remarks:

DateInterviewed by.....

Remarks:

Date employed.....Starting Salary.....Date will begin.....

INTERVIEWER'S RECORD

NAME _____ AGE _____ SINGLE _____ MARRIED _____

MAJOR INTEREST _____

HOMETOWN _____ (WIFE'S) _____

LOCATION PREFERENCE _____ REASON _____

FATHER'S OCCUPATION IS-WAS _____

PERSONS WHO ARE WELL ACQUAINTED WITH APPLICANT'S SCHOLASTIC AND GENERAL ABILITY:
NAME EVALUATION

1. _____
2. _____
3. _____

ACCTG. COURSES _____

AIA TEST SCORES _____

CO. REPR. CHECKS (✓) THE EVALUATION OF EACH QUALITY LISTED						REMARKS (use reverse side for additional space)
	UNSAT.	QUEST.	SATISF.	VERY GOOD	SUPERIOR	
APPEARANCE						
MENTAL ALERTNESS						
ATTITUDE						
AGGRESSIVENESS						
CAP. FOR DEV.						
INTEREST IN U.S.						
DO YOU RECOMMEND EMPLOYMENT		STATE WORK FOR WHICH BEST SUITED			COMPANY - LOCATION	
WHAT COMMITMENTS WERE MADE BY INTERVIEWER						
DATE		NAME OF INTERVIEWER			COMPANY	

ARMSTRONG CORK COMPANY**Interviewer's Guide****Rating****A B C D**

(Circle one)

Name Date

Interviewer

This guide supplements the completed application and provides the additional information needed for you to prepare a brief summary of this candidate's qualifications.

The number of questions to be asked by you during the interview will depend on the importance of this vacancy. These questions will also suggest other pertinent facts which should be discussed during the interview. Ask the questions printed in black for information—use the phrases printed in red for interpretation. Record as many facts as you can AFTER the interview.

Put this applicant at ease; be friendly; get him to talk, and tell him briefly about the Company.

COMMENTS

EDITOR'S NOTE: "Phrases printed in red" referred to in the above instructions, appear on the following pages as light face type.

Work Experience

START HERE for those who show a recent employment history.

What was the last company you worked for?

From to

On application number this company "I." Check dates with application. Is he a "job jumper"?

How did you get this position?

Note evidence of initiative or ingenuity as against family aid or chance.

What did you do in this position?

Get complete information. Note progress indicated. How is it related to this vacancy?

Did you supervise or instruct other workers? **How many?**

Note leadership capabilities.

Who was your immediate supervisor?

Get name and title. Check this with position or rank indicated.

What sort of a person was he?

Question further if friction is indicated.

Why did you leave this position?

Note whether termination was forced, temperamental, untimely.

If salary for this position is not indicated on application, check at this point.

(Repeat for next position, if desired)

World War II Record

START HERE for those who show recent military service.

In what branch of the Armed Forces did you serve?

When did you enter military service?

When were you discharged?

Discharge papers MUST be examined before employment to check dates and determine type of discharge.

If other than honorable discharge, applicant is probably not desirable.

Number of discharge points?

If not a "point" discharge—is it medical?

If medical, is he able to perform this job?

What was your rank when discharged?

Note any sign of progress. (A majority of drafted men reached rank of corporal or better during two or more years of service.)

Did you have any special training in the service?

To what extent can this be applied to the job?

Why didn't you return to your former employer?

Get a FULL explanation.

Education

START HERE for those just graduating from school.

Note school last attended (from application). Is the level of education reached sufficient for this vacancy?

Where did you rank in your class in scholarship? { Above average?
 Average?
 Below average?
 Circle one.

What were your grades?
 Ask for grades in several courses related to job requirements and as a check on class graduation standing.

Why did you select your particular course of study?
 Note purpose of selection. Is this study applicable to this vacancy?

Which course did you like least? Which most?
 How does this preference check with claimed grades and job interest?

Why couldn't you finish school? (If not graduated)
 Note whether reasons indicate instability.

Did you study any special courses after leaving regular school?

(If "yes") What were the courses?
 Note ambition, self-improvement.

Were these courses completed? (If not) Why not?
 Note perseverance.

Did you work to earn expenses while attending school?

Did you work to earn expenses during summer vacations?
 Note whether work was necessary or voluntary.

In what school activities did you participate?
 Note diversification of interest.

What offices did you hold in these school activities?
 Note leadership, teamwork qualities.

Have you ever held an office in any clubs, other than school?
 Membership denotes liking for people. Note leadership qualities.

Personal Data

Note marital status (from application).

How long have you been married?

What are the ages of your children?

Do you have any other dependents?

Do these indicate too large a financial burden for the income offered for this job?

How much time did you lose from school/from work during the last two years?
Excessive?

How long has your father been in his present occupation?

Obtain occupation from application.

Note family ambition, financial status, environment.

How many brothers do you have? Sisters? Number older?

Number younger?

(If youngest or nearly youngest, say in a half-serious tone) I notice you are the youngest (or nearly the youngest)

of the family. Did they spoil you?

Only manner of answer important.

Have you ever lived away from home?

"Apron strings"?

Other Important Data

What reasons prompted you to choose the particular work for which you are applying?

Are the reasons valid? Does the applicant know what he wants?

Why do you think you are qualified for this type of work?

Note self-assurance.

What are your ambitions?

Are these ideas reasonable or excessive?

Appendix B

PERSONNEL MANUAL

**Example of the Personnel Section
of an Administrative Manual. . . .**

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SECTION ON PERSONNEL POLICIES OF THE ADMINISTRATIVE MANUAL OF A LARGE NATIONAL FIRM

(The administrative manual from which this section is abstracted is intended for use by management and supervisory personnel. Unlike staff manuals, it is not distributed to staff members.)

Section I — COMPENSATION POLICY AND JOB CLASSIFICATIONS

Statement of Firm Policy

All employees are compensated in accordance with the abilities demonstrated by them during the period of their employment, giving due regard to their progress, loyalty, work habits, relationship with clients and fellow employees, aggressiveness and general attitude toward their work. Promotions and salary increases are a personal and individual matter with each employee and the final decision on these matters should be made by the manager or managing partner of the office.

Starting salaries are determined in accordance with the applicable classification and rates insofar as possible although it is recognized that even the most careful screening of prospective employees may not be sufficient to determine the value of any particular employee's worth to the firm.

Increases in salary are granted to individuals whenever, in the discretion of the appropriate department supervisor and manager or managing partner, such increases are merited. Since the staff employees of the firm are professional men, rates of advancement are therefore not uniform. The salary structure is reviewed at least twice a year, as of April 1 and October 1, to determine whether any employees merit increases within the mechanical structure of the compensation plan as outlined in the following subsections.

Compensation Plan and Job Classifications

Tax and Audit Staff Accountants

Supervisor

Experience Required. At least five years prior public accounting experience or its equivalent. Certified public accountant certificate preferred but not absolutely essential.

Duties. Supervision of Grade A and Grade B seniors, conducting certified audits or special assignments or handling of tax cases, special tax problems and related matters. The supervisor is generally a secondary contact with clients, the partner being the primary contact.

Supervising Senior

Experience Required. Four to six years experience in public accounting or its equivalent. Certified public accountant certificate is desirable but not mandatory.

Duties. Responsible for the direction of several semi-senior or Grade B senior accountants, conducting small or medium-sized audits simultaneously or tax department review and research working under a tax department supervisor. Responsible for direction of large groups of men on special engagements working under the direct supervision of a partner.

Senior Accountant—Grade A

Experience Required. Three to five years experience in public accounting or its equivalent.

Duties. Handling of large certified audits, systems surveys or tax research under the direction of a supervisor or partner.

Senior Accountant—Grade B

Experience Required. Two to three years prior public accounting experience or its equivalent, depending on the capabilities of the individual.

Duties. Handling small and medium-sized certified audits under the direction of a supervisor or partner and preparation of state and Federal tax returns. In the case of an audit of corporation with multiplant operations, one of these men would be assigned to each plant or branch under the direction of a Grade A senior or supervising senior.

Semi-Senior Accountant

Experience Required. One and one-half to two years prior public accounting experience or its equivalent, depending on the capabilities of the individual.

Duties. Handling small noncertified assignments including preparation of financial statements and tax returns and assisting a senior accountant in the conduct of large jobs.

Junior Accountant—Grade A

Experience Required. One year's previous experience in public accounting or its equivalent.

Duties. Assisting the senior accountant or semi-senior in all phases of a normal audit including analyses of fixed assets, prepayments, accounts payable and accrued liabilities.

Junior Accountant—Grade B

Experienced Required. Six months' experience as a junior accountant or its equivalent.

Duties. Handling bank reconciliations, inventory verifications and accounts receivable confirmations and similar work in the conduct of an audit.

Junior Accountant—Grade C

Experience Required. Two to four years of college training in accountancy or its equivalent. No previous business experience.

Duties. Detailed footing, copy work and other clerical assignments connected with certified audits.

Office Personnel

Office Manager (Nontechnical)

Experience Required. Administrative and personnel background required. College graduate preferred.

Duties. Supervise all office employees: secretaries, stenographers and clerical help. Expedite flow of interoffice communications and supervise accounting and clerical details of the office.

Office Employees—Grade A

Experience Required. Four to six years' experience in comparable field of work.

Duties. This classification is composed of private secretaries, statistical typists, chief bookkeepers and other clerical employees who have the ability, training and experience to handle work assigned to them with a minimum of supervision. Employee must have the ability to think independently and to be able to act on his own initiative; must also be able to undertake limited supervision of others.

Office Employees—Grade B

Experience Required. Three to five years in comparable field of work or its equivalent.

Duties. Consists of secretaries, statistical typists, bookkeepers and other clerical employees who maintain their work with limited supervision. Some ability to use their own judgment is necessary but very little supervision of other employees is required.

Office Employees—Grade C

Experience Required. One to three years in a related position.

Duties. Consists of stenographers, bookkeepers, switchboard operators, file clerks, et cetera, who must have some training or skill to perform their duties, but who work under direct supervision of the office manager or other employee.

Office Employees—Grade D

Experience Required. Experience helpful but not required.

Duties. Normally consists of messengers, assistant file clerks and other untrained clerical employees. Work is done under close supervision, but employee must be able to take and understand directions given. Only a very limited exercise of judgment required.

Special Classifications

The foregoing job classifications with respect to tax and audit staff accountants and also office personnel will be satisfactorily applicable in the majority of instances. By the very nature of the firm's business, however, there are innumerable instances in which specially trained and specially qualified individuals are employed whose abilities and responsibilities cannot be readily identifiable as belonging to any particular job classification. Generally speaking, individuals of this character will be classified as supervisors; their compensation however will in all cases involve special contractual arrangements depending upon their individual training and skills as well as their past experience.

The past history of the firm in this respect will indicate the wide variety of special arrangements that have been used from time to time, which arrangements generally included a basic salary comparable to that paid to individuals included in one of the regular classifications; in addition, various types of deferred compensation or profit sharing participation were occasionally utilized for upper level employees (in which cases payments were made after the close of the firm's fiscal year). Generally speaking, any arrangements made with respect to employees to be included in this special classification must give recognition to the firm's past precedent in this regard. The aggregate compensation paid should be determined in relationship to the regular job classifications as well as to such past precedent, giving full evaluation to differences in experience, training, responsibility and ability.

Salary Rate Schedules

Salary rate schedules applicable to the various job classifications are set forth in Supplement A of this appendix.

Section II — VACATION AND HOLIDAY POLICIES

Vacations are granted in accordance with the following policies:

Vacation Allowances**Regular Employees**

As a matter of general policy, the firm allows a two weeks' vacation period to all staff and office personnel who are regular employees, such

regular employees for this purpose being defined as those who were employed on or before August 31 of the preceding year and who, as of May 31 of the current year, have been continuously employed since that prior date.

At the discretion of the manager or managing partner, this general policy may be modified in exceptional circumstances. Three weeks' vacation is allowed to all employees with service of more than five years.

New Employees

The vacation allowance for personnel hired after August 31 of the preceding year is prorated on the basis of one day for each month, or part thereof, of employment through May 31 of the current year. (For example, a man hired during January of the current year would be entitled to a 5-day vacation) The months of June and July are not included for the purpose of determining vacation allowances.

Terminated Employees

Accrued vacation which is due to an employee who leaves the company will be computed from the preceding August 31 to the month of termination based on one day for each month, except that the months of June and July are not included for the purpose of determining such vacation allowance and providing such employee has been with the firm at least twelve months prior to termination. Employees dismissed for cause or who resign generally forfeit all rights to any accrued vacation. Exceptions may be made by the partners under unusual circumstances. In those cases in which an accrued vacation is due, the applicable formula for determining the amount of accrued vacation pay for each day, for this purpose only, is as follows:

$$\frac{\text{Present Annual Salary}}{2,080} \times 8 = \text{one day's vacation pay.}$$

Vacation Periods

1. The vacation period will ordinarily include the months of June, July, August, September, October and November of each year. Vacations cannot be taken one or two days at a time, although it will be permissible to take each week of the two week's vacation separately. The firm will not pay the employee salary in lieu of vacation, nor is it generally permissible to carry over a vacation period from one year to the next.
2. Vacation schedules will be based on the individual desires of the employees subject to the requirements of the firm. In cases of conflicting dates, priority will be given to the employee with the greater length of service. Employees entitled to vacations should file requested dates with the manager, managing partner or personnel supervisor before May 1 of each year and will be notified by June 1 as to whether such dates are available.

Holidays Regularly Observed

The firm regularly observes seven holidays as follows:

New Year's Day
Memorial Day
July Fourth
Labor Day
Thanksgiving
Christmas
Day of Annual Office Outing

In some cities there are general business holidays that are locally recognized and will be observed by the firm.

Section III – EMPLOYEES' SUPPLEMENTAL BENEFITS

Employees' supplemental benefits aid individual employees in the successful prosecution of their professional careers, provide some measure of security for them and their families, or provide some additional consideration over and above the amounts established as being their regular monthly compensation.

Certified Public Accountants' Examination

It is the policy of the firm to encourage all staff accountants to complete their university training in accounting through night school work, with the ultimate objective of their becoming certified public accountants. The firm will allow time off (not chargeable against accrued overtime hours as defined in the section entitled "Overtime Compensation") for the purpose of actually sitting for the examination. In addition, the firm will reimburse successful candidates for the amount of examination application fee.

If there is a regular state society Awards Dinner for successful candidates, it is considered to be one of the highlights of the year, and at the discretion of the manager or managing partner, the firm will normally reserve at least one table for the successful candidates and other members of the staff. The firm will pay for such dinner tickets.

Membership in Professional Societies

Membership of staff members in the state society of certified public accountants and the American Institute of Accountants is particularly desirable and helpful to the members of the staff. The firm will pay one-half of the annual dues of these organizations and the employee will pay the other half. Attendance at technical sessions, dinner meetings and participation on various committees is to be encouraged, although the firm will not generally stand any expense resulting therefrom, except in special

instances approved by the manager or managing partner of the office.

The firm also encourages membership in the American Accounting Association, the National Association of Cost Accountants and other professional societies, although it is not the policy of the firm to pay any part of these expenses. Attendance at various technical meetings is encouraged, but expenses thereof will not be paid unless specifically approved by the manager or managing partner of the office.

Subscriptions to Professional Periodicals

Generally speaking, accounting periodicals will be available in the office for study by staff members. In addition, the firm will purchase accounting and auditing bulletins of the American Institute of Accountants for staff members desiring them.

Certain periodicals, if individual subscriptions are desired, can be purchased by the employee and the firm will pay one-half of the annual subscription price. The periodicals presently designated by the firm are as follows:

1. *Tax Law Review*
2. *Taxes — The Tax Magazine*
3. *Monthly Tax Digest*
4. *The Journal of Accountancy*

If individual employees are interested in subscribing to other professional periodicals, the matter should be submitted to the manager or managing partner of the office for possible inclusion in this list.

Attendance at Professional Meetings

The firm policy is to encourage attendance of staff members at all professional meetings held by the American Institute of Accountants and the State Society of CPA's. However, as stated previously, the firm will as a general rule absorb only the expense of the Awards Dinner meeting, if any.

Illness

It is the firm's policy to protect insofar as possible the security of the employee in the event of a long period of illness. In brief, this policy is as follows:

1. The firm will pay a full month's salary during illness extending beyond two weeks in duration for each year of continuous employment. Thereafter the salary will be reduced by 50% and will be continued for a period which will be decided upon by the manager or managing partner of the office.
2. The firm reserves the right to have the employee examined by its own doctor at any time. In the event that the employee refuses to be examined by the doctor designated by the firm, salary payments shall stop immediately.
3. The benefits of this plan are available only in the event of illness and the employee has no vested rights in this plan. It covers periods of long illness

only. Employees will always be paid on their regular basis for time lost because of short periods of illness of two weeks or less in duration. In any case, such time off because of illness will be deducted from the accrued bonus hours in the case of staff members not subject to the Wage and Hour Law.

Overtime Compensation

It is the firm's policy in all cases to reflect insofar as possible the full value of an individual employee's services in the basic compensation. In some instances, for specific reasons, the full amount of such basic compensation will not be entirely paid on a regular bimonthly basis, but a portion thereof will be payable at the close of the fiscal year. In addition to basic compensation, however, the firm has specific plans of compensating all employees for overtime incurred by them in the discharge of their work. For this purpose all employees are classified into three basic groups: (1) those employees earning \$325 per month or over whose employment is covered by a contract with the firm under Contract Form A; (2) those employees earning less than \$325 per month whose employment is covered by a contract with the firm under Contract Form B; and (3) all office employees whose employment is not the subject matter of a contract with the firm. (The designated contract forms are set forth in the Supplements to this appendix).

Contract Employees Earning \$325 Per Month or Over

Net overtime compensation hours are defined as those worked by a covered employee in excess of the normal work week of the particular office, accumulated over the period from August 1 to the succeeding July 31, less any applicable time off. The net overtime compensation hours accumulated as of July 31 may be reduced by the employee by time off during the following period from August 1 to October 31. Any portion of the net overtime compensation hours not offset by the granting of time off during this period, will be paid for in cash (computed by multiplying the remaining net overtime compensation hours by the employee's present straight-time hourly rate) and will be paid before the end of the calendar year.

Any time off prior to July 31 of each year other than for allowable vacations and holidays will, as noted, reduce the net amount of overtime compensation hours accrued on July 31.

Time off granted in lieu of net overtime compensation hours payments will be arranged according to the needs of the firm, taking into consideration as well the convenience of the employee. Time off will be granted in units of one day or more unless the employee requests shorter periods. When requested by the employee, and if work schedules can be arranged, time off will be granted as a lengthening of the vacation period. Dismissal for cause or voluntary resignation may, at the discretion of the

manager or managing partner of the office, involve a forfeiture of any overtime compensation otherwise accumulated.

Contract Employees Earning Less Than \$325 Per Month

Staff employees earning less than \$325 per month will be compensated in accordance with the provisions of the Wage and Hour Law as amended.

The method used in accumulating overtime is identical to that procedure described in the section entitled "Overtime Compensation," with the exception of the following:

1. Overtime is accrued during the calendar year (rather than the firm's fiscal year) and the payment of the accrued overtime compensation must be made within sixty days after the close of the calendar year.
2. Compensation for hours worked in excess of contract hours in any one week must be paid within two weeks thereafter at the overtime rate specified in the employee's contract and those hours will be excluded from the annual calculation of accrued overtime hours. Contract hours are determined according to the following schedule:

<i>Monthly Salary</i>	<i>Contract Hours Per Week</i>
\$200	50
\$225	55
\$250	60
\$275	60
\$300	60

Contract Employees Advanced to Compensation of \$325 or Over

Contract employees earning less than \$325 per month who are advanced in grade so that their compensation is \$325 or more, and whose employment is covered by an appropriate contract, will have their overtime compensation for the year of change computed as follows:

1. Overtime accrued to the date of change in salary classification will be paid in accordance with the provisions of the Wage and Hour Law as amended. Such amount will be due and payable to the employee within sixty days after the end of the calendar year in which the change occurred. Overtime accruing subsequent to date of change will be accumulated and paid in accordance with provisions given in a previous section of this Manual entitled "Contract Employees Earning \$325 Per Month or Over."
2. It shall be the duty of the appropriate department supervisor to advise the employee of the change in computing his individual overtime hours, and at that time to determine what portion, if any, of the accrued overtime hours under the Wage and Hour Law will be taken in time off prior to the expiration of the sixty day period. This amount will, of course, be deducted in computing the overtime compensation paid to such employee.

Noncontract Office Employees

These employees will be compensated regularly on the basis of time and one-half for all hours worked in excess of forty hours during a normal work week. Recognized holidays will be included as working days for the purpose of this computation.

Supper Expense Reimbursement

All employees will be reimbursed for the actual expense of their supper not in excess of \$2 if they work at least ten hours during a regular working day, or six hours on any other day, and such work is done at the firm's office or the client's office at a distance that precludes the employee from dining at his home. When the overtime is specifically for the convenience of the client, the supper money should be charged to such client.

Insurance Plans**Life Insurance**

The firm will pay the premiums on group contracts covering an employee's life, accidental death and dismemberment in the amount of \$2,000 payable to such beneficiary that the employee may designate provided such employee has been regularly employed by the firm for at least six months. If the employee has been regularly employed by the firm for at least three years and earns a base salary of at least \$5,100 per year, the face amount of the policy shall be \$4,000.

Blue Cross and Blue Shield

Employees may obtain Blue Cross and Blue Shield insurance through the firm, although the expense of such contracts must be borne by each employee.

Annual Outing

An annual outing of each office of the firm is generally held during the summer months on a date designated by the manager or managing partner. It is not ordinarily the policy of the firm to invite any members of the employee's families or any clients to this affair. The entire cost of the outing will be paid by the firm.

Section IV — PERSONAL CONDUCT OF EMPLOYEES

Certain basic rules of personal conduct must be adhered to by all employees of the firm.

Smoking and Drinking

Smoking is permitted in our office by all male employees; however the use of tobacco in a client's office depends entirely upon the rules of that office.

The use of liquor is absolutely forbidden during office hours either in our office, at lunch or in a client's office. Excessive drinking by anyone at any time or place may be cause for dismissal.

Conduct in a Client's Office

Care should be taken by staff men not to adopt a familiar attitude toward either the client or his employees, and all contacts should be on a dignified and professional plane. None of the staff members is to do any personal entertaining of the clients or their employees without the approval of the partner in charge of the client.

Relationship with Clients

If anything important or out of the ordinary occurs with the client, it must be reported immediately to the accountant in charge, or in his absence to the audit staff supervisor, or the appropriate partner. It is important that the office be kept informed of any unusual events so that appropriate action may be taken.

Accountants should never make any accusations of fraud or dishonesty of any kind against anyone even if proof seems to be apparent. Such information should be passed on to the accountant in charge at once, as situations of this nature must be handled by the partner. A positive accusation against any person could subject the firm to a lawsuit for slander, libel or defamation of character.

A report must be made immediately by the employee to the audit staff supervisor if a relative of that employee is working in the office of one of our clients. Under no circumstances should a staff man continue work on an audit where a relative is working on the books.

No staff accountant has the authority under any condition to suggest tax savings plans or schemes to the client without first consulting a partner and obtaining his specific approval. Even then no specific position may be taken without first consulting with the tax staff.

Assistants should never discuss the client's financial affairs with him but should express their views to the in-charge accountant who will be the judge of matters to be brought before the client. The affairs of a client are not to be discussed with any unauthorized persons at any time. No excuse is acceptable for disobeying the fundamental rule of keeping client's affairs strictly confidential.

Care should be exercised by the accountant in-charge in making commitments of any nature to a client, for such commitments once made cause embarrassment if they have to be changed. Appointments made for a supervisor or partner or promises made with respect to delivery of a report or other data must be cleared by the appropriate parties before the client is advised.

Cashing Checks in Client's Office

The cashing of payroll checks in the client's office is forbidden. In specific cases, after receiving approval from the in-charge partner, an employee on an extended trip may cash expense advance checks in a client's office.

Section V — STANDARD OFFICE HOURS**Office Hours**

The office hours of the firm are fixed in each office by the manager or managing partner according to the practice in the business community. The established office hours apply to all general office employees and to audit and staff employees whose working day begins or ends in the office. Repeated tardiness or failure to observe office hours cannot be tolerated. It is to be noted that the basic work week generally amounts to forty hours.

Employees who are engaged in field work must observe the office hours of the client unless permission is obtained from the accountant in charge or the audit or tax staff supervisor to observe other hours.

Rest Periods

The firm does not approve regular rest or coffee periods, except for the switchboard operator. However, it is the firm's policy that those employees who feel the need of a rest period in the morning or afternoon should confine it to a period not in excess of 15 minutes between the hours of 10:00 a.m. and 11:00 a.m., or 2:30 and 3:30 in the afternoon. At no time should more than two employees leave together and, moreover, no one is to leave if so doing would disrupt the normal functioning of the office.

Absences

If it is impossible for an employee to be at work on a particular day, it is mandatory that such employee or member of his family telephone the appropriate supervisor or manager, before 9:00 a.m.

Section VI — TRAVEL EXPENSES AND EXPENSE REPORTS**Expense Advances**

Expenses will be advanced for out-of-town assignments to cover the cost of transportation, food, lodging and on long trips reasonable allowance for laundry and valet. Any expenditure upon which the employee has a question should be discussed with the supervisor or the in-charge accountant. Any expense report covering a particular assignment should be prepared immediately upon return to the office and in the event that the engagement has not ended at the end of the month, a report up to and including the last day of the month must be forwarded on that day to the office manager. The expense report form is presented in the supplements to this appendix.

Allowable Expenses

The means of transportation to be taken in handling out-of-town assignments must be cleared with the partner in charge of the engagement and the cost of that transportation is reimbursable. (When a private automobile is used, 7¢ a mile will be allowed). A maximum allowance of \$5 per day will be made for actual expenses for food and incidental expenses; the actual hotel expense for necessary accommodations will be reimbursed. The hotel bill and transportation envelope should be attached to the expense report.

Use of an Automobile in Connection with Local Engagements

Reimbursement for the use of an employee's automobile when it is used for transportation to and from clients in the local area will be allowed on the basis of 7¢ a mile subject to the following provisions:

1. No mileage will be allowed from the employee's home to the first stop of the day, it being assumed that the use of the car to that point has been purely for the convenience of the employee. An exception to this rule can be made by the manager or managing partner in special cases.
2. Mileage will be allowable from the first stop of the day to the offices of any additional clients; however, mileage from the final stop of the day to the employee's home will not be allowed unless specifically authorized as in (1) above. In certain instances the manager or managing partner might find it desirable to establish a monthly allowance for the use of the employee's automobile, such allowance must have due reference to the average monthly mileage of usage at the specified rate per mile.

Reimbursement for fare incurred in the local use of public transportation shall be under the same principles as apply in the allowance for automobile mileage.

Review of Expense Reports

It is the responsibility of the employee submitting the expense report to allocate charges included thereon to the clients who are properly chargeable for the expenses. Expense reports will be reviewed by the manager, managing partner or designated supervisor in each office for propriety and in any cases where the established rules have been violated, the matter should be discussed with the supervisor or partner in charge of the engagement.

Section VII — TRANSPORTATION AND HOTEL RESERVATIONS**Transportation**

The primary responsibility for the securing of appropriate transportation reservations is upon the employee concerned. However, for the

convenience of staff personnel, in each office individuals will be designated who will, upon request, obtain the necessary reservations and tickets for the employee or employees involved.

Hotel Accommodations

The primary responsibility for the making of hotel reservations also rests with the employee concerned. In each office, however, a designated individual (usually the office manager) will arrange for appropriate hotel reservations when requested.

If it is at all possible to project the length of the intended stay, the hotel should be advised of the estimated number of days. In order that the firm may maintain affable relationships with the hotels located in various cities, it is requested that any change or cancellation of a proposed trip be immediately conveyed to the hotel in which the reservation has been made. It is understood that the employee will use discretion in obtaining hotel facilities so as not to burden the client with unnecessary hotel expenditures.

Section VIII — STAFF ROOMS AND FACILITIES

Use of Staff Rooms

The staff rooms must be kept neat and orderly at all times. It is the responsibility of each man to see that his desk or table is free of all loose papers when he completes his work. Under no circumstances should working papers remain on the table over night and no working papers other than the current job in process shall be removed from the office except upon approval of the manager or managing partner.

All papers that are to be disposed of must be mutilated before being placed in the waste basket, since un mutilated papers may reveal confidential information to unauthorized persons.

Distribution of Incoming Mail

All incoming mail is delivered to a specifically designated individual for opening and distribution. A daily report of all mail received will be prepared by the person opening the mail, this to be circulated among the partners of the office. Items requiring reply will be so marked.

Handling of Outgoing Mail

All outgoing mail is to be reviewed by a partner, or by such individuals as he may designate, and shall be delivered to the mail desk. A log shall be kept listing all outgoing mail.

Delivery of Intraoffice Mail

It is the responsibility of the mail clerk to pick up and deliver at various designated stations throughout the office, the memorandums and letters which are placed therein.

Periodical Library

The firm maintains an up-to-date library of periodicals and books consisting of appropriate technical literature which is available to all staff members. All employees are welcome to read this material in the office when they are not specifically assigned. Under no circumstances should these periodicals be taken from the office without the permission of the manager or managing partner.

Section IX — EMPLOYMENT PROCEDURES***Application Forms***

A standard application form, a copy of which is set forth in the supplements, is to be completed by all prospective employees. This application blank should be kept in the prospective employees' file until such time as action is taken on the applicant. If the employee is hired, this application blank becomes a part of the permanent personnel file relating to the employee. If the employee is not hired, the application blank will be kept in the personnel files for a period of one year from the date of application, unless special circumstances suggest otherwise.

Interviewing Procedures

All prospective employees, either office or staff personnel, are normally interviewed by the manager, managing partner or the audit staff supervisor. If, in the judgment of the audit staff supervisor, the applicant appears to satisfy the qualifications of the particular position, he shall be interviewed by the manager or managing partner or alternatively by the office manager (in cases of office employees), by the tax supervisor (in the case of tax staff employees) and by the audit staff manager (in the case of audit staff employees) before any final judgment is rendered on the individual.

In cases involving partners' secretaries, special services employees and supervisory tax and accounting staff personnel, it is mandatory that such individual be reviewed by the manager or partner directly affected. If it is necessary that a decision be made while such manager or partner is out of the city, the applicant should be interviewed by the managing partner.

In all instances in which prospective employees are initially interviewed, a sincere effort should be made to determine their possible apti-

tudes for public accounting as well as their understanding of what activities are involved. The nature and character of our firm should be explained briefly in order to give the prospective employee a clear idea of the sort of organization he is approaching. Quite often the prospective employee will have an adequate background of knowledge with respect to public accounting and will have a clear idea of what the position involves. On the other hand there may be a number of instances in which the prospective employee may appear to have the aptitudes required for our profession and also appear to have considerable potential, but might be rather uncertain as to his own future goal either in public accounting or elsewhere. If the interviewer is convinced that such prospective employee might still have substantial potential, even if only on a short term basis of two years or more, in such instances it should be explained that employment with our firm is a very logical stepping stone to employment in private industry if the conclusion is reached that that step is to the best interest of all concerned. It should be explained that whenever a suitable opening with a client's organization is presented to the firm, it is definitely the firm's policy to first consider those of our staff employees who have indicated a desire to leave public accounting.

Initial Steps Upon Employment

When a new employee reports for work, he should be interviewed by the office manager who will be responsible for the following:

1. Securing W-4 form.
2. Preparing group insurance card (including explanation of the plan to the employee).
3. Completing wage authorization form (see supplements).
4. Preparing a personnel file folder.
5. Explaining the details of office routine such as starting time, lunch periods, time reports, expense reports, et cetera.
6. Introducing the new employee to all available personnel.
7. Giving the new employee the following material (for which he will sign an appropriate receipt where necessary):
 - a. Key to the office.
 - b. Copies of all appropriate manuals.
 - c. Current personnel list.
 - d. Copies of current staff bulletins (for audit, tax and special services employees).
 - e. Business cards, if the employee is a senior accountant.

Execution of Employee Contracts

All staff employees are given an employment contract setting forth the basis of employment.

Form of Contract

1. \$325 per month and over — Contract Form A set forth in the supplements.
2. Under \$325 per month — Contract Form B set forth in the supplements.

Execution of Contract

1. At the time a new employee reports for work, or is promoted in classification so that a contract on Form A is required, the appropriate department supervisor will prepare the proper form of contract and have it signed by the employee.
2. The contract must be signed by the manager or managing partner on behalf of the firm.
3. At least one witness should observe these signatures and affix his or her signature to the contract.
4. The contract should be prepared and signed in duplicate — one copy for the employee and the other copy to be retained by the manager, managing partner or personnel supervisor in the personnel file.

Sources of Prospective Employees

The following sources of prospective employees are ordinarily used:

1. Friends and acquaintances of partners and staff members.
2. Selected students from universities maintaining recognized accounting curricula.
3. Classified advertisements in local newspapers and professional periodicals.
4. Acquaintances of clients and business associates.
5. Employment agencies (it is not general firm policy to absorb employment fees which are properly payable by the employee; however, especially in the lower income brackets, it is recognized that the law of supply and demand controls and a certain amount of discretion must be exercised).

Testing of Prospective Employees

In many cases, it will be desirable to give aptitude tests in order to determine the capabilities of the particular individual under consideration. The tests are of three types:

1. In the case of junior accountants, it is desirable to test their technical skill. Recommended test: American Institute of Accountants Level II — Form C Achievement Test. Minimum grade approximately 50%.
2. In the case of supervisory and senior accountants, a personality evaluation test should be given. Recommended test: Worthington Evaluation Test (short form) or its equivalent.
3. Stenographers and secretaries should be given a technical proficiency test for shorthand and typing speed and accuracy.

Section X — TERMINATION OF EMPLOYMENT**Notice**

Notice of termination shall be given to employees by the partner, manager or supervisor in charge of personnel or directly in charge of the work of the individual involved in accordance with the details set out in the employment contract.

Compensation

Two weeks' salary may be paid in lieu of two weeks' notice which is the normal period required. In addition, terminated employees will be given

accrued overtime in the case of office employees, and accrued net overtime compensation to date of termination in the case of staff employees. In addition, vacation may be paid as outlined in Section II. Dismissal for cause, or voluntary resignation may, at the discretion of the manager or managing partner of the office, involve a forfeiture of vacation rights as well as any accrued net overtime compensation not covered by contract.

General

It shall be the duty of the partner, manager or supervisor in charge of the office to obtain the following items from a terminated employee:

1. Keys to the office.
2. Stenographic or statement presentation manual.
3. Brief case (if assigned).
4. Final time report.
5. Settlement of any expense advance or account receivable.
6. Data regarding disposition of group insurance policy.

Relations with Terminated Employees

All requests for references, employment data, et cetera, should be promptly handled by the partner, manager, or supervisor in charge of personnel matters. It is inadvisable, however, to furnish such information directly during the course of a telephoned request, because of the impossibility of immediately verifying the identity of the caller. Accordingly, as a protection both to the firm and the former employee, such information should be given only by letter or a return telephone call to an identified party.

Section XI — TIME REPORTS

Form and Period Covered

A standard time report (Supplement C) is used by the firm which must be submitted by each employee as of the 15th and last day of each month. This report must be submitted within three days after the close of the period. The form is set forth in the supplements as Exhibit F.

Preparation of Time Reports

It will be the responsibility of the employee to divide the scheduled working hours during the period covered by the time report into the following categories:

1. Chargeable hours.
2. Administrative time (normally incurred by certain office employees, review and audit staff supervisors).
3. Travel time — if such travel unavoidably occurred during the normal work

day. Travel during working hours is ordinarily discouraged unless absolutely necessary. (Time spent by an employee traveling to a client's office either before or after the normal work day is not chargeable to the client and may not be shown on the time report. Such travel time is a normally accepted aspect of our professional activity in the service of clients, and is no more chargeable to such clients than the time necessarily spent in traveling back and forth from individual staff members' homes to the office).

4. Time off or illness.
5. Unassigned time.

In all cases the reported hours should aggregate a minimum of eight hours per working day during the period covered by the report.

Review of Time Reports by Staff Supervisors

All time reports should be reviewed monthly by the manager or managing partner of the office. In those offices, however, where other departmental supervisory positions are established, the review of time reports should be delegated as follows:

1. *Office Staff* — time reports of all office employees shall be reviewed semi-monthly by the office manager.
2. *Tax staff* — time reports of all tax staff employees shall be reviewed by the tax staff supervisor.
3. *Audit staff* — time reports of all audit staff personnel shall be reviewed by the audit staff supervisor.
4. *Special services staff* — time reports of all special services personnel shall be reviewed by the in-charge partner of this department.

Office Review

The time reports also will be reviewed for completeness and accuracy by the office manager before being posted to the clients' accounts.

Section XII — PAYROLL PROCEDURES

Payroll Periods

There are two payroll periods a month. The first period runs from the first day to the 15th day of the month inclusive; the second payroll period runs from the 16th day to the last day of the month inclusive. All office and staff employees will be paid on the 15th and last day of the month for the period ending on that date.

Preparation and Distribution of Payroll Checks

The office will prepare the payroll checks in accordance with the established detailed procedures. The checks will be distributed to all employees in the office on the morning of the 15th and last days of the month. Those employees not in the office on payroll days should leave instructions with the office manager for the handling of their payroll checks.

Salary Advances

The office manager has authority to approve salary advances of \$10 or less, but is instructed to report all such advances to the managing partner. Any such advances to an employee should be repaid on or before the end of the payroll period during which the advance has been made or will automatically be deducted from the employee's payroll check. For a discussion of advances or loans in excess of \$10, reference is made to Section XIV of this Manual.

Section XIII — EMPLOYMENT OF PERSONNEL FOR CLIENTS**General Statement of Policy**

It is the policy of the firm, when requested, to assist clients in obtaining qualified personnel if the position is connected with the accounting department. The basic objectives should be to fill all openings within clients' organizations with individuals who are, or should be, friendly to the firm. The first consideration should be given to any staff man who might be suitable for the position and who has indicated a definite desire to leave the public accounting profession.

Office Procedure**Accumulation of Information**

The audit staff supervisor (or other designated person) has the responsibility of functioning as a clearing point for all information pertaining to job openings with clients and all individuals desiring positions in private industry, including staff accountants presently employed with our firm. All requests from clients for assistance in filling openings in their organization should be the subject matter of a memorandum by the partner in charge, outlining the nature of the position to be filled as well as the salary range applicable thereto. The memorandum should be addressed to the audit staff supervisor. Similarly, if a partner has knowledge of an accountant other than an employee of the firm who is interested in securing another position, a memorandum should be written outlining the individual's qualifications. This memorandum should also be addressed to the audit staff supervisor.

Preparation of Monthly Report

From the information outlined in the preceding paragraph, the audit staff supervisor will prepare a monthly report which indicates the jobs available, applicants available and positions filled as of the last day of each calendar month. This report should be distributed to each partner not later than the fifth day of the following month.

Specific Openings with Clients

On occasion, a client will ask us to obtain suitable candidates for a particular position and will rely on us exclusively to fill the vacancy. The audit staff supervisor should then arrange for appropriate advertisements as well as contacts with agencies, should screen the applicants in the first instance and thereafter should arrange with the partner in charge of the particular matter for a final review of the selected applicants. He also should see that the existence of the opening is brought to the attention of any present staff members who might be interested and qualified. Wherever possible, the firm should not be placed in the position of recommending one man to the exclusion of all other applicants. It is highly desirable to submit three or four capable men to the client, and permit the client to make the final decision.

Section XIV — GENERAL***Births, Deaths and Illness***

In case one of the firm's accountants becomes a father, whether by birth or adoption, a gift of an \$18.75 Savings Bond is made in the name of the partners to that child. In addition, the partners will send flowers to the mother, it being believed that about \$10 to \$15 would be adequate for this purpose.

The marriage of an employee should be brought to the attention of the manager or the managing partner and an appropriate gift will be given.

In the event of a death in the immediate family of an employee, child, parent, or in exceptional cases a brother or sister, the partners of the firm will send a spray of flowers costing about \$15.

In the case of a death in the immediate family of any employee, as defined above, it should be mandatory that one of the members of the firm represent the partners in paying their respects. The audit staff supervisor should follow through on this.

If an employee is hospitalized for over one week, or is ill at home over two weeks, the firm will send some token of candy, flowers, a book or fruit, depending upon the circumstances. However, each situation should be considered separately.

Collections of funds from employees to purchase gifts or tokens in these instances as well as in all other cases are forbidden. Such collections, ostensibly voluntary, can easily lose such voluntary character. They therefore impose a burden on certain employees. Despite the spirit of good will indicated by the instigators of such collections, the firm has found it necessary to make this prohibition in fairness to all.

Commissions on New Business

It is the firm's policy to pay staff members supplemental compensation in the nature of a fee for securing new clients.

The following are the standards which apply relative to the payment of such fees.

1. The new client should be secured solely as a result of the employee's efforts.
2. The job must earn the regular charged time rates.
3. It must be understood in writing that the firm is thereby purchasing the client and that the employee will not take the client with him if he leaves the employ of the firm.
4. The amount of such commission is subject to negotiation, but must not exceed 15% of the gross fees received annually from the client and must not be payable for a period in excess of five years.

Employees' Loans

The firm is not in a position to grant loans to employees; however, a working arrangement has been established with a local bank whereby loans may be secured for established employees for meritorious purposes. All such loans must be subject to the discretion of the partner or manager of the office. The size and duration of the loan will be determined by the employee's ability to repay the monies borrowed as well as the purpose thereof. The loans are guaranteed by the firm.

Grading of Certified Public Accountants' Examination Papers

If requested in a particular state the firm will give the State Board of Accountancy assistance in grading the papers of the May and November examinations. The man assigned to the grading panel must be certified and should indicate on his time report the nature of the work performed. The amount of compensation received for grading will be treated as income to the firm.

Special Relations with Clients

1. Any gifts tendered by a client to an employee must be rejected unless of nominal value; any offers of gifts must be reported to the partner in charge of the client.
2. Receipt of an invitation to any client's social function must be cleared in advance with the partner in charge of the client.
3. No purchases are to be made by an employee in a client's office unless specific approval has been received in advance from the partner in charge of the client.

*Supplement A***SALARY RATE SCHEDULES****(In Effect on April 1, 1952)****Tax and Audit Staff Accountants**

Supervisor	\$550 to \$750 per month
Supervising Senior	475 to 545
Senior — Grade A	425 to 470
Senior — Grade B	375 to 420
Semi-Senior	300 to 370
Junior Accountant — Grade A	275 to 295
Junior Accountant — Grade B	250 to 270
Junior Accountant — Grade C	225 to 245

Office Manager	300 to 400
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Office Employees

Grade A	255 to 325
Grade B	230 to 250
Grade C	205 to 225
Grade D	150 to 200

*Supplement D***APPLICATION BLANK**

Complete in your
own handwriting
using ink

(NAME OF COMPANY)

Application for Position as _____ Date _____

NAME _____
(Please print name) (Last) (First) (Middle)

ADDRESS _____ City _____ Telephone Number _____

Have you ever applied to this firm for a position _____ Date _____

Who referred you to this firm _____

Date of birth _____ Place of birth _____ U. S. Citizen _____

Age _____ Height _____ Weight _____ Physical Defects _____

Married () Single () Separated () Divorced () Widowed ()

Dependents, number and relationship _____

In case of accident notify _____

Time lost through illness during last two years _____

Draft Status _____ Social Security No. _____

Father's name _____ Father's nationality _____

Mother's name _____ Mother's nationality _____

Father's occupation _____

References - other than relatives (name three)

Name	Address	Occupation

(over)

Supplement D (cont'd)

Education	Years	Name and Location of School	Course of Study	Degree
High				
College				
Business				
Other				

EXPERIENCE

Give complete record of all employment you have had. Record most recent position first and work back. May we write to your present employer? _____

Dates of Employment (Month & Year)	Name and Address of Employer	Annual Salary	Description
From _____	Name _____	Final _____	Duties _____
	Address _____		_____
To _____	Immediate Supervisor _____	Start _____	Reason for leaving _____
From _____	Name _____	Final _____	Duties _____
	Address _____		_____
To _____	Immediate Supervisor _____	Start _____	Reason for leaving _____
From _____	Name _____	Final _____	Duties _____
	Address _____		_____
To _____	Immediate Supervisor _____	Start _____	Reason for leaving _____
From _____	Name _____	Final _____	Duties _____
	Address _____		_____
To _____	Immediate Supervisor _____	Start _____	Reason for leaving _____

Do you have a C.P.A. certificate _____ Date obtained _____

State in which taken _____ Written examination _____

I affirm that all of the information I have set forth in this application is true to the best of my knowledge and belief.

Signature in full

Remarks _____

*Supplement E***EMPLOYMENT CONTRACT A**

This contract is made and agreed to this..... day of
A. D..... by and between (Name of Company), Certified Public Accountants, of (city), (state), a copartnership, hereinafter called the company, and, hereinafter called the employee. In consideration of the mutual covenants herein set forth, the company hereby employs the employee upon the following terms and conditions:

1. The company will pay the employee a salary of \$ (.....) per month, payable in equal semimonthly installments during the period of actual employment and only during that period in which services are actually rendered.

2. The employee agrees to work for the company in the classification of a and to render satisfactory services within the customary meaning of that term, and further agrees to devote his full time to such employment. Full time shall be defined to mean the regularly established working hours of the company, plus such reasonable overtime as the requirements of the company and the servicing of its clients dictate, consistent with the usual service standards of the accounting profession and of the company.

3. The employee shall not undertake any work as tax consultant, accountant, auditor or bookkeeper, directly or indirectly, for any person, firm or corporation so long as he is in the employ of the company, nor shall he maintain any office facilities other than those furnished to him by the company. He shall, however, refer to the company any work of said nature which may come to his attention or under his control, but the company shall have the right to accept or reject such work within its sole discretion.

4. It is understood and agreed that when and as the abilities demonstrated by the employee shall so warrant, in the judgment of the company, he shall be advanced in position and duties to a position bearing a higher rate of compensation, notwithstanding the provisions of paragraph (1) hereof. Any such change in classification or compensation shall not affect the other provisions and restrictions in this agreement.

5. The employee hereby agrees that for a period of three years after the termination of his employment by the company, either voluntary or involuntary, he will not on either his own account or as a member of a firm, or on behalf of another employer, or otherwise, directly or indirectly, work as a tax consultant, accountant, auditor or bookkeeper for or solicit such business from, any client of the company.

6. Both parties hereby agree that this contract shall continue for one year from the date executed, and from year to year thereafter, it also being understood that the term of employment may be terminated by either party at the end of any month during the first or any succeeding year by giving to the other party adequate oral or written notice. Adequate notice shall be defined as notice of one calendar week during the first six months of the contract and two calendar weeks thereafter.

7. The employee further agrees that for a period of two years after the termination of his employment under the provisions of this contract he will not

employ nor offer to employ nor solicit employment of any employee of the company.

8. In the event that the employee violates the terms of any part of this agreement, the company shall have the right to apply to any court or competent jurisdiction for an injunction restraining the employee from further violation. The employee further agrees that he will pay on demand to the company as liquidated damages for any violation of paragraph (5) of this agreement a sum equivalent to the fees charged by the company in the preceding twelve months to the client or clients for whom any work was done or solicited.

9. The employee agrees that his right of termination as set forth in Article (6) shall be effective only during the period April 1 to October 31, inclusive, of each calendar year.

WITNESSETH the hands and seals of the parties hereto the day and year above written.

(Name of Company) (SEAL)

By_____Partner

_____(SEAL)
(the Employee)

WITNESS:

(Name)

(Address)

(Name)

(Address)

Supplement F
EMPLOYMENT CONTRACT B

This contract is made and agreed to this.....day of
A. D..... by and between (Name of Company), Certified Public Accountants, of....., a copartnership, hereinafter called the company, and, hereinafter called the employee. In consideration of the mutual covenants herein set forth, the company hereby employs the employee upon the following terms and conditions:

1. The company will pay the employee a salary of \$.....per month, payable in equal semimonthly installments, it being understood that this salary represents a regular rate of pay of.....cents per hour for each forty hours worked in each workweek and a rate of.....cents for all hours worked in excess of forty but not to exceed..... hours in each workweek and that the company guarantees to the employee this pay for the above-named..... hours in each workweek during which the employee actually renders services or has time off in accordance with the provisions of article 2, even if in any one workweek the employee should work less than the said.....hours. In case the employee should work, in any one workweek, in excess of.....hours, any such excess will be paid to him at $1\frac{1}{2}$ times his regular rate or..... cents per hour, which excess will be paid simultaneously with his regular pay at the end of the month following the rendition of services in excess of..... hours per week.

2. The employee agrees to work for the company in the classification of and to render satisfactory services within the customary meaning of that term, and further agrees to devote his full time to such employment. Full time shall be defined to mean the established working hours of the company, to the exclusion of other business activity, plus such reasonable overtime as the requirements of the company and the servicing of its clients dictate, consistent with the usual service standards of the accounting profession and of the company; provided, however, that during any calendar year the employee shall not be required to devote more than 2,024 working hours, less any allowable vacation time. In the event the employee is not employed by the company during the entire calendar year, he shall not be required to devote more than such number of working hours (on the basis of 2,024 per year less any allowable vacation time) as corresponds pro rata to the portion of the calendar year during which the employee was actually employed by the company. To effect these provisions by which the employee is not required to devote more than 2,024 hours per year (or such applicable portion thereof) less any vacation time, the company may give the employee time off at any time. For any time worked by the employee in excess of the 2,024 hours (or applicable portion thereof) less allowable vacation, and for which no time off is given, the employee will be paid at least $1\frac{1}{2}$ times his regular rate, and such amount will be paid within a reasonable time, not to exceed three months, following the end of the calendar year during which such excess hours were worked.

3. The employee shall not undertake any work as tax consultant, accountant, auditor or bookkeeper, directly or indirectly, for any person, firm or corporation so long as he is in the employ of the company, nor shall he maintain any office facilities other than those furnished to him by the company. He shall, however, refer to the company any work of said nature which may come to his attention or under his control, but the company shall have the right to accept or reject such work within its sole discretion.

4. It is understood and agreed that when and as the abilities demonstrated by the employee shall so warrant, in the judgment of the company, he shall be advanced in position and duties to a position bearing a higher rate of compensation, notwithstanding the provisions of paragraph (1) hereof. Any such change in classification or compensation shall not affect the other provisions and restrictions in this agreement.

5. The employee hereby agrees that for a period of three years after the termination of his employment by the company, either voluntary or involuntary, he will not on either his own account or as a member of a firm, or on behalf of another employer, or otherwise, directly or indirectly, work as a tax consultant, accountant, auditor or bookkeeper for or solicit such business from, any client of the company.

6. Both parties hereby agree that this contract shall continue for one year from the date executed, and from year to year thereafter, it also being understood that the term of employment may be terminated by either party at the end of any month during the first or any succeeding year by giving to the other party adequate oral or written notice. Adequate notice shall be defined as notice of one calendar week during the first six months of the contract and two calendar weeks thereafter.

7. The employee further agrees that for a period of two years after the termination of his employment under the provisions of this contract he will not employ nor offer to employ nor solicit employment of any employee of the company.

8. In the event that the employee violates the terms of any part of this agreement, the company shall have the right to apply to any court or competent jurisdiction for an injunction restraining the employee from further violation. The employee further agrees that he will pay on demand to the company as liquidated damages for any violation of paragraph (5) of this agreement a sum equivalent to the fees charged by the company in the preceding twelve months to the client or clients for whom any work was done or solicited.

9. The employee agrees that his right of termination as set forth in Article (6) shall be effective only during the period April 1 to October 31, inclusive, of each calendar year.

WITNESSETH the hands and seals of the parties hereto the day and year above written.

(Name of Company) (SEAL)

By _____ Partner

(the Employee) (SEAL)

WITNESS:

(Name)

(Address)

(Name)

(Address)

*Supplement G***WAGE AUTHORIZATION FORM**

(Name of Company)

**AUTHORIZATION FOR
CHANGE IN PAYROLL STATUS**

Date_____

Payroll Department:

Please change your payroll records as indicated below:

Employee_____ Effective Date_____

() Add to payroll Rate_____

Classification_____

() Increase salary From_____ To_____

() Increase charge time rate From_____ To_____

() Change in classification From_____ To_____

() Terminate Final check to include_____

Date

Remarks:

Authorized By_____
Approved (Partner)

Entered on Payroll records by_____ Date_____

Appendix C

STAFF MANUAL



**An Example of a Staff Manual Used for Staff
Instructions and Guidance. . . .**

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STAFF MANUAL

(A major portion of the staff manual of a large, national firm of certified public accountants is reproduced on the following pages as a good example of such a manual given to staff employees. It should serve to suggest the nature of items which may be covered appropriately in such a publication and, with suitable modifications, may aid other firms in the preparation of their own manuals.)

The purpose of this manual is to provide staff members with standards of conduct and suggestions which the firm considers necessary or desirable that its representatives follow. These standards and suggestions are the result of many years of experience in dealing with situations encountered in the conduct of the firm's work. The firm recognizes that all possible circumstances cannot be foreseen, and the manual purposely is flexible and therefore adaptable to unusual circumstances. Constructive suggestions for its improvement are always welcomed.

This manual does not outline auditing procedures or accounting methods. It deals with office routines and like matters and is for the information and guidance of members of our staff.

The firm would like to have each staff member become imbued with the spirit and ideals of the firm so that he will approach his work with a keen sense of responsibility for the tasks entrusted to him.

(A brief reference to the history of the firm is included at this point.)

Staff members should read the "Rules of Professional Conduct" promulgated by the American Institute of Accountants and consider them the general expression of the firm in respect of all matters therein contained. (Editor's Note: These rules are reprinted in Appendix B to Chapter 5 of this Handbook.)

Personal Conduct

Contact with Clients

Each member of the staff is a representative of the firm. It is important that his contacts with clients and business associates be such as will reflect credit on the firm. Many things, such as personal appearance, habits, behavior, attitude toward clients and employees, et cetera, help to form the impression made upon clients and others. Care should be exercised to avoid anything which may create an unfavorable impression.

Any staff member who is related to a client or to an officer or an employee having a responsible position in a client's organization must bring such fact to the attention of our personnel manager upon being advised of assignment to such a client.

It is desirable that staff members do not become intimate with clients and their employees. The attitude toward both should be one of dignified friendliness and relations should not be such as to be the cause of embarrassment.

Clients and their employees should not be antagonized. They should be accorded courteous, dignified treatment under all circumstances. Staff members should maintain their equanimity and dignity at all times. In the event of unpleasant developments or disagreements with a client, the incident should be reported immediately to the supervisor or partner in charge.

Confidential Matters

Discussion by staff members of the details of an examination should not be held within hearing of the client or his employees. The business of the firm must not be discussed with outsiders nor in public places with other employees of the firm.

The work of the public accountant relates to the affairs of others. Therefore, all matters becoming known to a staff member through his work for clients must be held in strict confidence. A client's affairs must not be discussed with a client's employees except by instruction of the client. Any request on the part of a client for information as to the scope of the examination or with respect to the contents of our working papers should be referred to the supervisor or senior in charge. Staff members must not discuss their work nor any feature of it with anyone except members of our organization. This rule prohibits such discussion with members of your family, close friends or others. Discussion of a client's affairs with other staff members should be limited to those currently engaged upon the work.

Financial Transactions with Clients

Money or gratuities must not be accepted from clients and any such offers must be reported promptly to the firm. Personal checks must not be cashed at clients' offices. Money must not be borrowed from or other debts contracted with clients or their employees.

Personal Investments

No member of our organization shall own or acquire any securities issued by, or have any financial interest in, a client whose balance sheet or affairs he examines while in our employ.

Relations of Supervisors, Seniors and Assistants

The supervisor in charge is responsible for the proper conduct of the examination and the preparation of the report and the senior in direct charge of the engagement is specifically responsible for the work done on the engagement. The senior will determine the work to be done by each assistant giving due consideration to the accounting ability and capacity of the assistant. He must have knowledge of the capabilities of the assistants assigned to him. If he has had no previous experience with

an assistant assigned to him, he should ascertain from the personnel department the assistant's qualifications. As much as possible of the detail work should be assigned to juniors. Every effort should be made to avoid using, on the routine and elementary phases of the work, men who are capable of more advanced work. All work of junior assistants must be reviewed carefully either by the senior in charge or by one of his senior assistants. Juniors should be questioned upon all phases of the work they performed immediately upon its completion.

If the personnel assigned to an engagement is not suitable for handling the work in a capable and economical manner, it is the duty of the supervisor or senior in charge to report the condition promptly to the personnel department. If such condition is not corrected promptly, the supervisor or senior should inform the partner in charge of the engagement.

Assistants should not undertake work which they do not thoroughly comprehend. If they do not understand the character and purpose of the work assigned to them, they should have the instructions clarified before proceeding with the work. It is expected that assistants will give loyal co-operation and support to supervisors and seniors and that supervisors and seniors will do everything practicable to aid assistants in increasing their knowledge and skill.

No Outside Work

Experience has shown that to render the most effective service to clients, staff members must give their exclusive attention to the work of the firm. Accordingly they are not permitted to solicit or to undertake any accounting work for their own account.

Use of Personal Automobile

The use of a staff member's car on business of the firm should be limited to occasions when it would be impracticable to use other means of transportation. See section on Automobile Transportation concerning reimbursement for use of personal automobile.

Smoking

Judgment should be exercised with reference to smoking in the office of any client. Rules of the client regarding smoking should be observed.

Criticism

The clientele, work, fees or characteristics of other public accountants should not be commented upon, criticized nor discussed with clients or clients' employees.

Staff members should not criticize a client's accounting system or discuss it with the client or his employees unless authorized to do so by a partner

or supervisor. Criticisms or suggestions of staff members concerning a client's accounting system should be reported to the senior in charge for his consideration.

Offer of Employment

Staff members must not solicit clients for employment. If a staff member is approached by a client with an offer of employment, the matter should be discussed promptly with the firm. The firm is pleased when an opportunity for advancement comes to any member of its staff and will gladly discuss questions of this kind with the staff member, giving due consideration to his best interest. Staff members must not discuss with a client or a client's employees such matters as the length of time he has been with the firm or the amount of his compensation.

Articles Written for Publication

The firm encourages the writing of articles for publication in accounting and other periodicals. Such articles usually indicate the firm connection of the writer. Embarrassment to the firm or to the staff member may result from the publication of articles prepared by a staff member which express views or conclusions differing from those held by the firm.

The firm, therefore, requires that any article prepared for publication by a staff member on the subjects of taxes, auditing or accounting be submitted to the firm for its review and approval before submission to a publisher.

Professional Work

Quality of Work

The firm requires each staff member to safeguard the firm's interests and to perform in an intelligent and creditable manner all work assigned to him. No assignment should be considered unimportant or unworthy of his best efforts. Important discoveries are frequently the result of intelligent and painstaking attention to matters of seemingly minor importance. The responsibility of a staff member is not fulfilled simply by seeing that the results of his work are set forth in his oral and written reports. He is responsible for carrying on the work as expeditiously as possible so that the cost will be kept within reasonable limits. The supervisor or the senior in charge should not permit any conditions to continue which operate to prolong the work unduly or bring discredit upon the staff or the firm.

Audit Programs

An audit program approved by a partner exists for each recurring engagement. Based upon our review of the system of internal control and accounting procedures, the supervisor should give consideration to the

adequacy of the program in the light of existing conditions. Changes in programs should be made only after consultation with and approval by a partner.

In undertaking work upon a new engagement, the partner in charge, together with the supervisor, will determine the scope of the examination to be made. If the engagement is expected to recur, a permanent binder and audit program should be prepared. If it is of a special nature and not recurring, a schedule should be prepared indicating the scope of the engagement and the work done. The notation at the head of each audit program, relative to changes in programs as required by circumstances, should receive careful consideration. Suggestions as to the best procedure is invited and no work should be undertaken without understanding the instructions and the reasons for them. If, in the judgment of a staff member, it appears desirable to do more or less than specified in the audit program, the staff member should submit the question through proper channels to the supervisor. The partner in charge must be consulted regarding important features developed during the progress of the work.

Working Papers

Every staff member should become thoroughly familiar with the contents of the latest firm bulletins concerning engagements, audit programs, working papers, and so forth.

Assistance from Clients' Employees

Clients should be urged to have employees assist us by locating and arranging documents, papers, et cetera, as requested and by preparing for our use those schedules which can be checked by us to determine their accuracy. Clients' employees should not have access to our working papers and should not be informed of the progress or extent of the examination.

If the client's employees delay our work by negligence or deliberate failure to provide required information, relief usually can be obtained by discussing the matter with officials of the client. In the event of delay or failure to secure desired information we will be considered at fault if we have not sought remedy from the proper person in the client's organization.

Report Progress of Work

The supervisor in charge should be kept informed of the progress of the work. Work which ordinarily would be done by client's employees should not be undertaken by us without approval of the supervisor or partner in charge. The senior in charge of the engagement is required to report promptly to the supervisor in writing, any factors which affect the scope of the work or prolong the examination beyond the time anticipated.

The following factors are listed as examples of matters which should be so reported:

- Requests by the client for additional services (including current work).
- Instructions to client's employees at client's request.
- Accounts not ready for examination.
- Checks, vouchers, or other required papers badly filed.
- Material delay in securing data.

If satisfactory progress cannot be made because of lack of co-operation inadequate records or unsatisfactory working conditions, the firm should be advised promptly. Excuses for delay will not be accepted by the firm unless it has been advised previously of the existence of unsatisfactory conditions.

Prospective Clients or Additional Work for Clients

Staff members should not agree to proceed with work for a prospective client unless approval of a partner is first obtained or to do work in addition to that for which arrangements were made with the firm unless approval of a supervisor is first obtained.

Excessive Time

The supervisor should note carefully the amount of time estimated, or required on past examinations, and if such time is likely to be exceeded in the current engagement, the partner in charge should be notified at once.

Reports Ready for Review

The supervisor and partner should be informed, in advance, when reports will be ready for review so that reviews may be made promptly.

Assignments

All matters relating to assignments must be taken up with the personnel department. Any assignments made by partners should be reported immediately by staff members to the personnel department.

Assignment data requests, indicating the number of assistants needed and the approximate period each assistant will be required, should be prepared by the supervisor and submitted to the personnel department at the time the engagement memorandum is prepared. If it later develops that the engagement will extend beyond the estimated period the personnel department should be notified of such change without delay. This department also must be notified of the availability of a staff member not later than the day before releasing him from an engagement. This rule serves to facilitate assignment to other work. The senior in charge of the work is responsible for this notification, but it is the duty of the assistant to call the matter to the senior's attention.

In the event that a client's office is to be closed for any reason (except holidays observed by the firm) the personnel department should be informed as early as possible so that, if practicable, other work may be arranged for that day.

When staff members are unable to report at the office, or at the client's office, by reason of illness or other cause, they should notify the office by telephone or telegraph, so that the client may be notified. Should staff members be on out-of-town engagements, the client's office should be notified directly in addition to notifying the personnel department.

When staff members are to report to the office for reassignment on the next working day, and have not received an assignment, they should not leave the client's office before the firm's regular closing hours without communicating with the personnel department. It is often necessary, at the very close of the working day, to communicate with staff members regarding their next assignment.

All staff members reported by a senior as available for a new assignment on a certain day should be released on schedule unless previous to that day other arrangements are made with the personnel department. To enable us to start engagements promptly as scheduled, strict adherence to the above rule is necessary.

Keep in Touch with Office

Staff members must keep the office informed of their whereabouts during business hours. Upon leaving the office they should advise the telephone operator where they may be reached during their absence from the office. If working at a location more than one mail day distant, notify the office by telegraph of any change in location.

Staff members assigned to out-of-town engagements should inform the office of the name of the hotel at which they plan to stop. If subsequently a change is made, the office should be informed immediately by telegraph.

Staff members should notify the office promptly of any change of home address or telephone number. In the absence of a telephone the nearest pay station or private telephone from which he may be called should be furnished to the personnel department.

Receipt of Clients' Records

Books, checks or other papers, the property of clients, should not be taken from clients' offices without consent of clients. Such papers should be kept in a separate envelope marked, "To be returned to Mr." The file department must be advised immediately when a client's records are brought into our office and when returned to the client so that appropriate notation of their receipt and return can be made. Such records, when returned, should be accompanied by a letter. A punctilious regard for the client's property will maintain his respect for our business methods.

Keys or other articles borrowed from clients should be returned promptly when no longer required.

Care of Clients' Records

Books and papers of clients should not be disfigured in any way, and, to this end, all check marks made on the books should be small and neat, but not obscure. Notations should not be made on the books

Marking or Stamping Records

Do not mark or stamp over the figures or reading matter on checks, vouchers and invoices. Particular care should be taken to keep vouchers and other papers in their regular order and to return them to their proper places in the files, et cetera.

Care of Working Papers

The senior in charge is responsible for the proper care of all working papers, et cetera, during the course of the engagement. Working papers must be kept in possession of a staff member. They should be securely locked up whenever they are out of his possession. Brief cases, et cetera, containing working papers should be placed in the client's safe, vault or other fireproof compartment each night and over week ends. In certain instances it may be desirable that working papers be in the possession of the senior at all times and not kept in the client's safe overnight.

Work Suspended

Occasionally it becomes necessary to suspend work upon an engagement. In such instances working papers should be suitably indexed or marked and placed in the custody of the file department, or placed in the bag vault, to facilitate continuing the work in the absence of the men originally assigned to the engagement. Working papers must not be left at a client's office if work is suspended for an indefinite period.

Arrangements for Engagements

Supervisors are to make the arrangements for recurring engagements or bring to the attention of the partner in charge, engagements for which arrangements should be made by the partner. The arrangements for each engagement should be confirmed by letter and an engagement memorandum prepared for review and approval of a partner.

One engagement memorandum covering the work to be performed for each client should be prepared by the supervisor at least once each year. Separate engagement memoranda must be prepared to cover special engagements and work in addition to that contemplated in the engagement memorandum on file.

If an engagement requires work by any of our other offices, arrange-

ments should be made with such office as far as possible in advance of the starting date.

Interoffice Engagements

Instructions to other offices covering work for clients should be sent in duplicate well in advance of the examination date. These instructions should state clearly and definitely the scope of the examination and work to be performed by the other offices. The preceding year's working papers retained in our file should be forwarded under separate cover.

All reports, either in manuscript or draft form, and working papers covering the work which our office does for other offices should be sent to the other office only after review by a supervisor and after the letter of transmittal has been signed by a partner of this office.

Office Memoranda

An office memorandum must be prepared by staff members with respect to any important matters which should be called to the attention of a partner. Examples of such matters are:

1. Conferences with clients on significant accounting problems.
2. Conferences with representatives of the Bureau of Internal Revenue, with counsel, and with clients in regard to tax matters.
3. Conditions materially affecting the progress of an examination.

Frequently, telephone messages received in the office by a partner, supervisor or a senior must be passed along to other staff members on a particular assignment. If the other staff members cannot be communicated with promptly it generally will be found desirable to record the telephone message in an office memorandum directed to the interested personnel.

Reports

Draft Reports at Clients' Offices

All work on an engagement should be completed, as far as possible, at the office of the client: A client may not be aware of the time spent on an engagement if a considerable amount of work is done away from his office. Furthermore, it is frequently necessary to refer to the client's records while drafting the report and this is more expeditiously done if the report is prepared at the client's office.

Explicit Phraseology

Reports should be constructed to focus attention upon significant facts or conditions. Good English and clarity of expression are prime requisites. Worthwhile opinions or suggestions are essential. Make reports concise and explicit, and have in mind that the recipient may not be familiar with technical accounting terms.

Accuracy

Drafts of reports should not be prepared carelessly, relying upon the report department to detect and correct errors of spelling, grammar and arithmetic. An error in a subsidiary schedule has made necessary the retyping of many pages of a report and has caused expense and serious delay which the exercise of more care would have avoided.

Every staff member should become familiar with the latest firm bulletins relating to the preparation and typing of reports.

Approval for Typing

The report department will accept for typing only manuscripts which have been approved by a partner or supervisor. After typing is completed and compared, but before final review by a partner, the supervisor in charge of the engagement must read carefully the complete report or statement and indicate that he has made such review by initialing the office copy.

Published Statements

It is the policy of the firm to check the printers' proofs of all published statements bearing the firm name and to obtain copies of the reports published. The accountant in charge of each engagement in which the publication of statements is involved should refer to the latest firm bulletin concerning published reports.

Working Hours**The Working Day**

The office operates on a regular workweek of forty hours consisting of five days of $7\frac{1}{4}$ hours each and one day (Saturday) of $3\frac{3}{4}$ hours. Office hours are from 9:00 a.m. to 5:00 p.m. from Monday through Friday with an allowance of forty-five minutes for luncheon and on Saturdays from 9:00 a.m. to 12:45 p.m. without any time allowance for luncheon. It is important that staff members report punctually. When not assigned to work, attendance at the office is required unless definitely excused.

However, members of our organization are not required to report to the office on Saturdays or to work that day unless circumstances of an engagement require it. Staff members who desire to work at the office on Saturday should obtain a key for this purpose from the personnel manager. Arrangements for the procurement of supplies or working papers from the file room should be made on Friday. Partners will make themselves available at any time when necessary.

When engaged on work for clients outside the office of the firm, staff members should observe, within reason, the hours of the offices in which they are working. Whenever the client's office hours prevent a full working day being devoted to the work, staff members should charge $7\frac{1}{4}$ hours

and bring the matter to the attention of the partner in charge. However, the "time off" account and not the client should be charged for the time on Saturday mornings when no work is performed.

Traveling Time

Days spent in traveling, except Saturdays (after 12:45 p.m.), Sundays and holidays, should be charged to the client. In such cases, the time charged should be limited to the usual office hours. As much traveling as possible should be done at night but no charge should be made to the client for night traveling.

Overtime

Circumstances at times require the extension of our regular working day by an overtime period. The firm appreciates that staff members accept such situations as unavoidable. During winter months, especially, it is often necessary to work overtime, but every effort should be made to avoid unnecessary overtime work, and to keep overtime work within reasonable limits. Overtime work may be undertaken only upon approval of the senior in charge. The firm recognizes that the attempt to maintain the highly concentrated attention demanded by our work over unduly prolonged periods is likely to dull keenness of perception and places a severe physical strain upon staff members; hence demands from clients for excessive overtime work should be discouraged and discussed with a partner.

Vacations

Members of the staff who have been in the service of the firm for a year or more are entitled to two weeks' vacation each year at a time when their duties will permit. A three weeks' vacation is granted to staff members with more than five years' service and a month's vacation is granted to those with more than twenty-five years' service. Leaves of absence for military service may be included in computing firm service time. Permanent staff members who have been with the firm for less than one year will be entitled to one day's vacation for each month employed up to June 30. Additional vacation allowances will arise from overtime credits mentioned in the section on "Pay For Overtime." Requests for preferred vacation periods should be made prior to May 1 of each year.

Time Reports

Importance of Time Reports

Time reports and daily work analysis schedules constitute basic records upon which the firm in a variety of circumstances must depend. Both should be complete and clear so that reference to other sources for like information will not be necessary. Where there are subsidiary or other-

wise related companies or branches, state the hours devoted on work performed for each separate company or branch, giving the location.*

Time Recorded

Time should be charged in units of one-half hour except where one-quarter of an hour is necessary to complete charging a full $7\frac{1}{4}$ hours for each day. Time reports must be prepared to account for $7\frac{1}{4}$ hours for each working day (Saturday $3\frac{3}{4}$ hours). If work is required on other than an official working day, time reports should be prepared only for the time actually worked.

Classifications of Time

Staff members are required to comply strictly with the following time classifications:

1. Time on assignments for clients is to be charged to the client who is to be billed for services. Assistants should ascertain from the supervisor or the senior in charge of the engagement to whom the time should be charged. Our client is not always the company the records or statements of which we examine.
2. *Unassigned time.* This classification is to be used when staff members are awaiting assignment. It will be charged for work of a miscellaneous nature which members of the staff may be asked to do during such waiting time and which is not to be charged to a client or to some other account. It will also be charged for time spent in reviewing accounting and auditing pronouncements and tax and court decisions and rulings if such time is not properly chargeable to clients or research.
3. *Research.* This account will be charged for time spent on research or statistical work when authorized by a partner and when such time is for the benefit of all offices of the firm. Such work will include the compilation of data from published reports and the review of tax laws, decisions and rulings, when not made for the account of clients, but for the preparation of bulletins which are distributed to all offices. This account should also be charged for time spent on research, et cetera, in connection with meetings or conventions of national professional societies. Time reports charged to research must be approved by the partner who made the assignment.
4. *Publications.* Time devoted to the various publications of the firm should be charged to the separate account provided for each publication.
5. *Administration.* Members of the staff, except supervisors and members of the tax department, will rarely have occasion to use this account. Other members of the staff should charge time to this account only upon specific instructions of a partner or the personnel manager. This account also should be charged with time relating to participation in activities of chapters of local or state professional societies.
6. *Vacation.* This classification is to be used for absence from the office for the regular vacation period which is defined under the caption "vacation" in this manual.
7. *Holidays.* This classification is to be used for absence from the office on such public holidays as are recognized by the office, notification of which is posted

* Various other sections discussing in detail the manner of completion of the firm's various staff time reports and analyses, have been omitted from this appendix.

on the bulletin boards. Generally these are: New Year's Day, Lincoln's Birthday, Washington's Birthday, Decoration Day, Independence Day, Labor Day, Columbus Day, Thanksgiving Day and Christmas Day.

8. *Sick Time.* This classification is to be charged for absence from the office by reason of personal sickness.
9. *Lost Time.* This classification will be charged for absence due to illness in the immediate family and other involuntary reasons such as jury duty.
10. *Time Off.* This classification is to be charged for time taken off by members of the staff at the convenience of the firm.
11. *Training School.* Time spent by trainees while attending our training school will be charged to this account. Staff members will also charge this account for time devoted to the preparation of material and presentation of subjects at the training school.

Personnel Reports

Written personnel reports are prepared by supervisors concerning the abilities of seniors working under their direction. Similarly, seniors prepare such reports relative to the abilities of their assistants. These reports form the basis for assigning more responsible work to staff members who have shown the capacity to accept greater responsibility. The reports should be carefully prepared and returned to the personnel manager promptly.

Compensation *

Salaries

Salaries are paid on the 1st and 16th days of the month for the semi-monthly periods ending on the preceding days.

Salary Checks

If so requested, salary checks will be deposited by us in employees' bank accounts. Arrangements have been made for cashing salary checks at a nearby bank. Salary checks must not be cashed at a client's office.

Pay for Overtime

Overtime is paid only to those staff members who are subject to the provisions of the Fair Labor Standards Act. All time over forty hours per week, exclusive of "time off" and "lost time" (not "sick time") during that week, is credited at time and one-half. Such credit is reduced at straight time to the extent of "prepaid time," that is, the excess of "time off" in previous weeks over overtime credits. Any remaining net overtime is paid, on a regular pay date, to the end of the latest full week reported on the preceding semimonthly time report. Staff members who have more "time off" than overtime credits continue to receive full salary and

* Sections explaining the various group life, hospitalization and disability insurance benefits have been omitted from this appendix.

no overtime is paid until the overtime credits exceed all past "time off."

Staff members exempt from the provisions of the Fair Labor Standards Act are not paid overtime unless specific arrangements to the contrary are made at date of employment. However, for many years it has been the practice of the firm to grant time off based on overtime credits when staff members are not engaged on work for clients.

Salary Deductions

Federal insurance contributions, Federal income tax withholdings and state disability benefits law contributions are deducted from salaries in accordance with current laws.

Surety Bond

All employees are required to be bonded by a company selected by the firm and at the firm's expense.

Notice on Leaving

The notice required to be given, either by the firm or the employee, on the discontinuance of their relations will depend upon the arrangements mutually agreed upon, if any, when becoming employed.

Traveling Expenses

Out-of-Town Engagements

It is the desire of the firm that staff members shall travel and live while on out-of-town engagements in a manner befitting their professional standing and that they be reimbursed for business expenses actually incurred. At the same time, it is necessary that the expenses be kept at a minimum. Staff members should live comfortably without being extravagant. The personnel department will arrange for transportation and hotel reservations in advance, whenever practicable.

Air Transportation

The firm does not encourage the use of air transportation, nor does it discourage its use in such cases as it appears necessary or expedient. In any event, the firm will not require any staff member to use air transportation if he does not wish to do so.

Automobile Transportation

The mileage allowance for authorized use of personal automobiles by staff members on firm business is at the rate of eight cents per mile. Within cities, public travel facilities generally offer the most rapid and convenient transportation, and staff members should use their cars on firm business only when these facilities are inadequate. If a staff member

uses his car on firm business when other satisfactory means of transportation are available and a car is not required by the particular circumstances of an engagement, reimbursement will be limited to the amount of the rail or bus fare between the points involved.

Type of Expenses

The following list indicates the character of expenses for which reimbursement will be made:

Traveling:

- Fare (except when provided by the firm or the client).
- Sleeping and chair cars (one berth or seat).
- Transfers (personal baggage).
- Gratuities (porters in Pullman cars, hotels, et cetera).
- Mileage for personal automobile.

Subsistence:

- Rooms and meals (including gratuities).
- Laundry, clothes pressing, carfares, and such things as are usual to include in expenses, depending on locality and conditions.

Miscellaneous:

- Telegrams and telephone charges, relating to business matters.
- Postage.
- Other (to be itemized).

All traveling expenses are limited to reasonable amounts depending on locality and circumstances.

Rooms by the Week

Consideration should be given to the probable length of time that will be required to complete an engagement. When feasible, secure hotel accommodations by the week at reduced weekly rates. Week-end trips home are authorized when the related travel expense would not exceed subsistence for the week-end out of town.

Family Allowance

In lieu of reimbursement for actual cost of room and meals, a flat allowance may be granted to a staff member assigned to a lengthy out-of-town engagement if accompanied by members of his family. Such arrangements should be made with and approved by the partner in charge of the engagement.

Expenses, Government Work

Staff members assigned to engagements involving expenses for the account of any division of the government should inform themselves of the government regulations regarding expense allowances and vouchers.

Expense Reports**Expenses Out-of-Town**

Prior to departure on out-of-town engagements, staff members are furnished a cash fund for expenses. Such funds should be accounted for by expense reports, supported by receipted hotel bills and such other vouchers as are obtainable. All out-of-town expenses must be reported on the regular form provided for that purpose and must be approved by the supervisor or senior in charge of the engagement, if present at the location. A report of all expenses must be made promptly at the close of each engagement and where the engagement is of more than two weeks' duration, a report should be made at least weekly. Settlement for funds advanced must be made at the termination of each assignment. Any unexpended balance should not be carried forward and used for another assignment.

Expenses in Town

On all work in the city where the related expenses are of an incidental nature, application for reimbursement should be made on the petty cash expense form. Reimbursement for such expenses may be obtained from the cashier on presentation of a petty cash expense slip approved by the senior in charge of the engagement. An allowance of \$3.00 will be made for supper expense when it is necessary to work in a client's office or in our office ten hours or more a day. In the event it is necessary to work five hours or more on a Saturday, an allowance of \$1.50 will be granted for luncheon; on a Sunday or holiday such allowance will be \$3.00.

Equipment and Supplies**Equipment and Supplies Provided**

Portfolios, folders, working paper, pencils, erasers, et cetera, are provided for the use of staff members and may be obtained from the file department.

Keys

Office keys and portfolio keys will be issued to staff members at the discretion of the firm. Care should be taken to guard against loss of keys, and, upon leaving the employ of the firm, they must be returned to the personnel manager.

Brief Cases

Brief cases containing working papers and stationery supplies will be prepared in advance for each engagement and kept in the file room tagged with the name of the client and the senior in charge. Staff members should give the file department instructions in advance regarding the make-up of brief cases. Requests for additional supplies should be transmitted to the file department.

Brief cases are charged-out to the senior in charge of the engagement for which they are withdrawn. It is the responsibility of the senior to determine that brief cases are returned to the file department immediately upon completion of the engagements.

Transfer Cases

When completion of an examination or report is postponed, all papers should be transferred from brief cases to red manila envelopes. Return the brief cases to the file room and place the envelopes in the bag vault.

Bag Vault

The bag vault adjacent to the staff rooms is reserved for papers pertaining to uncompleted engagements. All brief cases, packages and special envelopes should be clearly marked with the names of the clients and the seniors in charge. Working papers to be filed, or clients' records to be returned, should not be retained in the vault after the work is completed.

Wasting Paper

Care should be taken not to waste paper. Do not use time reports, expense slips, nor ruled paper for rough calculations which are not to be retained as part of the working papers. Stationery should not be left behind at clients' offices. Unused stationery should be returned to the file room on completion of an engagement.

Machines

Adding and calculating machines, slide rules, et cetera, are provided for the use of staff members.

Library

The library is provided for the use and information of the staff. Books may be withdrawn upon application to the librarians (floor receptionists) and upon signing the card to be found in the envelope attached to the back cover. Books withdrawn must be returned to the librarian within a period of three weeks or be renewed at the end of that time.

Required Reading

The firm issues bulletins regarding audit procedure and tax matters to the staff from time to time. These bulletins must be read carefully and their instructions followed. Binders containing copies of bulletins previously issued are available in the library and in the file department.

Bulletins issued by the American Institute of Accountants and the Securities and Exchange Commission also should be read.

The firm has compiled a cumulative index of all the above bulletins which should be consulted as needed.

Mail and Telegraphic Communication

Address Mail to Firm

All communications pertaining to firm business should be addressed to the firm and not to individuals. In addressing mail to the firm do not write on the envelope anything indicative of its contents, as such indication may provide pertinent information to anyone seeking to tamper with the mail.

Subject Head

Correspondence with the firm concerning work in progress, et cetera, must contain the name of the client at the head of the letter.

Separate Letter for Each Client

In writing to the firm in regard to the affairs of more than one client, write a separate letter relative to each client.

Incoming Mail

To avoid delay due to absence of staff members, clients should be requested to address all correspondence pertaining to firm business to the firm and not to an individual. Mail bearing a client's name on the envelope or wrapper will be opened upon receipt and directed to a partner and then to a supervisor.

Outgoing Mail

All letters to clients, clients' employees or to other offices of the firm relating to the business of the firm must be written in name of the firm.

All Mail Approved and Signed by Firm

No letters relating to the business of the firm may be sent out without first having been submitted to a partner for approval and signature.

Firm Stationery

Firm stationery may not be used for any letter not relating to the business of the firm.

Telephone Calls

Personal telephone calls should be kept at a minimum. Incoming calls other than in relation to the business of the firm should be discouraged. A client's telephone should never be used for personal calls except in an emergency. If it is necessary to make a long distance call from a client's

office on matters not connected with our work for that client, the staff member must ascertain the cost of the call and pay for it at the time. The name, address, or telephone number of a client must not be disclosed to friends or others outside the office. Should it become necessary for relatives or friends to communicate with a member of the staff, the office of the firm is to be called, and not that of the client.

Mailing List

The report department maintains records for the proper addressing of correspondence to clients. This record is kept up to date principally through the data furnished by staff members on the "Mailing List" form. The form is furnished by the file department.

If significant changes in a client's personnel or changes in address, corporate name, et cetera, come to the attention of a staff member, he must prepare an "Amendment to Engagement Memorandum" or a revised "Mailing List" form immediately.

It is very important that the mailing list be revised currently and, to accomplish this objective, the full co-operation of the staff in reporting changes is required.

Files**Correspondence**

The file department maintains files of the firm's correspondence with each client. The files, which may be obtained by staff members by calling at the file department, must be returned to that department at the close of each day and must never be removed from the office of the firm.

Reports and Tax Returns

"Blue" office copies of reports and office copies of tax returns may be obtained from the file department upon request. They must not be removed from the office of the firm except in special cases and then only when sanctioned by a partner.

"Yellow" office copies of reports or of schedules accompanying tax returns are also kept in the file department. They may be used or cut up to facilitate the preparation of reports and tax returns for the next engagement for the client.

Miscellaneous

The file department maintains files of working papers, claims for refund, Treasury Department documents and briefs for each client. Only the working papers may be removed from the office.

Appendix D

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(See also "general Reference Books" in bibliography of basic books on personnel as given at end of Chapter 7)

CHAPTER 10

STAFF COMPENSATION AND UTILIZATION

STATEMENT OF SCOPE

STAFF REQUIREMENTS

Preliminary Requisites. Seasonal Problems (Peak Season Remedies; Slack Season Remedies).

STAFF COMPENSATION

Compensation Plans in General. Basic Compensation (Salary Rates and Ranges; Overtime Payments; Bonus Plans; Profit-Sharing Plans). Fringe Compensation (Pensions and Retirement Plans; Vacation Provisions; Protection Against Incapacity or Death; Group Insurance; Welfare Programs; Library Facilities; Salary Advances and Loans; Medical Service; House Organs). Advancement (Basic Policy; Timing; Uneven Progress; Obtaining CPA Certificate; Outside Sources; Personal Considerations; Placing Released Personnel; Hiring of Staff Members by Client; Rehiring Former Personnel; Filling Vacancies from Staff; Frequency and Rate of Salary Increase; Length of Service in Grade).

STAFF UTILIZATION

Working Schedules (Overtime; Slack Periods). Responsibility for Assignments (Factor in Assigning Staff Members). Scheduling Work for Completion (Transfer of Personnel Before Completion). Delays. Audit Programs. Time Estimates. Women Accountants.

APPENDIX

List of Firms with Fiscal Years other than Calendar Year.

CHAPTER 10

Staff Compensation and Utilization

BY A. STANLEY HARMON

Statement of Scope

EVERY ACCOUNTING FIRM has its own special problems with respect to staff compensation and utilization. However, there are general principles and practices which are broadly applicable and without careful consideration of which no firm can hope to solve its own problems successfully.

It is the purpose of this chapter to discuss the application of these principles and practices as definitely as possible to certain particular needs of the special field of public accounting. Their exposition rests primarily upon information from three sources. One is the personal experience of the author in public practice over an appreciable period. Another is the information contributed by thoughtful members of the profession in their writings on the many aspects of the subject. The third comprises the results of a survey conducted late in 1951 by the American Institute of Accountants.

The Institute survey questionnaire was sent to a large number of representative firms throughout the country. To insure that responses would reflect differences as to small, medium-sized and large organizations, questionnaires were sent to a representative number of firms in each classification. For purposes of comparison, classifications were fixed as follows:

<i>Firm Size</i>	<i>Staff Personnel</i>
Small	1 to 15, inclusive
Medium	16 to 35, inclusive
Large	Over 35

In each instance, partners were counted as staff personnel. In the small firm group an adequate number of sole proprietorships was included.

STAFF REQUIREMENTS

Preliminary Requisites

Fundamentally, staff needs depend upon two factors. How much work can reasonably be estimated as in hand or in prospect? What is the nature of the work? The answers to these questions almost automatically reveal

what grades of personnel are needed and the number of individuals in each classification.

Before the required personnel can be utilized, certain important preliminary steps must be taken. The personnel must first be secured and terms of compensation arranged. Selection and classification of staff employees to render professional accounting services are now subject to very carefully defined procedures. Both are outside the scope of this chapter. Chapter 9 covers staff selection and training, Chapter 26 defines and discusses the duties of junior accountants and Chapter 27 does likewise as to senior accountants.

Seasonal Problems

A particular condition has long existed that has made it very difficult for accounting firms to organize their arrangements as to compensation and utilization of staff members along regular and permanent lines. Twice a year they have been confronted with end-of-year and midyear peaks of business and in the intervals between these there are severe recessions from a normal tempo. During the rush periods it has been common not only to have permanent personnel work many extra hours under pressure but also to employ temporary and less qualified and experienced assistants at special (sometimes per diem) rates of pay who are rarely fully versed in the policies and practices of the firms taking them on. In the slack periods there has often been the equally disturbing problem of releasing some fairly well skilled and specially trained staff members and of contending with excessive idle time for the irreducible staff nucleus retained.

Unless such prolonged and disruptive deviations can be reduced to a controllable and modest minimum, it is impossible to set up or to count upon orderly and effective personnel cost and utilization. For this reason it seems desirable to discuss the problem involved and its possible solution before going on to consideration of normal organizational practices. Fortunately, the profession has made progress toward maintaining staff requirements on an even keel through the year.

Peak Season Remedies

In the Institute's survey, almost 70% of the small and medium-sized firms and half of the large firms indicate that the semiannual concentrations of business constitute a major problem for them. However, 94% report that they have been able to reduce appreciably the intensity of these rush periods by spreading the work over longer periods.

Four specific measures are indicated by the firms to be most helpful. The two most effective and most widely used are (1) inducing clients to adopt their natural business year and (2) doing a considerable amount of interim work. Also beneficial and employed to a lesser degree are (1) making quarterly or semiannual audits, and (2) making monthly interim examinations.

While all the reporting firms encourage their clients to adopt a natural business year, 25% state that they frequently obtain an unfavorable reaction to the suggestion. This probably represents the cases where there is no clearly marked natural business year. Aside from these there is probably another adverse factor. There is a definite tendency for single-product companies to seek the economic stability inherent in diversification by adding other products. In some of these instances the natural business year may be subject to change or the calendar year may seem to offer an easier choice.

Nevertheless, the trend includes definitely toward greater use of the natural business year. Clear indication of this is revealed by a recent study in one industrial region in Connecticut. From about one hundred accountants queried, forty replies show that through the accountants' efforts, 147 companies had changed over from a calendar year to a natural fiscal year. Where it is clearly advantageous to a client to change to a natural business year, reluctance to change is usually the only obstacle the accountant has to overcome. Where the client is a new concern and a natural fiscal year is logical, even this obstacle disappears. Pertinent to this angle is the statement in the November 1952 issue of the AIA membership bulletin (*The CPA*)¹ that, in reply to a CPA firm's request, the Commissioner of Internal Revenue ruled recently that a change of accounting period would be granted only where acceptable business reasons are presented and that a request for such change to alleviate congestion of work in the accountant's office during the first ninety days of the year is not a sufficient basis, having no direct relation to the character and seasonal nature of the taxpayer's business. An indication of use of a natural business year by types of business appears in Appendix A.

In the Institute survey, the firms responding considered practically as important as the adoption of a natural business year the doing of as much interim work as possible on year-end and midyear engagements. As a matter of fact, the wisdom of this is so generally accepted that in the planning of audits such preliminary work is usually outlined and scheduled as essential procedure. For this reason the truly remarkable degree to which such preliminary work is possible is covered comprehensively in Chapter 14 of this Handbook as an important part of the basic subject of planning and control of audit procedures.

Slack Season Remedies

Decreasing the intensity of rush periods by spreading the work over more time lessens the slack periods to the extent to which the rearranged work can be allocated to the slack season. Further filling in of the slack season is possible in several ways.

Perhaps the most effective of these is the expansion of services to clients. A relatively high proportion of clients fail to use the services of their

¹ See references at end of this chapter.

accountants to the most advantageous extent. It is always a legitimate and often a very vital part of accountants' formal or informal reports to clients to indicate areas of possible improvement in the client's affairs through greater use of the accountant's skills. The most obvious instances of this type are, of course, the cases where clients stipulate limited services which are definitely inadequate to achieve the results they desire or require. Failure to point out such inadequacy is nothing less than dereliction of professional obligation on the part of the accountant.

Most of these possible additional services can be done readily in times of least activity. Some examples like these come easily to mind: (1) the preparation of manuals of procedure to improve the efficiency of a client's organization and implement control of principles governing operations, (2) the periodic review of all established control procedures from the handling of raw materials through all payroll phases, and including billing and shipping, (3) the review and reclassification of factory burden rates, (4) the review of problems involved in personnel changes, including realignment and reallocation of duties, (5) the development and continued revision of reports to management from the client's internal accounting organization, (6) the analyses of business trends and results, and comparison with trends of competitors.

There are, of course, much broader and more fundamental forms of service which can be expanded effectively to the advantage of many clients, both in the field of auditing and in other specialized areas including advisory and consultative service. All of these are made the subject of extensive coverage in this work. In Chapter 2 on Building and Keeping a Clientele the topic of maximum service to present clients receives detailed treatment and in Chapter 25 are covered the productive possibilities of the CPA as a business consultant. It is true that basically consultation and advice are matters dealt with primarily by principals and partners and not staff personnel. But it is equally true that both may lead to or depend upon staff activities of considerable magnitude.

A certain amount of time of staff men during periods of slack business can be utilized for training and development of the staff. A staff member's usual work contributes materially to his training, but there are other phases of training, such as study, staff classes, reviews, reading of articles, and so on that slack periods are best suited for from the important standpoint of time being available. Slack periods comprise the ideal occasion for a critical examination of recent intensive activity with a view to extracting from such a survey ideas for improvement of performance in future periods of greater activity.

Another interesting possibility meriting consideration is the ever-present possibility of making available some staff members to certain clients for temporary use on special projects as to which such clients would normally neither require permanent personnel nor be in position to refer the projects to their accountants for handling on a regular fee basis.

The problem presented by the alternating "feast and famine" aspects once distressingly common in the public accounting field cannot be said to have been cleared up completely. But there has been a distinctly noticeable flattening out of the sharp up-and-down curves representing deviation from normal activity within the year. This is due in good part to the measures just discussed. That such amelioration is not merely theoretical is evident from the reactions of several firms in the survey conducted by the Institute. Asked in questionnaires on different chapters to comment on points related to the existence of seasonal slack periods, a gratifying number recorded that they no longer had such periods or had diminished them very materially.

STAFF COMPENSATION

Compensation Plans in General

The range of such plans is very great. At one end is the simple payment of a fixed salary to each employee. At the other extreme is payment of a fixed salary, with bonuses based on various production or profit schedules, numerous fringe benefits involving health, life and accident insurance, pensions, vacations graduated according to length of service, and so on. There may even be a percentage-of-net-profit basis in lieu of any salary,² and in addition to all other compensation features there may be commissions to staff personnel for business brought to the firm. On all features other than straight salary, numerous variations are employed. For example, a percentage-of-profit basis may involve a share in all the profits from all business or merely a share of the profits on such engagements as the specific staff member covers in his assignments.

How much a staff member is paid depends upon a number of factors. The most important is, naturally, the nature and value of the service he renders. Positions are usually classified but within classification there can be a rather wide minimum-maximum range of pay. Training and experience have a decided bearing, as well as length of service. But there also are two additional factors that cannot be ignored. One is that compensation is sometimes based on what a firm must pay; the other that it is sometimes what the firm can afford to pay.

The compensation that a firm must pay is the minimum comparable rate for the specific classification in its area. If it will not pay that, it cannot secure personnel. If it cannot pay that, it is not established on a sound economic basis. Its income must be sufficient to pay at least the irreducible minimum set by competition within and without the profession. When its net income exceeds both minimum compensation needs and a normal profit for the principals the answer to the question of how much the firm can afford to pay is governed solely by the attitudes of the principals. From the usual accounting standpoint, no part of straight salary actually involves profit-sharing. Nevertheless it is clearly evident that a firm that pays appreciably more than current rates for stated classifications is

sharing its prosperity with its staff and presumably in consideration of staff contributions to the firm's prosperity. The same would be true of fringe benefits except to the extent that certain of such benefits are in the course of time becoming general practice and therefore a normal cost.

The fixed relation between fees and staff compensation shows up unmistakably in the practice of many firms of figuring fees to clients at $2\frac{1}{2}$ (or some other ratio) times staff compensation or per day at 1% of the annual compensation for each staff member. Reversing the formula, it is evident that where a staff member's productive time results in fees of \$15,000 for the firm his annual compensation, using the $2\frac{1}{2}$ -to-1 ratio, would be about \$6,000.

Basic Compensation

Within the term "basic compensation" (as distinguished from "fringe benefits") are included (1) straight salary, (2) bonuses, (3) profit-sharing, and (4) overtime pay.

Salary Rates and Ranges (Base Pay Plus Bonuses)

The Institute survey sought to obtain informative data on this subject. The questionnaire replies are tabulated below:

Minimum-Maximum Salary Range (Base Pay, Plus Periodic Bonuses) December 1951			
		Minimum	Maximum
<i>Inexperienced Juniors</i>	{ Small firms	\$125 Monthly	\$275 Monthly
	{ Medium firms	140 Monthly	275 Monthly
	{ Large firms	175 Monthly	275 Monthly
<i>Experienced Juniors (One or More Years' Experience)</i>	{ Small firms	\$150 Monthly	\$350 Monthly
	{ Medium firms	175 Monthly	325 Monthly
	{ Large firms	175 Monthly	320 Monthly
<i>Semi-seniors</i>	{ Small firms	\$200 Monthly	\$425 Monthly
	{ Medium firms	225 Monthly	400 Monthly
	{ Large firms	260 Monthly	425 Monthly
<i>Seniors</i>	{ Small firms	\$250 Monthly	\$600 Monthly
	{ Medium firms	300 Monthly	600 Monthly
	{ Large firms	350 Monthly	650 Monthly
<i>Non-Partner Supervisors</i>	{ Small firms	\$5,000 Annual	Open
	{ Medium firms	4,500 Annual	Open
	{ Large firms	5,000 Annual	Open

The returns set forth above reveal a wide variation for all classifications. As the table shows, this is due only in part to the difference in size of the three groups of firms and the resultant effect of this upon their rates. The minimum rates of small firms are apparently lower than those of larger

firms but their maximum rates tend to be as high as those of the largest firms. The probable explanation for this is that the range for the small firms represents the difference in ability to pay between a very small firm not long in practice and a small firm with a permanent and reasonably lucrative practice of long standing. This difference apart, the variations undoubtedly represent differences in geographical areas and within such areas further differences as between small communities with restricted industrial development and large cities with highly diversified business activities.

Some organizations employ some full-time staff employees on an hourly or per diem basis of compensation. Twelve per cent of the firms covered by the Institute survey do this. The percentage actually is somewhat higher for small firms since no large firms report the practice. While exact details of such employment are not available, two possibilities seem logical. One is that small firms, where the volume of work is not adequate to provide for a regular basis of compensation, engage one or more permanent employees who work regularly for them over yearly periods but not for a regular number of hours a day or a regular number of days a week. Their workday or workweek is regulated by the work available and they are likely to fill in the remainder of their time with outside activities.

Small firms can, by paying staff men only for productive hours, reduce the risks inherent in irregular activities and thus be certain of profitable results from the fixed ratios of difference between income earned and salaries paid.

The other possibility is that, to some extent, payment on a per diem basis constitutes profit-sharing, since the daily rate paid is usually higher in equivalent than the going monthly rate and the employee willing to speculate on the extent of activity is in a position to earn more when he is fully occupied.

Where, in both types of cases, adequate volume or stability is attained it usually is the practice to switch staff personnel to full-time employment on a weekly or other regular periodic compensation basis.

The general hiring of temporary staff personnel during busy seasons represents a different situation. Such employment constitutes a supplement to permanent personnel and while the indicated improvement in stabilization of the work load has made the engagement of temporary employees less of a necessity, 50% of the firms reporting in the Institute survey still find it necessary. In the case of the large firms the proportion is 62%. This higher rate is undoubtedly due to the very large engagements these firms are more likely to have, and the need to handle a substantial amount of detail work within a comparatively short period.

Normally it is advantageous for a firm to rehire the same temporary employees if their previous services proved satisfactory and they are available. The survey results indicate that almost 45% of all firms frequently re-engage the same temporary staff personnel. However, it is interesting

to observe that a breakdown reveals that slightly more than half of the small firms, only a third of the medium-sized firms and practically no large firms do this.

Fully 40% of all the reporting firms sometimes add to their permanent staff employees who were initially hired temporarily. The practice is less current among the small firms while fully half of the medium-sized and large firms follow it. However, these percentages can be deceptive. Small firms have fewer permanent openings available than larger firms, have less occasion to hire temporary employees and when they do they take on many less proportionately.

Overtime Payments

Such payments fall into two classes: those paid pursuant to Federal Wage and Hour legislation and those paid at the discretion of the employer.

In the Institute survey, 65% of the firms answering recorded that they pay overtime rates, at time and a half, only because of and to the extent required by Wage and Hour regulations. The remaining 35% also provide overtime pay at some rate for staff employees not within the terms of Federal Wage and Hour legislation. Almost half of these presumably simply pay the hourly rate for each hour in excess of the regular number of hours worked per week; some others pay time and a half, and a small number pay a rate in between.

A particular point regarding payment for overtime under Federal Wage and Hour regulations deserves mention. This is that 90% of all the firms answering in the survey make no attempt to base such payments upon whether the work performed by the firm or the employee comes within the ruling definition of interstate commerce. Obvious possible reasons for this attitude are: (1) the firm voluntarily extends the prescribed rate to all employees receiving pay within the federally fixed limits even though they are not engaged in interstate commerce, (2) the inability to come to any reasonably safe conclusion that a particular engagement or service does or does not involve employment in interstate commerce, (3) it is less expensive to make payment without regard to interstate commerce relation than to keep detailed records to segregate hours affected from those exempt, and (4) it is inequitable as well as bad for employer-employee relations to base payment or nonpayment of overtime on so arbitrary and artificial a distinction.

Federal Wage and Hour Law provisions for payment of overtime relate fundamentally to time in excess of a basic workweek of forty hours. However, there are many firms that have variable basic workweeks or rates of pay which require averaging or other adjustment to establish a workable and equitable method of paying overtime acceptable under the law. There are several approved methods for such averaging or adjustment

known as the irregular workweek, the Belo-type, the time-off and the long workweek plans. These are fully described in Chapter 7 on Office Organization and Records together with an indication of the extent of their use.

Some firms that do not give financial compensation for overtime (other than to those earning within the federally prescribed salary limitation) provide added compensation in other ways. Two methods are equally favored. Twenty per cent of the firms in the Institute survey offset the accumulated overtime by a proportionate increase in vacation time. A similar percentage offset the overtime against unassigned slack period time. In the latter case the employer gives the employee days or parts of days off whenever work schedules permit.

Closely related to the matter of overtime is the subject of supper money. There seems to be some doubt as to when a special allowance for this should be made and whether such allowance, if made, is in addition to overtime.

In the absence of evidence of a definite rule on the subject, it is considered that certain general considerations should govern. To justify payment of a supper allowance, it would seem reasonable to expect that the period of overtime being worked should be long enough (1) to cause the employee to miss having his supper at home or elsewhere according to his usual routine or (2) to require a break in the overtime period so that the employee will have supper at a reasonable or his usual hour. Where a supper money allowance is made, it is not considered that overtime should also be paid for the supper time period. What the regular supper allowance should be would depend on individual firm decision and is usually the same amount for all classifications.

Supper money arrangements for employees subject to Federal Wage and Hour legislation are subject, of course, to the possibility of administration rulings as to overtime for supper periods or the amount of allowance. No such rulings seem to have been made up to this time. Where employees are exempt from Federal overtime provisions because of the amount of their base compensation the question of whether supper money is to be paid them when putting in extra time would seem to be a matter for individual decision by each firm.

Bonus Plans

Seventy-two per cent of the firms in the Institute survey have in effect some form of bonus or profit-sharing plan. Unfortunately, information is not available as to the prevalence of each type.

Bonus arrangements can vary widely. They can mean occasional payments of appropriate amounts to individuals as a reward for unusually effective service in connection with a specific assignment or over a considerable period of time on general work. In such informal instances no other regulatory conditions are stipulated or considered. However,

in some cases they may in effect be in lieu of an increase in salary where the performance of the staff member is so outstanding as to merit suitable recognition yet the economic stability of the firm or its future foreseeable income is not so certain as to permit an increase in staff remuneration which will constitute a permanent addition to the salary cost.

A rather peculiar argument is sometimes advanced in favor of an occasional bonus payment in lieu of a salary increase. This is that where a salary increase is granted the recipient improves his standard of living and is, in the sense of security or saving no better off. It continues that if he receives a bonus as a lump sum he can use it for some such special purpose as a payment on mortgage principal or as savings, whereas he would not apply a moderate salary increase in like manner. It is then asserted as a conclusion that a bonus, under such conditions, is of greater benefit than a salary increase.

Where formal bonus payments are made at stated intervals various conditions may apply. All staff employees may be covered or only certain of them. The amount may be a stated percentage of base pay for each person or it may be a different percentage for each classification of personnel. Where there is modification as to coverage, it may be with respect to classifications or according to length of service. A minimum requirement may be established as to length of service and percentages varied according to length of service.

Where periodic bonuses are in effect these represent actually a fixed increase in basic pay and payroll costs are therefore higher proportionately than bare salary totals. Such bonuses may be as advantageous to employees as regular increases, yet to the employee they have the disadvantage of remaining optional as to actual payment or as to their extent and therefore not to be counted upon with certainty. The very nature of this disadvantage to the employee constitutes, of course, a distinct advantage to the employer.

In setting aside a specific total sum for bonus payments, all firms are of course governed by income results. This influence can be indirect or direct. In the indirect type, where the income received or foreseeable makes a bonus payment possible the firm sets aside an arbitrary amount for allocation to individuals or classifications. In the direct type, the amount set aside periodically is not an amount set arbitrarily on each occasion but an actual percentage of net profits. In such event, while the resultant payments to personnel may be called bonuses they represent a sharing of profits. One important difference between receiving bonuses and sharing in profits is, of course, that the employees tend to view the latter as somewhat of a vested interest in the firm's earnings and the former as discretionary and uncertain. Yet, realistically, it cannot be ignored that employees consider all forms of compensation — whether straight salary, bonuses, profit-sharing, cost of living index supplements,

or others — as permanent increment and any diminution in money amount of any one of them as a decrease in pay.

Profit-Sharing Plans .

A formal profit-sharing fund or allocation may involve either a participation in all profits of the firm or in a specified portion or proportion. All employees may share in the participation or only certain classes or certain individuals. Determination of the personnel participating, or of the extent of shares assigned, may depend upon grade of classification, length of service, or specific assignments worked on, or may reflect highly special arrangements with specific individuals. For instance, in the Institute survey 18% of the firms having profit-sharing agreements in effect provide that the employees share only in profits from engagements in which they take part. This custom is evidently more prevalent among the small firms where the proportion using it is 25%.

The participation by a specific staff member in the return from business he brings in to his firm (as distinguished from participation in profits on engagements to which he is assigned) is more in the nature of a commission representing a sharing of the fee than profit-sharing. This particular subject has been covered accordingly in Chapter 12 on Fees for Services. There are, however, many instances of firms making a special allowance in figuring an employee's bonus for new business resulting from his efforts in lieu of paying him a specific commission based on actual fees.

Not all firms compute in the same way the "profits" (or bonus fund) to be divided among staff personnel. The following table represents the principal items deductible from net billings and the percentage of firms reporting in the Institute survey which deduct each such item:

<i>Item Considered</i>	<i>% of Firms Deducting</i>
General office expense	92%
Occupancy cost	87%
Report preparation cost	91%
Staff base salaries	96%
Travel expense	96%
Unproductive time allowance	66%
Partners' time billed	40%

Profit-sharing does not always mean a present division or payment of funds. It can mean a plan with retirement provisions whereby a proportion of profits is set aside regularly to establish an income-earning fund which will furnish retirement benefits ultimately. It may be used to good advantage either to provide such benefits where the definite responsibility of fixed payments under a formal pension plan cannot be assumed or to supplement the retirement benefits already provided for under a formal pension plan. Further discussion of this type of profit-sharing will be found in the next section.

Fringe Compensation

Certain provisions for personnel which were once referred to as voluntary "benefits" have come more and more to be considered basically as "compensation." To a great degree this is due to a change in social viewpoint. Once these were incidental benefits conferred, principally out of the generosity of the employer. Now they are looked upon as earned and as related directly to basic compensation, and in the case of organized labor are negotiated with wage rates. Vacation time, sick leave and similar items fall into this class.

A further reason for the change is attributable to the development of a broader outlook with respect to lifetime security for employees. Until recently the interest of employers as to security of personnel related primarily to security during their employment by the employer. Provision for the future was the individual problem of each employee and under economic conditions prevailing, the employees were supposed to provide personally for future security out of their basic compensation. Conditions have changed. The individual's preoccupation with lifetime security is much greater now and is influenced appreciably by the increasing difficulty of making individual provision for the future due to various causes, including the greater burden and prevalence of taxation and the tendency of industry to reduce the period of years of productive employment.

The conclusions in the last two paragraphs reflect the social trend among the larger industrial and commercial establishments. They have not yet directly reached the professions to any appreciable extent, but they may and probably will. Certainly in the long run the fringe benefits provided by a large segment of industry, whether voluntarily or by negotiation, will compete with the professions and will influence similar developments in public accounting.

Pensions and Retirement Plans

Of the firms covered in the Institute survey, only one reported that there is a pension or retirement plan operative. One of the principal reasons for only one firm so reporting is apparently the relative newness of the profession. Very few men except principals have as yet reached retirement age within the profession. Furthermore, it is not likely, unless some changes in character of employment opportunities takes place, that many staff men will attain retirement for age. Up to the present at least, the career of public accounting has led either to the position of principal or partner or to positions in industry. The end of this course is not yet in sight, and until it arrives pension problems will not likely beset the accounting firms.

For many accounting firms, and particularly small ones which have not yet achieved a degree of economic stability permitting a long-range forecast of approximate income, the adoption of a pension plan with more

than nominal benefits for employees is rarely feasible. A formal pension plan calls for annual payment by the employer of a fixed sum regardless of the amount of business receipts or profits. However, for many firms it is possible to set aside annually from profits some proportion of earnings to create a fund for establishment of retirement benefits.

An interesting "profit-sharing pension plan" employed successfully by a medium-sized accounting firm has been outlined by Carl Esenoff.³ All employees employed six months or more take part. The firm's annual contribution is allocated in proportion to salaries. After three years' services, 30% of the allocation becomes vested. Ten per cent increases in vesting occur annually so that 100% vesting results in ten years. At the expiration of that period, participants may receive 10% annually of their total accumulation. An employee leaving prior to ten years of service receives his vested portion but the remainder, which he forfeits, is reallocated among the remaining participants. In case of retirement or disability, the total allocation of the employee may be paid him; in case of death, it is paid to his estate. A particularly interesting provision allows an employee who becomes a partner to withdraw his entire allocation. Esenoff stresses that this provision has been of great value to new partners in furnishing a portion of their capital contribution on admission to partnership.

Vacation Provisions

Practically all the firms queried in the Institute survey indicate that for all classes of staff personnel, from juniors to supervisors inclusive, the basic provision is for a regular vacation of two weeks for every employee who has been employed for a minimum period of one year. For permanent personnel employed less than one year, two methods are favored. One is to grant one week's vacation after six month's employment. The other grants one day of vacation for every month of employment.

Forty-five per cent of the surveyed firms record that the length of vacation period varies according to length of service. While this applies to cases where vacations are allowed when length of service is under one year, it is also applied when length of service is beyond a fixed number of years. It is customary to grant one additional week after either five, ten or some other fixed period of years of service, and there are a few instances where a fourth week is made available to those having many years of service with the firm.

Leave of absence with pay may supplement regular vacation periods on occasion. This is more likely to be true for higher grades of personnel where services rendered are measured more by quality than by time and where such extra leave with pay is granted in recognition of the possible need for a longer recreational or recuperative period. This is likely to occur when a senior or supervisor long with the firm has put in an exceptional period of extra hours without added compensation.

The chief difficulty experienced by accounting firms with respect to vacations is scheduling them. The usual vacation season begins just as the midyear busy period starts. Under these conditions, the common solution is usually to schedule vacations in line with the periods selected by personnel but subject to rearrangement should pressure of work make it imperative. There must be, of course, a definite understanding that such a possibility is a natural occupational hazard of the profession. The fact that 84% of surveyed firms schedule vacations subject to possible change made necessary by engagement deadlines makes this conclusively clear.

Some firms attempt to meet the problem by requiring personnel to take one week prior to the busy season and one after it. The disadvantages of this to the personnel are obvious, although some employees occasionally have a preference for such an arrangement. Another attempt at solution calls for one week of vacation in summer and the other in fall or winter. This also has an appeal for some staff members. It is, however, more readily applicable to those having three weeks' vacation and who are willing to take two of them in fall or winter. The growing appreciation of fall months for vacations is helpful but the end of a busy season often finds almost everyone anxious to get away promptly and feeling a real need to do so.

The problem of vacations for principals or partners has added complications. A sole proprietor often finds it impossible to get away either because there is work he must do or because he has no assistant capable of handling matters satisfactorily during any prolonged absence. As for partners, this difficulty would not seem to exist. Yet it does appear that there is reluctance on the part of many partners to go on vacation and that where they fail to do so resultant impairment of their efficiency and productivity is inevitable. Some firms consider it so essential that partners take a vacation they make it compulsory and even include this provision in their partnership agreements.

Generally there is no set schedule for partners' vacations. Firms seem to leave it to the determination of each individual as to when and how long vacations shall be. Most firms reporting on this particular point comment significantly that the time for a partner's vacation is "when he can get away." Junior partners, of course, are not usually allowed similar leeway and are governed by the decisions of senior partners.

Protection Against Incapacity or Death

Sick leave applies normally to definitely limited periods of illness. Beyond the stipulated periods, if there is any further arrangement it is under a formal plan covering physical disability resulting from illness, frequently with insurance protection.

Ninety per cent of the firms in the Institute survey provide sick leave at full salary for limited periods. The period limitation generally is one

day a month or two weeks a year. However, there is good reason to believe that firms have such limitations in order to have a definite indication of policy but do not enforce them rigidly. Exceptions are indicated to be so general as to reveal that the special considerations in each case govern. A good deal depends upon the length of service of the employee, his value to the firm, his degree of loyalty, his record, and the firm's ability to extend as much assistance as the particular circumstances seem to warrant. Where the illness continues beyond the period stipulated for payment of full salary and it is not possible or desirable to continue full salary payment, some firms grant further sick leave on part pay for another stipulated period.

In certain industries and more particularly in the service of the Federal government, sick leave may be cumulative. This means that an employee is entitled to a specific number of days of sick leave yearly and if any part of this is not used during the year the unused portion is carried over and added to the newly accrued period. In effect, a vested right to such leave develops and as an inevitable result the leave may be used without any actual illness being considered a prerequisite. No such practice appears to have developed in the public accounting field.

In the author's firm, existing regulations, if followed strictly, would bar more than one month's sick leave at full pay in any year for any staff member. Yet such a rule automatically applied without consideration of the actual circumstances can work both injustice and hardship. Illness may occur in a particular case after years of no absence for illness. Having this in mind, payments of full salary have been made throughout the entire course of prolonged illness in several instances where employment covered ten years or more.

Group Insurance

The firms in the survey report having group insurance in effect as follows:

Life insurance	67%
Hospital insurance	60%
Accident insurance	40%
Sickness insurance	25%

In each classification of insurance the percentage of small firms is smaller than for all firms as a whole but the difference is not large and indicates the recognition given by the small firms to the need for providing such benefits.

One-third of the firms in the survey which report having group insurance have their own plan and arrangements with insuring companies. That the other two-thirds employ plans involving wider groups stresses a fact of great significance to small firms. Group insurance requires that there be an adequate minimum number in a group and few small firms

can meet this requirement within their own organization even if all employees are willing to participate. For such organizations it is of inestimable value that it is possible for their participating personnel to form part of a larger group which can fulfill minimum requirements. An outstanding example of this for the accounting profession is the fact that as of March 31, 1952 the participating members of the American Institute of Accountants' Insurance Trust totaled 9,082 individuals from 1,422 firms and carried about \$48,000,000 worth of life insurance.

Welfare Programs

This subject, from the special standpoint of staff selection and training, also is touched upon to some extent in Chapter 9.

The basic objective of any welfare program for personnel is maintenance of morale. Self-interest requires this, but this self-interest is mutual. Such programs afford, therefore, an excellent opportunity for co-operative employer-employee relations of a very high and effective order.

Personnel morale is not maintained merely by paying adequate or even better than run-of-the-mine compensation. Practically no one wants to be simply just as well off as he would be elsewhere. He wants — and it is a perfectly reasonable desire — to be better off than he would be elsewhere. It is therefore essential that in addition to all of the forms of compensation, direct and indirect, already discussed, there be some special incentive provided by the employment held which makes the position more desirable than one available elsewhere.

Such incentive may assume various forms. Examples are: a pleasant place in which to work; agreeable employer-employee relations; increases in compensation and advancement in position at reasonable and periodic intervals and in line with length of service and demonstrated efficiency and capacity for growth; clearly defined and expressed personnel policies made known to staff; training programs; and so on.

For every employee there is more to a salaried position than simply earning a living at the moment. Both the beginner and the experienced worker think of the future. The older worker thinks of the future more in terms of continued security upon retirement. The beginner and the younger worker are interested more in getting a decent foothold and going up from there as far as opportunity and ability will take them. They also visualize security on retirement, but have more ambitious plans. There also is a natural desire to do work one likes or is most fitted for or which offers the greatest possibilities for progress.

Every employer, who has his own ends to further and his own aspirations, must consider these factors in selecting, training, compensating and utilizing personnel. Where welfare programs provide realistically for the progress and betterment of each employee meriting recognition they provide equally for the welfare of the organization as a whole and

create an esprit de corps which inspires each individual staff member to feel he is an integral, valuable and valued part of the organization.

All firms cannot provide similar or equal incentives. Yet small firms are not necessarily at a disadvantage. Large bodies move slowly in more than one sense. In a small firm pay may not be as good initially or even later. Still advancement may be more rapid, breadth of experience may be acquired more quickly, there is certainly more intimate contact with the firm's general activities and the path from, say, junior to partner may be more direct, shorter and less impeded by competition.

In the accounting profession, there is no obstacle generally to steady advancement from the lowest salaried position to a senior partnership other than purely personal limitations. This forms, probably, the highest incentive any employee can have. It is based primarily upon the realization that the more efficient a staff member becomes the more desirable it is that he be utilized in the broadest possible area of activity. Such broadening of scope, responsibility and performance carries with it inevitably and imperatively commensurate advance in position, financial return, and prestige. An accounting firm proceeding along different lines is hardly functioning effectively.

It is probably because of adequate recognition by the profession generally of the principles and practices underlying maintenance of morale that there have been no moves toward unionization of staff personnel. This question was not covered in the questionnaire sent out on this chapter in the Institute survey. However, it was included in the questionnaire issued for Chapter 7 on office organization and records, and related to office staff personnel only as distinguished from accounting staff personnel. Asked to what extent wage-and-hour problems arose from (1) unionization and (2) Federal legislation respectively, not one firm indicated any difficulty under the first factor.

In accounting firms, staff meetings constitute an excellent medium for development of good staff morale. While they are held primarily to outline and discuss technical subjects and to improve performance of assignments and the proficiency of the staff, they are most effective when definite stress is laid upon the importance of the role of each individual as an essential factor in the functioning of the organization as a cohesive unit.

About 45% of the firms surveyed hold staff meetings at regular intervals. Some hold their meetings every other month, and others as often as once a week. The average for all firms is about ten a year with the average for small firms tending to be slightly higher. Two-thirds of the firms holding such meetings do so during regular office hours.

Some social staff meetings are also arranged by firms; 60% of those reporting have staff parties at Christmas time. About 50% have social meetings at other times, in the form of annual dinners, outings or similar affairs. A few firms report further group social activity in the form of bowling teams engaged in weekly competition.

Another significant welfare activity is defraying expenses of staff members in attending meetings of professional societies, or assisting personnel in connection with study courses. About 75% of the firms consulted pay all or some part of the expenses for local meetings, and about 70% do likewise for state society meetings. Thirty per cent pay all and 20% pay some of the expenses of staff men at national professional meetings. About 40% make available study courses to staff members and pay the full cost. Where staff members take outside courses aimed at professional training about 20% of the firms pay all or part of the cost. In order to encourage staff men to become members of professional societies, many firms also pay part or all of their dues for such membership. A discussion of this practice will be found in Chapter 9 on Staff Selection and Training.

Library Facilities

The library of an accounting firm is of utmost benefit to its staff personnel when personal use is permitted and encouraged. One manifest form of encouragement is to bring certain appropriate books, magazines and articles to the attention of staff members and, so far as it will not interfere with use of library for firm purposes, to make the contents available for home reading under proper regulations as to issuance and return.

Every firm but one reporting in the survey indicated possession of a library consisting of works on accounting subjects. The small firm which replied that it had none probably has no library in a formal sense but does have a limited number of appropriate volumes which form a suitable nucleus for growth. Indicative of the extent of assistance that can be rendered staff members by making library facilities available to them, the questionnaire returns show that the small firms have a range of 15 to 1,200 volumes with an average of 173, the medium-sized firms a range from 50 to 700 volumes with an average of 220, and the large firms a range of 100 to 1,000 volumes with an average of 468. Another practical way of making helpful professional literature available to staff members is to subscribe to certain publications on their behalf. In such cases, due regard is had, of course, to selecting periodicals for the grades and capacities of the individual staff members.

Salary Advances and Loans

Practically every firm must consider this problem on occasion. It is a matter as to which a policy is possible but the enforcement of which depends greatly upon the circumstances of each case. Broadly speaking, the making of such advances and loans is not a desirable practice. When there is general provision for it, it is apt to be abused. Further, when staff members frequently have occasion to seek advances or loans a serious doubt exists that such personnel possess requisite economic and temperamental stability.

Understandable emergencies may occur, however, where assistance of this sort may well be a wise procedure. This would occur, for instance, in the case of a competent and valued staff member with long service and a known record of stability who through an unforeseen circumstance beyond reasonable anticipation is faced with a need to make a large expenditure he cannot readily meet out of his own capital or earnings. Probably the best course for any firm is to have a definite rule against advances or loans with an unwritten and purely informal reservation that in such highly unusual cases exception may be made on consideration of all the circumstances and on appropriate terms.

Medical Service

One feature sometimes found in welfare programs is free periodic medical examination of personnel. However, not one of the firms in the Institute survey furnishes such an examination. Presumably firms providing insurance plans which require a preliminary physical examination consider this sufficient. It is the opinion of the author, however, that permanent personnel should be examined at least once every two years at the expense of the firm. The value of this from the standpoints of both employer and employee seems quite evident.

House Organs

Almost anything worthwhile saying is worthwhile recording. The more interesting or valuable the comment, the greater the reason to reduce it to writing. And written words are more easily understood and retained than the spoken phrase. They also can be referred to again at will. Such reflections and related ones have a direct bearing upon the many ways in which a regularly issued informal firm bulletin or more formal house organ can contribute to the furtherance of the activities of an organization.

Many large accounting firms have house organs. Some, like "*The Arthur Andersen Chronicle*" and the "*L. R. B. & M. Journal*," are outstanding and are read by staff members of other firms. It would be regrettable, however, to infer from the appearance, scope and cost of such particular organs that such an effective feature is beyond the reach of the small firm. Actually the small firm's modest bulletin, mimeographed and stapled, and with a potential maximum circulation of perhaps no more than six to a dozen readers can by virtue of the firm's small size have a more forceful and effective impact and an intimacy of treatment and reference that can excite the envy of the more modish and extensively read chronicles.

It is well to study the varied efforts of other firms in this respect. It does not follow that they must be considered as true guides to one's own product. Individuality of treatment and even of appearance is desirable. Primarily, however, the publication must reflect accurately and effectively

the particular spirit and purpose of its own organization. It must be in essence the articulate and spontaneous expression of the personalities that collectively form the organization. How technical it should be, what particular features it should contain, how serious, how personal, how humorous, depends not upon what some other firm is doing but upon what suits the need of the specific firm itself. It cannot copy others. It must be original.

To meet these requirements, its production will require a reasonable amount of time and skilful labor which should not be allotted grudgingly. If it produces tangible results in training, increased efficiency or esprit de corps in reasonable relation to effort exerted, it is successful. Careful experimentation should reveal the coverage which elicits the most desirable response. For that matter, there should be fairly frequent turnover in the editorial staff so that all staff members may have an opportunity to display their own ability and to endeavor to surpass others in friendly rivalry. This provides, too, a group of readers who have a special and critical interest in each issue.

Any firm interested in a possible checklist of contents for a house organ or firm bulletin will find one in a recent book by Charles S. Rockey.⁴

Slack Period Lay-offs

Earlier in this chapter reference is made in discussing seasonal difficulties to the particular problems in slack periods of lay-offs and excessive idle time. While there has been a welcome and appreciable amelioration of these difficulties, they still exist to some extent and information concerning the degree to which they do is helpful.

Six per cent of the reporting firms state they still find it necessary (in 1952) to lay off *clerical employees* during slack periods. However, only 2% are compelled to lay off juniors and not one firm finds it necessary to lay off temporarily either seniors or supervisors. This is an exceptionally fine showing, but for the profession as a whole may not reflect a permanent condition.

Advancement

Advancement in employment, aside from intangible forms, means an increase in compensation, promotion to a higher position, or a happy combination and coincidence of both. The employee finds it pleasant to be surprised by such occurrences. Where possible, it is useful as an incentive producer for the firm to systematize increases in compensation and promotions so as to provide for periodic advancement according to seniority and demonstrated ability. Exceptional cases, of course, should continue to be governed by the relevant special circumstances.

Of the firms responding in the Institute survey, 50% have an established policy for promotion and raises. Where there is such a policy, two-thirds of the firms make its general outline known to personnel.

Basic Policy

In creation of basic policy the formulation of certain standards to classify and evaluate personnel for advancement is desirable. This need is greater when the firm is large and its organizational structure complex. Survey results show that 45% of the firms classify staff members for promotion according to certain professional characteristics and that such characteristics are assigned varying weights for the different classifications. (One such classification appears in Appendix B of Chapter 9.) Unfortunately, they also reveal that the firms differ greatly in the listing of characteristics and assess them according to highly individualistic patterns. While greater standardization is doubtless desirable, both the listing of characteristics and the weight assigned each will presumably still be governed basically by the special needs of each firm.

As to where final decision as to promotion rests, the responsibility in every instance is executive. In single proprietorships the owner of the practice is the authority. In partnerships the designation of authority will vary according to the number of partners, the executive duties assigned each, and the size and complexity of the organization. In the Institute survey, where there was a sole proprietor the answer was "the employer," in small and medium-sized firms it was habitually "the partners" and on occasion "the senior partner," and in large firms a specific partner was indicated, or sometimes "the staff manager" or the "managing partner."

Sixty-six per cent of the firms queried in the survey conduct periodic reviews of the records of staff members for promotion. Sixty per cent do the same as to compensation increases. Where such periodic reviews are held, 60% of the firms do so at six-month intervals, about 28% yearly, and 8% every three months. The size of firms apparently does not affect the situation.

Timing

Timing as to promotions and salary increases is very important. Recognition of service of an employee should follow closely upon the heels of a reasonable period of demonstration of valuable service or of increased proficiency or ability. If it does not occur then, there is almost certain to ensue dissatisfaction on the part of the staff member, and definite impairment of his initiative, productivity and even loyalty.

A rather obvious time for such matters is right after prolonged periods of greatest pressure of work. For practically all accounting firms one most auspicious occasion is after the rush of the year-end period with its particularly heavy tax-work burden. It is probably around May 1 that most firms reach the moment when the entire organization feels a sense of relief and usually great satisfaction at having come successfully through another period of high achievement and can take inventory of what has been done and what lies ahead.

The practicing public accountant's primary assets to be inventoried at this time consist of his clientele and his staff. In effect he must summarize and assess what he has to do, what resources he has available and how he can most efficiently apply the latter to the former. As to his staff, one effective way to do this is to set down the names of all staff members on a good-sized worksheet with all the relevant plus and minus ratings for requisite qualifications and achievement. The result in each instance can then be compared with previously adopted standards for retention, increase in compensation and promotion. Where there are several partners, the evaluation of each partner as to every staff member he is qualified to pass upon should also be obtained and the possibly widely differing reactions effectively reconciled. Reports of superiors (in-charge seniors, supervisors and managers) as to performance of specific assignments also require consideration. Rating sheets may be helpful.

Uneven Progress

On occasion there may be instances where staff members who have had good records of performance and progress in the past have not done as well as usual during the recent period or as well as their known ability would warrant. Arbitrary adverse action in such cases is rarely justified. There is generally a definite cause for such a result and there should be no decisive judgment until a real effort has been made to ascertain and eliminate the undesirable unknown factor. The best results in this direction are most likely to be obtained by a friendly and frank discussion of the circumstances with the staff member by that partner having direct responsibility for him. Such discussion may reveal the existence of a cause that the firm can do something about. Even if it does not, the concern displayed by the firm may be helpful in improving the morale of the staff member by making him realize that there is a very real interest in his personal well-being and that he is considered to be a vital part of the organization and not viewed impersonally as a mere cog in a machine.

Most of the firms reporting that they review personnel periodically presumably follow some such procedure. Asked whether they have a policy of automatic promotion or dismissal, less than 8% answered that they have.

Obtaining CPA Certificate

Closely related to the subject of advancement is what a firm does when a staff member obtains his CPA certificate. In the survey, 65% of those responding stated that certain action is taken. This action varies from firm to firm. Some grant a special increase in salary; others, where a certificate is a requisite for promotion to a stated classification, put through the promotion and the related increase. A few also place the certificate holders in a group as potentially eligible for partnership. Among firms where there is no such definite action, some sort of official firm

acknowledgment is made through some ceremony. Generally this takes the form of a dinner in honor of the recipient of the certificate.

Outside Sources

Advancement sometimes comes to staff personnel from outside sources. In the Institute survey, firms were asked whether, when a staff member receives an outside offer, any inducement in the form of a raise or a promotion is offered to retain him. Thirty per cent of the replies were in the affirmative. Presumably what this implies is that consideration of the employee's value is accelerated ahead of the fixed time for periodic review.

Probably additional questions should have been asked to ascertain how often the 30% do this and under what circumstances. Realistically certain obvious factors would seem to be applicable to each case separately. Each employee represents an investment by the firm based upon his training and the nature of the experience afforded him. From that standpoint he has a definite future value based on expectation of further utilization. Another consideration is whether he can be replaced readily from within the organization, or, if necessary, from without. An examination of all these points will give an adequate basis for a decision as to whether there is an impelling reason to retain the staff member's services and, if there is, the nature and extent of the inducement to be considered.

Personal Considerations

A sincere interest in the personal welfare of the staff member also requires attention to other points. An important consideration is whether the outside offer is one which it would be to the undoubted advantage of the employee to accept from the standpoint of broader opportunity for the future even though at the moment the current employer can match or surpass the immediate return available in the position offered. Another possible consideration relates to the goodwill factor inherent for the firm in having former staff members holding responsible positions in the private accounting field. Particularly among the large firms there is a very decided appreciation of the definite advantages of having their "alumni" spread widely and strategically in the business world.

Placing Released Personnel

Closely related is the problem that arises when it becomes necessary to release competent personnel. Practically all of the firms answering a survey question on this point make a determined effort to secure new positions for such personnel. Quite naturally self-interest influences greatly the choice of fields in which the greatest effort is made. In a broad sense, there are three major fields available. These are: (1) other public accounting firms, (2) clients of the firm, and (3) other concerns.

Ninety-two per cent of the responding firms make their major effort to place released personnel with their own clients, and 90% are willing to make an effort also to place them with other industrial concerns. However, only 65% consider such placement with other public accounting firms.

Two further points are worth comment regarding placing of public accounting personnel in other fields. One is that while there are men with a seemingly adequate educational background who do not develop well as public accountants such men, if completely satisfactory in all other essentials, may still be very valuable elsewhere. Such persons, having been educated intentionally for public accounting, will have therefore a more thorough and broader accounting background than would be possessed by the average individual a client would find available for top clerical or supervisory positions or those involving an appreciable knowledge of general accounting. In such cases there is an opportunity to render both a client and a staff member a very great service.

The other point relates to the care to be exercised to avoid placing unqualified personnel or incompetent "cast-offs" with clients or others for positions relating to accounting matters they cannot handle. The responsibility of the accounting firm making any placement of released personnel elsewhere is measured by the fact that the new employer is fully justified in assuming that the accounting firm is in fact giving an implied warranty of fitness.

Hiring of Staff Members by Clients

One of the most appreciative gestures a client of an accounting firm can make is applying for permission to hire a staff member of the firm. Often this points up clearly the effectiveness of past recommendations or reports to the client and a taking of appropriate measures in consequence which go so far as to secure qualified personnel from the accountant making the recommendation or report.

Survey results indicate that about 85% of firms get frequent or occasional requests from clients specifying personnel classed as semi-seniors or seniors. About 77% get similar requests for supervisors and only 56% for juniors. Most of the firms getting such requests receive them occasionally rather than frequently, but the factor of frequency is definitely related to grade. Small, medium-sized and large firms all record that by far the most frequent call is for seniors. This is, in turn, presumably a reflection of the type and scope of the positions involved.

Survey returns indicate interesting reactions by accounting firms to such requests. The reaction in 16% of all cases, no matter what the grade, is unfavorable. The reasons for such reaction are not particularized and may well be various. One may be that personnel cannot then be spared because of the difficulty or impossibility of immediate replacement. Another may be that a specified individual cannot be spared although

another of the same grade can be. A third may be that the accounting firm does not consider the person asked for or the grade to which the request relates to be appropriate for the opening.

Where the reaction is favorable, there is appreciable variation according to the grade involved. For the junior classification it is favorable with 46% of the firms and 38% remain indifferent.

Respecting semi-seniors, the reaction is favorable with 60% and indifference is registered by about 23%. Where seniors are concerned, the reaction of 66% is favorable and indifference manifested by about 17%. On supervisors, requests are viewed favorably by half the firms and with indifference by about 35%.

Rehiring Former Personnel

It happens sometimes that a competent staff member who has left an accounting firm becomes available again to the same firm. Whether, as a rule, such an employee should be rehired if there is an opening merits consideration. Only 50% of answering firms in the survey state they make a practice of rehiring such personnel. The reasons why the others do not can at least be surmised. A staff member who has resigned to go elsewhere and presents himself later for rehiring does so probably because there is no other immediate possibility for him, at the same time knowing that his previous departure may be held against him or will, as it should, affect his relative seniority. The firm to which he applies for rehiring may well consider that such misgivings on his part will militate against the probability of completely satisfactory results. Where the former staff member is one who was released because someone had to be released and he was considered least qualified for retention the desirability of rehiring such an individual when other more qualified candidates are available is definitely more than doubtful. It is pertinent that one large firm which does not now rehire former personnel comments "All our experiences have been bad!"

Filling Vacancies from Staff

Nothing is likely to impair staff morale more than filling a position from the outside when in lower classifications there is personnel qualified to fill it. Three inevitable results can be expected. The staff members who might reasonably have expected promotion are made to feel that they are not considered competent or eligible for higher positions. The entire staff is made to feel that the first choice for a higher position does not belong to them as a matter of right and therefore that there is no actual certainty of opportunity for advancement as broad as the firm's normal development should permit. The new staff member is apt to find all other employees unco-operative, particularly those who feel they have suffered by his hiring. Both he and the firm suffer accordingly. For such reasons, it is a well recognized and almost invariably honored procedure through-

out the business world to fill vacancies from present personnel unless the vacancy is a new one involving requirements which are not met by current personnel and are outside the usual organizational structure. Accounting firms generally conform.

Such a wise policy has one distressing aspect. While it increases the likelihood of long years of employment with appropriate advancement, it operates to bar the hiring in higher classifications of qualified individuals seeking employment. In effect, it insures that an older employee of higher grade has greater security for the future as long as he remains employed and little prospect of any if he finds himself unemployed.

Frequency and Rate of Salary Increase

Survey results show there is a difference based on grades in the frequency with which salary increases are considered. As to juniors, 75% of the firms consider this semiannually and the rest annually. For semi-seniors and seniors the percentage drops to 60% for semiannual consideration and with respect to supervisors to 50%. This seems manifestly to follow a reasonable rule of more frequent small raises to lower grades and less frequent and possibly larger increases for higher grades.

The Institute survey sought to learn what percentage of current salary is considered normally to be a satisfactory increase at any one time. The returns included a large number of different percentages which had to be averaged to be meaningful. The most frequently reported percentage was 10% and while the majority of returns specified other percentages a very high proportion of them were in the general neighborhood of 10% as indicated by such replies as "5-10%," "12%," "10-15%," and so on. The general average therefore approximates 10%.

Length of Service in Grade

A very significant factor bearing on advancement is the average length of time staff members spend in each classification before promotion to the next highest grade. Survey returns were obtained which can be considered as indicative rather than conclusive. In this connection, it is well to have in mind that the maximum period of time a staff man usually remains in a classification before advancing to the next is significant also in another way. Clearly the end of the maximum period represents the point at which a staff member who has failed to advance by that time to the next classification has indicated that he is of only very limited potential future value to his firm.

For juniors about 40% set the period at from one to two years, about 14% make it from one to three years, about 36% fix it at from two to three years, and the rest give miscellaneous results not differing greatly from the three general periods recorded. In total, 90% believe a staff man should have advanced out of the classification within three years.

For semi-seniors, 42% of reporting firms give a period of from one to two years within the classification; about 8% set it from one to three years, about 33% fix it at two to three years, and about 15% put it at from two to four years. In total, 83% expect a staff man to move out of this grade in three years.

For seniors, certain understandable variables intrude. In firms where there is no higher classification except principal or partner the period may well be prolonged indefinitely and yet be marked by several appreciable increases in compensation and responsibility while the individual is marking time for advancement to a partnership or perhaps to participation to some extent in profits without an actual interest in the practice. It is therefore with such probabilities in mind that the results must be considered. Twelve per cent set the period at one to three years within the classification, about 9% at two to three years, about 15% at three to five years, and 33% specify a range of one to ten years.

As to supervisors variation is greater, of course, and tends to suggest that the period depends primarily upon the special circumstances of each case. As one large firm reported, "there can be no 'average' pattern."

The 1952 salary scale and "fringe benefits" in effect in one large national firm are detailed in policy form in the Administrative Manual in Appendix B of Chapter 9.

STAFF UTILIZATION

Utilization of staff, from the procedural standpoint, is aimed at the basic objective of attaining the best results, measured in terms of both quantity and quality. It involves primarily, therefore, the adoption and application of methods found most effective for the purpose.

Working Schedules

In the formulation of the most productive working schedules, several factors require careful consideration. How long in consecutive hours the average individual can work effectively is governed by (1) the nature of the work, which may be physical or mental, easy or difficult, disagreeable or interesting, (2) the length and nature of respite dividing the daily and weekly work periods, (3) the training and experience of the worker, (4) the physical and mental condition of the employee, (5) the working conditions, (6) the individual purpose for which the worker is engaged in employment, and so on. In essence, work involves the output of energy which is limited and must be constantly renewed. The energy cannot be fully dissipated before renewal. Renewal must occur before diminution becomes harmful. Also efficiency decreases at an accelerating rate as energy is lost. Proper utilization therefore demands working schedules regulated by such considerations, with temporary deviations from regular hours made only in times of pressure and with full recognition of the declining curve of efficiency. There is a point at which excessive expenditure of energy may result in temporary or even permanent deprecia-

tion of the basic store of human energy represented by personnel. All this is, in effect, the background of the gradual evolution of current methods of utilization of personnel. Variables are manifestly introduced by the specific circumstances in each industry, field or profession, and in the case of each single individual.

In the accounting profession, the Institute survey shows, 25% of the reporting firms have a 7-hour day, 34% a 7½-hour day and 41% an 8-hour day. This is exclusive of overtime. In general, the firms with a longer workday have a somewhat shorter regular workweek. Fifty-four per cent have a 5½-day workweek and 46% one of 5-days.

The survey answers do not indicate specifically the general trend as to basic hours per week. A firm with a 7-hour day may have a 35-hour week if it follows a 5-day week schedule. A 7½-hour day may mean a 37½-hour workweek on a 5-day basis or a 40-hour week if the workweek comprises five and a half days. Where the workday is eight hours the regular workweek is clearly a 40-hour 5-day week. More definite information as to regular hours and workday and workweek periods of accounting firms is given in Chapter 7 on office organization and records in a discussion of office hours.

Certain special factors tend to affect the public accountant's regular workhours and workdays. One is the obvious fact that staff members on engagements requiring their working on the premises of clients must frequently conform to the clients' working hours and days in order to have access to records and personnel. Another is that with the growing prevalence of the 5-day week in the business world, accounting firms have to adjust their workweek accordingly or be sure their staff can be occupied productively in their own offices on Saturday mornings. The proportion of accounting firms using the 5-day week is therefore quite likely to increase. A further probable influence is that in some geographical areas, and particularly in the larger cities, shorter hours are the rule.

The great degree to which hours of staff members are governed ordinarily by the working hours of clients is indicated strikingly by the response to a particular survey question. Eighty-five per cent of the answers stated the staff members on an outside engagement ordinarily work about the same number of hours as the client's staff. Interestingly, when broken down, the compliance with client's staff hours is only 70% in the case of small accounting firms and practically 100% for all others. Fifteen per cent of the replies revealed the staff members in such event work longer hours than the client's staff. It is standard practice in the profession for staff manuals to stress adherence to clients' working hours.

Overtime

Overtime may be necessary in a public accounting office at almost any time of the year. When the need occurs outside of the year-end and mid-

year busy seasons, it applies usually to a specific engagement and even then perhaps only to some staff members. In such cases certain practices are sometimes considered advantageous. Returns in the Institute survey indicate that in such cases about 40% of the firms rotate overtime assignments among the staff and that about 13% specifically give preference on overtime to those who request it. Of course, these procedures are subject necessarily to other considerations such as appropriate assignment of personnel to the engagement and to the effectiveness of over-all scheduling of all personnel on all engagements.

During the two customary rush periods of the year, overtime is general and involves increased hours for most staff members. The Institute survey elicited interesting replies to questions seeking to ascertain the extent of such overtime as reflected in workweek hours, the particular methods of adding overtime and the degree to which overtime affects efficiency.

Ninety per cent of the firms increase the number of hours in their workweek during the peak season. Not all do it in the same way. Ninety-two per cent of them use Saturday, 80% do overtime at night, and only 35% use more consecutive hours in the day (a longer workday).

One point appears to explain why adding to consecutive hours in a day is least favored. Saturday, the preferred period for extra work, is presumably the time when most additional hours are available. It is also the best time to use to avoid excessive accumulation of hours during a single day or series of days, and therefore apt to produce a higher and more effective return per hour of overtime. For the same reason, though to a lesser degree, night work is preferable to working longer consecutive hours during the day because there is a helpful recuperative period intervening between the regular workday hours and the night overtime period. There are some firms that, where possible, like to break up the cumulative effect of overtime by permitting night work on alternate days only.

The survey returns include an occasional reference to Sunday overtime. There appears to be a strong feeling against such a practice. It seems to be used only when there is no other alternative.

That the adverse effect of overtime on efficiency is fully recognized by the accounting profession is clear. Only 25% of the survey replies on the subject stated that it is considered that a longer workweek does not impair efficiency. Seven per cent think it impairs efficiency appreciably and 68% believe it does so slightly. At some future time it may be possible to conduct studies as to the limits within which there is found to be no or only slight impairment and the point at which appreciable impairment becomes manifest.

One method of averaging time over the year is to reduce the workweek during slack periods to less in days or hours than the regular workweek. The amount of reduction is governed, of course, not by the excess time

worked during the busy periods but to the extent suggested by the extent of the slack. In other words, the reduction may be necessary but it is neither desirable nor welcome.

Slack Periods

Forty-two per cent of reporting firms find it expedient to reduce their workweek to less than forty hours during slack periods. The replies did not indicate, however, the amount of reduction required.

Even when the workweek is reduced, there may still be occasions when there is not sufficient work to keep all staff members busy. Two major problems arise in this connection. Should personnel be required to report regularly to the office regardless? What can be done to keep the staff occupied even though not productively?

When staff members are idle for an appreciable length of time in an office, the mere visibility of their idleness creates a bad impression. Further, the idleness quickly impairs collective and individual morale. The reactions of surveyed firms indicate that they consider the second result at least two and a half times as bad as the first.

Nevertheless, 85% of the reporting firms require all staff members to report regularly to the office even when there is not sufficient work for them. This suggests strongly that some form of useful, if not directly productive, activity is carried on.

Actually, with the exercise of a little ingenuity there is no real lack of measures to keep staff members busy with matters that will be beneficial in the long run. Chapters 9 and 19 contain definite ideas on this point. The first, dealing with staff selection and training, contains much on staff training classes, reading and development that can be applied intensively in nonproductive periods. The second, dealing with report writing, covers a good deal on the subject of standardization of reports, clarity of report comment, and specific steps to be taken during the slack season to improve the writing of future reports. This too furnishes an almost inexhaustible field for very helpful exploitation of any spare time that becomes available. And of course the opportunity for other forms of individual study and technical reading are unlimited.

In the author's opinion, one of the greatest opportunities to use the staff effectively during slack periods is furnished by engagements which accountants accept usually more to take a useful part in community life than to engage in a remunerative activity. Institutional and other work of this sort, such as audits of hospitals, colleges, schools, clubs, and so on can generally be performed during slack periods. One firm doing an appreciable amount of such work is known to accept these engagements only for the period between April 1 and December 1 and to have thereby over a period of years balanced its time so efficiently that it hires no extra personnel in the peak seasons and loses a very small amount of unassigned productive time in the slack seasons.

Most firms have one or more accounts of a semicharitable nature, such as church, community chest, and similar audits. There is rarely any difficulty in securing consent to having this work done in the slack season, particularly if the consideration extended such clients as to fees is directly related to the possibility of doing the work at a time most convenient to the accountant.

Responsibility for Assignments

One of the most important tasks in staff utilization is assignment of personnel. This requires considerably more than knowing what personnel is available and the abilities of the personnel. It requires a broad and comprehensive knowledge of accounting and of the special requirements of each engagement scheduled. Also requisite is the administrative ability to get the best results from the staff members available and to use them in such a way as to use the special abilities of each to the best advantage. This involves not only such use within a specific assignment but also in shifting personnel from one assignment to another. It may call for moving one or more men from one engagement to another before the first is finished. The doing of all these things follows certain well defined patterns.

Eighty-three per cent of the firms reporting in the Institute survey state that their assignments of field engagements to in-charge accountants are made usually by a principal of the firm. With respect to large firms, this percentage drops to 50%. This suggests that in other cases the assignments are made by managers or supervisors.

The survey sought to learn what were considered to be the major factors in the assignment of a supervisor to an engagement. In considering the replies, it seems warranted to apply them also to assignment of in-charge accountants to specific engagements. There is a difference, of course, as the choice of a supervisor in relation to an engagement must take into consideration that he will probably supervise several of them simultaneously at a higher level of authority and responsibility, while the choice of an in-charge accountant need relate directly only to a specific engagement.

Two major factors in assigning a supervisor are indicated by the returns. Listed in order of importance according to the frequency of their listing, and taking into consideration that there is very little difference in such frequency, the factors are: (1) familiarity with the specific engagement, (2) special qualifications, (3) size and scope of engagement, (4) availability and (5) general professional ability.

The assignment of staff members to an engagement is affected also by certain factors, and these represent appreciably different methods of approach. The factor advanced as most important by a large proportion of the reporting firms is the special requirements of the engagement. An

appreciable but substantially lesser number consider as most important the past performance of the assigned personnel as a team. Some place first the preferences of the supervisor or in-charge accountant as to their assisting personnel.

Aside from the firms favoring the methods stated, one medium-sized firm specified availability as highly important. Another in the same size group commented that it tries to get as many staff members as possible acquainted with each engagement. This makes individuals highly interchangeable, broadens staff experience and lessens the loss felt when any staff member leaves the firm.

Factors in Assigning Staff Members

This comment highlights the significance of other questions asked in the survey. In assigning duties to individual staff members, (1) are these restricted principally to the types of work they have performed before, (2) is an effort made to include activities more advanced than or differing from those given them on other assignments, or (3) is little consideration given to correlation of duties and the individual in either of the two ways stated? The replies show that only 12½% of firms restrict the duties of individual staff members principally to duties previously performed by them, while 75% make an effort to give them different or more advanced duties, and 12½% give little attention to following either course intentionally.

Another series of questions covered the nature of possible specific instructions to in-charge accountants to so use their assistants, within the limits imposed by efficient performance of the engagements, as to train them for the future along certain indicated lines. Sixty-eight per cent of the replies recorded that a specific requirement is that such use of staff assistants should be for the purpose of making them more competent generally in all phases of auditing. Thirty-nine per cent of the answers say the matter is left to the discretion of the in-charge accountant and 3% require that staff members be used so as to become specialists in stated areas.

In the author's opinion, the modification of ideal conditions to recognize realities is a frequent occurrence. For example, an ideal setup for a given assignment might comprise one partner or supervisor on part time, two seniors, two semi-seniors and four juniors and call for performance of the contemplated engagement by them in three weeks. Assuming that it then develops before the engagement is started that the partner or supervisor will be unable to give as much time as expected and that only one senior and one semi-senior of the personnel originally assigned will actually be available, changes will be required to redistribute in another effective way the "balance" originally sought in the assignments made. The senior to be used will have to be a top-grade man capable of competent performance with a minimum of supervision. His semi-senior

must be one about ready for promotion to senior. Enough juniors will be required to complete the original numerical complement for the group and three or four of these should be the most capable men of their grade available.

While classification of personnel is, in general, an indication of the grade of work to which members of each classification are usually assigned, the relation of classification to actual assignment is not rigidly applied and the degree of application varies significantly according to the size of accounting firms.

Seventy per cent of the small firms and 83% of the medium-sized firms reporting in the survey indicate that classifications of staff members according to assignment vary from one engagement to another. In the large firms this percentage drops to 22%. The large firms have a big enough staff with sufficient personnel in each classification to assign duties more regularly in line with grades. The small firms, and particularly those with only two or three staff members, must inevitably often have personnel of higher grades performing duties usually falling within the scope of lower classifications and also may sometimes assign some staff members to duties of the next highest grade, as a matter of necessity.

In essence the formal functional division of staff personnel into classifications does not bar a degree of fluidity of use both within classifications and upward and downward. Such fluidity or flexibility, as indicated, is greater in small firms but is also present in the large organizations to some extent. There is, of course, another reason for this beside the adapting of the staff to the work at hand. This is that as personnel in each grade becomes capable of handling the duties normally performed by members in the next higher classification, their ability to do so must be tested cautiously under careful supervision by assignment to work related to the higher classification. Size or complexity of an engagement also may play a part. Some engagements can only be handled by a fully experienced senior with past competent service as an in-charge accountant. Others, however, may permit use of a semi-senior as the in-charge accountant who on a larger engagement would be competent only to act as an assistant to the in-charge accountant.

The most obvious instance of duties performed outside the actual classification is that of the sole practitioner who has a new and small practice and no staff personnel. He performs the duties of all grades until such time as he acquires an assistant and then has to cope with assigning the latter to duties within the assistant's gradually increasing competence.

Scheduling Work for Completion

A factory production line cannot turn out goods as planned unless every related activity is scheduled and made to adhere to schedule. It is exactly the same in the systematic operation of a public accounting office.

The scheduling must be as accurate as possible, yet it cannot be too rigid. It must be sufficiently flexible to allow reasonably for contingencies and possible deviations, yet its goal must be to utilize to the utmost possible extent the staff available for the work definitely in hand over the scheduled period.

Sixty-five per cent of the firms reporting upon this phase of the survey maintain a schedule of future engagements. The percentage is somewhat less for small firms which are naturally less apt to have either volume and complexity of work or the size and classification of staff to make the careful scheduling and regulating of work practically imperative. The work schedule, according to survey returns, usually covers four weeks ahead. There are, however, many recorded instances of longer periods ranging from sixty days to six months. The two extremes, oddly enough, are reported by small firms. One such firm limits its advance schedule to one week. The other covers one year.

The survey returns show that, as to the important details carried on work schedules, all of the firms list each specific engagement, 90% show the expected date of completion, 82% record the men assigned, and 57% note the date each staff member will be available for another assignment. A few firms also list other items of special interest for them. One large firm specifies the number and grade of man hours estimated for each engagement.

Some firms maintain subordinate working schedules for each staff member. Of those doing this, 71% show the estimated total chargeable time for the period covered by the schedule, 40% the time already allocated and 38% the engagements to which the individual is assigned. One large firm also finds it desirable to add time analysis by a breakdown into chargeable time and several categories of nonchargeable time.

Transfer of Personnel Before Completion

Normally it is desirable to keep staff members on engagements until their specific assignments have been completed. In practice, however, it sometimes becomes necessary to transfer an individual from one assignment to another before completion of the first. Medium-sized and large firms covered in the survey do not seem to admit experiencing this need at any time, since all report completion of all specific assignments. Seventeen per cent of the small firms indicate that they sometimes find transfers essential before completion. This is understandable since the larger the number of staff members the greater the likelihood of being able to keep a staff member on the duty assigned until completion. The smaller the staff the greater the need for interchangeability of functions, personnel and assignments.

Transfers from assignments before their completion by the persons originally assigned may occur for any one of several reasons and these reasons are not necessarily given the same degree of importance or con-

sideration by all firms. Asked in the survey to check factors which might cause them to transfer an individual from an assignment before his completion of it, the firms queried made the following response. Ninety per cent would do so to meet a deadline on another job, 68% at a client's request, and 58% at the request of the in-charge accountant. Fifty per cent listed incompetence to perform the duties assigned, a similar percentage would transfer men to make productive use of staff, 22% would do so at the request of the staff member concerned, and 20% to provide widest possible rotation of duties among staff members.

The indicated reasons for possible transfers from assignments prior to their completion point up informatively some of the essential qualifications a staff member should have to be most valuable to his firm and, in consequence, to himself. He must be adaptable to change and this adaptability should have a wide range for he must be equally able temperamentally to pursue an assignment unremittingly to its conclusion no matter how long, difficult or even monotonous it may be or to stop in the middle of such an assignment and take up another at any point without this affecting his interest, efficiency or mood.

The staff men, too, must be able to get along diplomatically with clients and their personnel under all circumstances, and to make every in-charge accountant for whom he performs assignments consider him highly competent and as a man he wants on future engagements. His competence must extend also as widely as possible in the general field of accounting so that his firm may be able to use him advantageously in many ways and so that there will be little likelihood of his being given an assignment which he will not be able to handle well. And, clearly, it should never happen to him that a client requests his firm to take him off an assignment.

A staff member with all these qualities is clearly a paragon. But to the extent to which he approaches such an ideal, to that extent is he qualified to progress in his profession. There will be a very definite relation between the degree to which he possesses these qualities and the rapidity and nature of his advancement.

Delays

In adhering to working schedules, possible delays must be anticipated and avoided. Such delays may come in any phase of an engagement but the basic effect of all is to delay the report, with numerous vital consequences affecting both the client and the auditing firm.

In the survey, firms were asked to check certain causes for lost time or delay and were requested to indicate whether those checked occurred often or seldom.

The following table summarizes the returns received and indicates the relative importance of each cause based on frequency:

<i>Cause</i>	<i>Rated in Order of Frequency</i>
Failure to write basic substance of report as work being performed in field	First
Failure to adjust audit program to developments during course of audit	Second
Failure to discuss report with client before final typing	Third
Failure to prepare adequate audit program	Fourth
Failure to obtain sufficient data from client as to scope of audit	Fifth
Failure to inform in-charge accountant as to nature of audit and report desired	Sixth

A few firms listed other causes of delay and all were stated to occur often. A medium-sized firm specified the transferring of men to other engagements. A firm of similar size mentioned missing data because of lack of thoroughness and added this was due possibly to the inexperience of staff men promoted too fast. One large firm recorded in somewhat too general language "failure to meet schedule." This would seem to mean primarily that in scheduling work for completion the necessary time is under-estimated or that in various ways there is failure to adhere to the set schedule.

The author feels that not only often, but lamentably too often, the really fundamental cause of delay is lack of thorough preparation of working papers. Field work may be completed according to schedule but on review questions are asked which cannot be answered by reference to the working papers and they are found not to contain all data essential for the final report. Here, of course, it is not review or report preparation which is the direct cause of delay and loss of time but the inadequacy of field work which ostensibly has been completed according to and on schedule.

Audit Programs

The inadequacy of working papers referred to above is clearly related to the question of audit programs. Where there is a satisfactory and comprehensive audit program and it is carried out conscientiously, there is very little likelihood of inadequate working papers. In this chapter audit programs are considered incidentally from the standpoint of utilization of personnel. A much broader coverage is to be found in Chapter 14 on the planning and control of audit procedures and there are also references to such programs in Chapter 15 on audit working papers.

Of the firms queried in the Institute survey as to whether they consider an audit program essential for every engagement, 68% replied in the affirmative. It seems reasonable to infer that all or some of those answering in the negative consider an audit program is essential for some engagements and that the decision would depend upon size and complexity of the audit. It is also likely that many who do not use a formal

program nevertheless use notes or outlines which amount to an informal program.

There are various ways in which the use of audit programs contributes to the effective utilization of personnel. Eighty-eight per cent of the firms asked to list these specified that such programs save time in giving instructions to staff, 84% that they eliminate any need to go back to take care of omissions, and 82% that they eliminate lost motion by some staff members who might not otherwise know how to proceed. Seventy-six per cent consider they prevent duplication of effort by personnel and 70% that they are essential to secure maximum efficiency. One firm added it felt audit programs beneficial in that they permit utilization of past experience both generally and as to the particular audit.

Two medium-sized firms pointed out possible disadvantages that should be avoided. One stated that an audit program, if too detailed, may eliminate initiative. The other remarked that an audit program presents the danger of getting stereotyped unless kept current, and so the program should be viewed as a guide only and subject to modification and simplification. This of course is a commentary applicable to all audit programs, as is well pointed out in Chapter 14.

Time Estimates

In the preparation of effective working schedules, accurate estimation of required time is indispensable. Where the size and nature of an engagement require it, a time budget is the formal outcome of the estimating. Forty per cent of the firms represented in the survey use time budgets in preparation for audits. Naturally, the percentage is somewhat lower for small firms.

The firms preparing such budgets consider certain major points in estimating time requirements for audits. These in the order of reported frequency are: (1) nature and scope of audit, (2) prior experience on the same audit, (3) prior experience on similar audits, (4) general competence of personnel assigned, (5) estimates of the supervisor or in-charge accountant, (6) pressure of time in meeting the report date, and (7) the time of year at which audit occurs (peak or slack season).

A time estimate is not necessarily made an integral part of an audit program but there can be good reasons for making it so, and 26% of firms asked about it in the survey do this. It is interesting to note that no large firm reported doing so while one-third of the small firms did.

However, firms that do not make time estimates a physical part of audit programs often make them comparable in detail by relating time subdivisions to the specific subdivisions of the working programs.

The ways in which firms consider a time budget particularly helpful in staff utilization are, in the order of frequency recorded in the survey, (1) it gives a basis for estimating when staff members on one engagement can be expected to be ready for another, (2) it gives staff members a

time standard to go by, (3) it provides one basis for judging the performance of individuals, and (4) it tends to prevent improper allocation of time to different phases of an audit. Two supplemental comments are made by firms. A medium-sized organization states that it insures completion of engagements within a reasonable time and thus helps avoid having to explain excessive time and making fee adjustments. A large firm, with presumably the same general thought in mind, comments that a time budget helps control the fee.

A time budget, like anything else, can be used unwisely. In this respect the firms surveyed point out that these possibilities are to be guarded against: (1) a tendency on the part of staff members to spend automatically the allocated time (no more and no less) for each phase of an audit, (2) a tendency to repeat in preparing time budgets the time allocations for the same audit on prior occasions even if proved unsatisfactory, and (3) a likelihood of too much reliance on time budgets in estimating when personnel can be scheduled for another assignment.

Women Accountants

That women are in the accounting profession to stay is hardly debatable. The vital question really is as to the extent of their participation in it. Two factors seem to indicate the probable limitations. One is that for some requirements they are handicapped. These pertain to taking of physical inventories, the unrelenting pressure of work during peak seasons and the difficulties involved in using them for out-of-town assignments. The other is that a woman tends to be less certain of making a permanent career of accounting than a man and, whether single or married, is more likely to withdraw from business activity prematurely. This may make it difficult and inexpedient for firms to train women progressively for higher classifications or to consider them as potential principals or partners.

Fifty per cent of the firms surveyed hire some women accountants. The percentages, however, on the average are very small.

Where women are hired, 70% of the firms give them field assignments. However, two-thirds of these firms place restrictions on such activities. Among these one medium-sized firm states it uses a woman staff member only to assist clients' bookkeepers in emergencies. A large firm records that it makes restrictions dependent on wishes of clients. Another large firm lists out-of-town assignments as the sole restriction.

Queried as to specific factors tending to limit extended use of women accountants, reporting firms attached equal importance to two major points. These are lack of availability for travel and for physical inspection of inventory and plant. Also listed but considered relatively minor are objection by clients, inability to stand extended overtime, taking time off frequently, and antipathy manifested by male staff members.

A theory is sometimes expressed that one reason for considering women for positions may be a general willingness on their part to accept lower salaries than men. It is possible this may have been a significant reason at one time in some business fields and may yet be in a few. It does not seem applicable to the professions where women of equal ability are considered worth equal compensation. As for the accounting profession, every one of the firms surveyed that hires women accountants stated the lower salary factor is never considered. Moreover, as to business generally the growing adoption of antidiscrimination laws is eliminating sex as a differential and where such laws are not yet in existence their principle prevails rather widely as custom or practice.

A development meriting attention is that about 17% of the firms surveyed indicate that clients sometimes express a preference for the use of women accountants on engagements. No particular cause is assigned for this. However, two reasonable surmises are possible. One is that such a preference would be apt to be stated by a client where one or more major executives are women. There is a real increase in the number of such firms. The other is that there are very many large business organizations devoted wholly or in great part to women's requirements. Even where such organizations are run entirely by men, it may well be that on audits of such organizations women accountants, on certain aspects at least, would have a better understanding than men.

It does not appear that there is any very discernible increase in the number of women applying for employment as accountants. Only about 14% of firms queried find any indication whatever of increase. However, it is pertinent that no small firm reports noting such an increase whereas 40% of the large firms do.

Conclusion

This chapter does not purport to provide ready-made formulas for the immediate and easy solution of every staff problem. It is apparent from the division of opinion among accounting firms on almost every question that there are varying ways to obtain desired results and that the variations are often governed by the special circumstances of each case. What does impress the author on completion of this chapter, and some readers may agree with him, is that all of the problems discussed can be solved effectively in some way, provided there is reasonable balance between general objectives and special circumstances. In this objective, the recorded experience of the profession should be a helpful guide.

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Appendix A

THREE HUNDRED SUBSTANTIAL COMPANIES HAVING FISCAL YEARS OTHER THAN THE CALENDAR YEAR

This information was obtained as the result of a study made in the early part of 1952 by a firm of accountants to determine something about fiscal year closings of various businesses.

The following list and summary show the fiscal years and type of business of three hundred substantial companies having fiscal years ending in the following months:

<i>Month</i>	<i>Number</i>	<i>Month</i>	<i>Number</i>
January	42	July	24
February	13	August	18
March	22	September	40
April	12	October	42
May	8	November	25
June	54	Total	<u>300</u>

FISCAL YEARS ENDING JANUARY 31

Aldens, Inc. (18)*	Joseph Horne Co. (17)
Allied Stores Corp. (17)	Hoving Corp. (19)
Arnold Constable Corp. (17)	Interstate Dept. Stores, Inc. (17)
Associated Dry Goods Corp. (3)	Kobacker Stores, Inc. (17)
Benrus Watch Co., Inc. (14)	G. Krueger Brewing Co. (1)
Best & Co., Inc. (17)	Lane Bryant, Inc. (19)
H. C. Bohack Co., Inc. (16)	Lerner Stores Corp. (19)
Brown & Bigelow (4)	Mandel Bros., Inc. (17)
City Stores Company (17)	Mangel Stores Corp. (19)
Crowley, Milner & Co. (17)	The May Dept. Stores Co. (17)
Emporium Capwell Co. (17)	Meier & Frank Co. Inc. (17)
The Fair Co. (17)	Mercantile Stores Co., Inc. (17)
Federated Dept. Stores Inc. (17)	Miller and Rhoads, Inc. (17)
Gimbel Bros., Inc. (17)	Montgomery Ward & Co., Inc. (18)
Godchaux Sugars, Inc. (2)	National Dept. Stores Corp. (17)
Goldblatt Bros. Inc. (17)	Oppenheim, Collins & Co., Inc. (19)
Gorham Mfg. Co. (14)	Outlet Company (17)
W. T. Grant Co. (19)	Sears, Roebuck and Co. (18)
H. L. Green Co., Inc. (19)	United States Radiator Corp. (10)
Hecht Co. (17)	Western Department Stores (17)
Hibbard, Spencer, Bartlett & Co. (15)	Wieboldt Stores, Inc. (17)

* Coding to indicate type of business. See summary by Type of Business which follows this list.

FISCAL YEARS ENDING FEBRUARY 28

Beatrice Foods Co. (2)	Midwest Piping & Supply Co., Inc. (10)
Collins and Aikman Corp. (3)	Pacific American Fisheries, Inc. (22)
Eversharp, Inc. (14)	Parker Pen Co. (14)
The Great Atlantic & Pacific Tea Co. of America (16)	W. A. Sheaffer Pen Co. (14)
The Great Western Sugar Co. (2)	Sterchi Bros. Stores, Inc. (19)
Libby, McNeill & Libby (2)	United Shoe Machinery Corp. (11)
	Utah-Idaho Sugar Co. (2)

FISCAL YEARS ENDING MARCH 31

American Crystal Sugar Co. (2)	Longines-Wittnauer Watch Co., Inc. (14)
American Stores Co. (16)	National Radiator Co. (10)
Beaunit Mills, Inc. (3)	North American Rayon Corp. (3)
Bulova Watch Co., Inc. (14)	Pettibone Mulliken Corp. (8)
Champion Paper & Fibre Co. (4)	Philip Morris & Co., Ltd., Inc. (1)
Davega Stores Corp. (19)	Phillips Packing Co., Inc. (2)
Daystrom, Inc. (11)	Remington Rand Inc. (11)
First National Stores, Inc. (16)	Rome Cable Corp. (12)
Foster & Kleiser Co. (22)	Todd Shipyards Corp. (13)
Grand Union Co. (16)	United States Industrial Chemicals, Inc. (5)
W. F. Hall Printing Co. (4)	
Holly Sugar Corp. (2)	

FISCAL YEARS ENDING APRIL 30

American Car & Foundry Co. (13)	H. J. Heinz Co. (2)
Austin, Nichols & Co. Inc. (15)	Peabody Coal Co. (21)
Brown-Forman Distillers Corp. (1)	Selby Shoe Co. (14)
Cosden Petroleum Corp. (6)	Solar Aircraft Co. (13)
Crown Zellerbach Corp. (4)	Truax-Traer Coal Co. (21)
Fibreboard Products Inc. (5)	True Temper Corp. (10)

FISCAL YEARS ENDING MAY 31

Dow Chemical Co. (5)	Pillsbury Mills, Inc. (2)
Flour Mills of America, Inc. (2)	Raytheon Mfg. Co. (12)
Gamewell Co. (12)	Stokely-Van Camp, Inc. (2)
General Mills, Inc. (2)	Western Natural Gas Co. (21)

FISCAL YEARS ENDING JUNE 30

Allied Mills, Inc. (2)	McKesson & Robbins, Inc. (15)
The American Agriculture Chemical Co. (5)	Michigan Sugar Co. (2)
American Molasses Co. (2)	Motor Products Corp. (13)
American Ship Building Co. (13)	National Airlines, Inc. (22)
Archer-Daniels-Midland Co. (5)	National Manufacture & Stores Corp. (19)

FISCAL YEARS ENDING JUNE 30 (Cont.)

Aspinook Corp. (5)	Noma Electric Corp. (12)
Atlas Plywood Corp. (14)	Omar Inc. (2)
Ayrshire Collieries Corp. (21)	Pabco Products, Inc. (14)
The Best Foods, Inc. (2)	Pepperell Mfg. Co. (3)
E. L. Bruce Co. (14)	Potash Co. of America (5)
Carpenter Steel Co. (8)	The Procter & Gamble Co. (5)
Chickasha Cotton Oil Co. (5)	The Quaker Oats Co. (2)
Colorado Fuel & Iron Corp. (8)	Reeves Brothers, Inc. (3)
Columbia Pictures Corp. (20)	Seeman Brothers, Inc. (15)
Coty, Inc. (5)	L. C. Smith & Corona Typewriters, Inc. (11)
Davison Chemical Corp. (5)	Sparks-Withington Co. (12)
Eastern Sugar Associates (2)	L. S. Starrett Co. (11)
Francisco Sugar Co. (2)	Stop & Shop, Inc. (16)
Franklin Stores Corp. (17)	The Timken-Detroit Axle Co. (9)
Hancock Oil Co. (21)	Torrington Co. (of Maine) (10)
International Minerals & Chem. Corp. (5)	United Merchants & Manufacturers, Inc. (3)
Julius Kayser & Co. (3)	United Wall Paper, Inc. (4)
Keystone Steel & Wire Co. (8)	Universal Winding Co. (11)
Lehn & Fink Products Corp. (5)	Vick Chemical Co. (5)
Magnavox Co. (12)	Virginia-Carolina Chemical Corp. (5)
Manati Sugar Co. (2)	Western Newspaper Union (4)
Manhattan Shirt Co. (3)	
McDonnell Aircraft Corp. (13)	

FISCAL YEARS ENDING JULY 31

Addressograph-Multigraph Corp. (11)	Miller-Wohl Co., Inc. (19)
American Sumatra Tobacco Corp. (1)	Modine Manufacturing Co. (9)
Anderson, Clayton & Co. (3)	National Bellas Hess, Inc. (18)
Central Aguirre Sugar Co. (2)	Northrop Aircraft, Inc. (13)
Davidson Bros., Inc. (17)	Royal Typewriter Co., Inc. (11)
Froedtert Grain & Malting Co. Inc. (1)	Joseph E. Seagram & Sons, Inc. (1)
Julius Garfinckel & Co. Inc. (17)	A. O. Smith Corp. (8)
D. H. Holmes Co., Ltd. (17)	South Coast Corp. (2)
F. L. Jacobs Co. (9)	United Electric Coal Companies (21)
King-Seeley Corp. (9)	Waukesha Motor Co. (9)
M & M Wood Working Corp. (14)	Woodward & Lothrop (17)
R. H. Macy & Co., Inc. (17)	L. A. Young Spring & Wire Corp. (11)

FISCAL YEARS ENDING AUGUST 31

Central Soya Co., Inc. (5)	Murray Corp. of America (10)
Consolidated Textile Co., Inc. (3)	National Linen Service Corp. (22)
Dana Corp. (13)	Schenley Industries, Inc. (1)
Hallicrafters Co. (12)	Seeger-Refrigerator Co. (12)
Kelsey-Hayes Wheel Co. (9)	The Sherwin-Williams Co. (5)
Loew's Inc. (20)	Spencer Kellogg & Sons, Inc. (5)
Martin-Parry Corp. (10)	Warner Bros. Pictures, Inc. (20)
Masonite Corp. (4)	Wesson Oil & Snowdrift Co., Inc. (2)
McCord Corp. (9)	Woodall Industries, Inc. (9)

FISCAL YEARS ENDING SEPTEMBER 30

The American Distilling Co. (1)	Emerson Electric Manufacturing Co. (12)
American Steel Foundries (8)	Gibson Refrigerator Co. (12)
Armstrong Rubber Co. (7)	Hayes Manufacturing Corp. (13)
Ashland Oil & Refining Co. (6)	R. Hoe & Co., Inc. (11)
Automatic Canteen Co. of America (14)	Horn & Hardart Co. (19)
Beech Aircraft Corp. (13)	Joy Manufacturing Co. (11)
Bendix Aviation Corp. (13)	Laclede Gas Co. (22)
The Black-Clawson Co. (11)	The Liquid Carbonic Corp. (5)
Black & Decker Manufacturing Co. (11)	Mergenthaler Lintotype Co. (11)
Brewing Corp. of America (1)	Nash-Kelvinator Corp. (9)
Burlington Mills Corp. (3)	National Pressure Cooker Co. (10)
A. M. Byers Co. (8)	National-Standard Co. (10)
Canada Dry Ginger Ale, Inc. (1)	Outboard, Marine & Manufacturing Co. (13)
Cessna Aircraft Co. (13)	Ralston Purina Co. (2)
Clinton Foods Inc. (2)	Roeser & Pendleton, Inc. (21)
Cornell-Dubilier Electric Corp. (12)	South Porto Rico Sugar Co. (2)
The Cuban-American Sugar Co. (2)	Tishman Realty & Construction Co., Inc. (22)
Cuban Atlantic Sugar Co. (2)	Walgreen Co. (19)
Cunningham Drug Stores, Inc. (19)	West Indies Sugar Corp. (2)
Detroit Harvester Co. (11)	
Duplan Corp. (3)	

FISCAL YEARS ENDING OCTOBER 31

American Air Filter Co., Inc. (10)	Hygrade Food Products Corp. (2)
Armour & Co. (2)	International Harvester Co. (11)
Carrier Corp. (11)	A. C. Lawrence Leather Co. (14)
J. I. Case Co. (11)	Lee Rubber & Tire Corp. (7)
The Celotex Corp. (14)	Minneapolis-Moline Co. (11)
Cherry-Burrell Corp. (11)	John Morrell & Co. (2)
Continental Motors Corp. (11)	The Oliver Corp. (11)
The Cudahy Packing Co. (2)	Pittsburgh Brewing Co. (1)
Dayton Rubber Co. (7)	Rath Packing Co. (2)
Deere & Co. (11)	Reliance Electric & Engineering Co. (12)
Dresser Industries, Inc. (11)	Republic Pictures Corp. (20)
Emerson Radio & Phonograph Corp. (12)	Ryan Aeronautical Co. (13)
Firestone Tire & Rubber Co. (7)	Servel Inc. (11)
Foote Bros. Gear & Machine Corp. (11)	A. G. Spalding & Bros., Inc. (14)
Fort Pitt Brewing Co. (1)	John B. Stetson Co. (3)
Gar Wood Industries Inc. (11)	Swift & Co. (2)
General Shoe Corp. (14)	United States Leather Co. (14)
The Glidden Co. (5)	United Stockyards Corp. (15)
Adolf Gobel, Inc. (1)	Universal Pictures Co., Inc. (20)
Greif Bros. Cooperage Corp. (14)	Western Tablet & Stationery Corp. (4)
Hat Corporation of America (3)	Wilson & Co., Inc. (2)

FISCAL YEARS ENDING NOVEMBER 30

Avco Manufacturing Corp. (12)	Brown Co. (4)
Bastian-Blessing Co. (14)	Buffalo Forge Co. (11)

FISCAL YEARS ENDING NOVEMBER 30 (Cont.)

Consolidated Vultee Aircraft Corp. (13)	Hunt Foods, Inc. (2)
Continental Foundry & Machine Co. (8)	International Shoe Co. (14)
Cook Paint & Varnish Co. (5)	McLellan Stores Co. (19)
Devoe & Reynolds & Co., Inc. (5)	Mueller Brass Co. (8)
Douglas Aircraft Co., Inc. (13)	Rice-Stix, Inc. (3)
Eagle-Picher Co. (5)	Standard Brands Inc. (2)
Endicott Johnson Corp. (14)	United Can & Glass Co. (14)
Ex-Cell-O-Corp. (11)	Wayne Pump Co. (11)
The General Tire & Rubber Co. (7)	William Whitman Co., Inc. (3)
Hart Schaffner & Marx (3)	Wyandotte Worsted Co. (3)
Hooker Electrochemical Co. (5)	

SUMMARY OF FISCAL YEARS BY TYPE OF BUSINESS*Fiscal Years Ending in*

<i>Type of Business</i>	<i>Jan.</i>	<i>Feb.</i>	<i>March</i>	<i>April</i>	<i>May</i>	<i>June</i>	<i>July</i>	<i>Aug.</i>	<i>Sept.</i>	<i>Oct.</i>	<i>Nov.</i>
<i>Manufacturing</i>											
1. Beverages and Tobacco.....	1		1	1			3	1	3	3	
2. Food and Kindred Products	1	4	3	1	4	9	2	1	6	7	2
3. Textile and Apparel.....	1	1	2			5	1	1	2	2	4
4. Paper, Publishing, Printing and Allied Industries.....	1		2	1		2		1		1	1
5. Chemicals, Drugs, Paints and Allied Products.....			1	1	1	12		3	1	1	4
6. Products of Petroleum.....				1					1		
7. Rubber Products									1	3	1
8. Primary Metal Industries....			1			3	1		2		2
9. Motor Vehicles and Motor Vehicle Equipment (Except Electrical Equipment)						1	4	3	1		
10. Fabricated Metal Products (Except Machinery and Transportation Equipment)	1	1	1	1		1		2	2	1	
11. Machinery (Except Elec- trical)		1	2			3	3		6	12	3
12. Electrical Machinery, Equip- ment and Supplies.....			1		2	3		2	3	2	1
13. Transportation Equipment (Except Electrical and Motor Vehicle Equipment			1	2		3	1	1	5	1	2
14. Miscellaneous Manufac- turing	2	3	2	1		3	1		1	6	4
<i>Distribution</i>											
15. Wholesale Trade	1			1		2				1	

SUMMARY OF FISCAL YEARS BY TYPE OF BUSINESS (Cont.)

<i>Type of Business</i>	<i>Fiscal Years Ending in</i>										
	<i>Jan.</i>	<i>Feb.</i>	<i>March</i>	<i>April</i>	<i>May</i>	<i>June</i>	<i>July</i>	<i>Aug.</i>	<i>Sept.</i>	<i>Oct.</i>	<i>Nov.</i>
<i>Retail Trade</i>											
16. Food	1	1	3			1					
17. Department Stores	23					1	5				
18. Mail Order Houses	3						1				
19. All Other Retail Trade.....	7	1	1			1	1		3		1
<i>Miscellaneous</i>											
20. Motion Pictures						1		2		2	
21. Extractive Industries				2	1	2	1		1		
22. Miscellaneous		1	1			1		1	2		

Appendix B

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CHAPTER 11

PROCEDURES FOR TECHNICAL SUPERVISION AND REVIEW OF WORK

SCOPE OF SUPERVISION AND REVIEW

Need for Internal Supervision and Review (Purposes of Review; General Scope; and Errors). Responsibility for Supervision and Review (Principal or Partner; Staff Men; and Branch Offices).

REVIEW PROCEDURES FOR REGULAR AUDIT

Field Reviews (Basic Considerations; Objectives; and End Product). Office Reviews. Principles of Reviewing. Review of Statements and Adjustments with Client. Correction of Errors. Review of Report.

REVIEW QUESTIONNAIRE

Basic Data. Representations by Client. Audit Working Papers and Report.

REVIEW PROCEDURES FOR OTHER WORK

Tax Returns. System Installation. Special Investigations. Miscellaneous Work.

CONCLUSION

APPENDIXES

Illustrative In-Charge Accountant's Review Questionnaire. Illustrative Office Review Questionnaire. Illustrative Statement of Report Review Policy for an Accounting Firm and Illustrative Checklist for Report Review.

CHAPTER 11

Procedures for Technical Supervision and Review of Work

BY A. FRANK STEWART

SCOPE OF SUPERVISION AND REVIEW

Need for Internal Supervision and Review of Work

THE NEED FOR SUPERVISION and review of work is imposed by a requirement far more vital and demanding than a purely contractual obligation to perform an agreed assignment satisfactorily. This higher requirement stems directly from the fact that public accountants are engaged by clients to perform personal service of a professional character. A responsibility devolves therefore upon the accountants to insure that the service rendered is actually personal and that it is performed according to the explicit standards of the profession. Performance of various phases of an engagement may be delegated to subordinates, but responsibility for its competent performance as a whole cannot be. It remains primary and indefeasible as to the principal and can only be met, where tasks are delegated, by comprehensive internal supervision and review that give the service rendered its requisite personal and professional character.

A condition associated with the practice of public accountancy, which in many respects is singular to that work, is represented by the interest maintained in the examination and in the report thereon by persons other than the accountant and the client. These persons are generally referred to as third parties and they comprise investors, bankers, security dealers, and others who are concerned with the financial affairs of the company.

While it is true that a confidential relationship exists between the accountant and his client, the client will have no hesitancy in submitting the report to third parties without seeking the consent of the accountant. The average report should be so constructed as to fulfill averages uses, and a test often employed is for the accountant to ask himself what information he would want the report to contain if he were a third-party user. Reports for special purposes require special presentation to meet the desired ends.

Purposes of Review

There are differences of opinion regarding the purposes for which a review of the work and the report is made. One authoritative group considers that a review should be designed to make sure that the information contained in the working papers is correctly brought into the financial statements and that the exact facts developed during the examination are completely disclosed. This group attaches supreme importance to the use of formal and standard review procedures, exacting in and of themselves and tolerating no departure therefrom.

The other position, which is held by most practicing accountants, asserts that required review should take place not only after the field work is performed but also throughout the entire period of control of the engagement, and, logically, should begin as early as acceptance of the client. Thus there is also preview and supervision as well as review, and it is felt that the extent and nature of such comprehensive scrutiny is inevitably variable in each engagement. This leads to the conviction that the particular procedures and methods to be used in each case cannot be reduced to a common denominator applicable to every case and on the contrary are a matter for the personal judgment, responsibility, and decision of the principal or firm.

To hold to a hard and fast set of rules to govern review procedures of all accountants is to advocate methods that either could not or would not be applied. The reason for this is obvious. Accounting firms are not all the same size and they range from the individual practitioner to the large firms having hundreds of accountants of varying degrees of special knowledge and ability. A firm of accountants comprising but a few men is in no position to establish the classification of accountants that exists among the large firms. Partners of small firms may be doing the most routine of auditing tasks in the morning and deciding questions of policy in the afternoon — indeed they are often interrupted in one to do the other.

It is a difficult matter to require that an accountant who personally does the work and signs the statements must apply to himself the same close check and scrutiny of the work done that he would apply to the work of another accountant. And yet there is scarcely any accountant worthy of the name who has not at some time looked at his own working papers during a subsequent examination and wondered how he could have handled an item as he originally handled it.

That there is need to review the work on the engagement, no rational accountant can deny. Review is necessary because the responsibility for the accurate and thorough performance of the engagement rests upon the individual practitioner or the accounting firm issuing the report. Great as may be the confidence reposed in the accountant writing the report, he should not be permitted to speak for a firm unless a review has been made of his work, because of the obligation for the accuracy

and completeness of the work which rests upon the firm. Review is necessary also to make certain that the performance of duties delegated to subordinates has been accurate and thorough; to make certain that the engagement has been completed in accordance with the terms governing it; and to recognize and handle developments which have an unforeseen bearing on the scope, purpose, and ultimate value of the engagement.

General Scope

Basically, to be adequately comprehensive, review must ultimately have covered the nature and extent of the work done, the inspection and check of the working papers that have been assembled, and the careful editing of the completed report and statements. This will not have been done unless the following fundamental questions can be answered with completely satisfactory certainty:

1. Were the audit and the extent of verification, including independent confirmation, sufficiently comprehensive?
2. Are the assets properly valued and clearly stated?
3. Has adequate provision been made for all liabilities, direct and contingent?
4. Are income charges and credits properly classified?
5. Have correct accounting principles been applied and has their application been consistent?
6. Do the working papers contain all necessary analyses, schedules, and explanations necessary to support the statements and opinion?
7. Does the report present correctly, intelligently, and adequately the results of the examination?

Errors

If the reasons already advanced are not sufficient to establish the necessity for a review of the work and report, there remains as another reason the need to guard against that ever-present enemy—errors. Errors of principle, errors of judgment—everyday plain old errors of mathematical exactness. Accountants are not phenomenal men. They are subject to all the chances for error that are present in life and guarding against error is always uppermost in accountants' minds. Substantially all accountants welcome a review of their work because they are so conscious of their own frailties; nevertheless, staff seniors should be indoctrinated with the idea that no report should be submitted for review unless it is believed to be letter and figure correct, and no report should be turned in when its writer knows that changes will have to be made therein before it can be typed.

There should be no great arguments in behalf of the necessity of review. It is an axiom of accounting practice that the work and reports are to be reviewed in the best manner that the circumstances of the engagement will permit.

Responsibility for Supervision and Review

Principal or Partner

The use of the term principal is an all-embracing one. In small firms the principal often is the individual practitioner or one of the partners. Large firms have a ladder of authority extending through an organization from juniors to semi-seniors, to seniors, to in-charge accountants, to principals and to partners. Such a distinction is impossible in small firms and the elaborate delegation of duties and appointment of responsibilities exist for them only in the realm of fantasy.

Responsibility is seldom sought in modern life but the authority which presupposes it is greatly desired, particularly in public work. Responsibility for the adequacy of accounting work exists in tiers. To approach the final placing of it in any other manner is to admit a lack of knowledge of the many details present in an auditing engagement. To say that the accountant controlling the engagement must satisfy himself that every adding machine tape has been correctly listed or that every posting has been correctly checked is too absurd to admit of argument. Competency and integrity of subordinate employees are not qualities to be reinvestigated with each engagement. They may be looked into during the first few engagements of a new member of the staff, but as a rule accountants soon learn the degree of reliance that can be placed on the different staff members.

Small and medium-sized accounting firms have an advantage over the larger firms in determining the abilities of the staff members. The small firms are more successful, as a rule, in keeping their staffs unchanged throughout the entire year; as a result the partner or principal develops a personal interest in the man and in his work which encourages easy access to the solution of technical problems as they arise during the progress of each engagement, while at the same time providing a reliable measurement of the abilities of the staff men.

Staff Men

The practice throughout the country with respect to the partners' responsibilities is not uniform. Some firms have one partner review all reports issued from the office but in such cases this partner, who is generally known as the report editor, rarely attends at the scene of the engagement. Other firms have each partner responsible for certain engagements and this responsibility, depending upon the size of the firm, extends from attendance at the scene of the engagement to reviewing the reports and signing the statements.

Occasionally a strange philosophy presents itself in the minds of some accountants, who rely entirely upon the reviewer to detect their errors of commission or of omission. Such accountants do not last long, and they are soon replaced with men of serious mind who earnestly try to

execute correct work and apply thereto the best judgment of which they are capable, often scrutinizing their finished work as if they were themselves to be its final reviewer.

The basic responsibility rests upon the man who does the work; his responsibility extends to the accountant in charge of the engagement. Both parties are responsible to the partners. A partner takes upon his firm the responsibility which follows the approving of an engagement and the signing of the report. This does not mean that every partner must review the work and statements and give his consent to the signing. Few engagements would ever be finished if this concept were rigorously applied. Disputed and doubtful points and policy questions continuously engage the attention of more than one partner, but routine engagements are entrusted to the decision of one partner and he makes the decisions even though they may be binding on all partners.

Branch Offices

It is not often that reports issued by a branch office are referred to the main office in advance of issuance when the branch office is equipped to complete the report. There are some who think this should be done but the impracticability of such procedure will prevent general compliance. Partners or branch managers should sign the reports, and it is rare, if ever, that anyone of lesser authority should be permitted to sign for them. Accounting firms maintaining liability insurance coverage are sometimes required to furnish their insurance carriers with a list containing the names of those of the firm who are properly authorized to sign the reports.

Some of the firms with a number of offices permit each office to complete and deliver its own reports and then send a copy of each to the firm's principal office for post-review. The results are valuable in insuring standardization of reporting methods, in maintaining high quality of report writing (especially footnote writing) and generally establishing adherence to the firm's reporting standards.

REVIEW PROCEDURES FOR REGULAR AUDIT

Field Reviews

Proper review should occur not only after the field work has been finished but also throughout the entire period of the engagement. This involves preview before starting, supervision during, and review at the completion of, the field work. The extent and nature of each review is necessarily variable as to each engagement because of differing conditions, in view of which they cannot be reduced to a standardized or rigid process because they are matters of the personal judgment of the principal or partner.

The general attitude of the profession is probably well expressed in the following statement:¹

"Much of review is preview and most of it is supervision. Consideration of the procedures employed by the field auditor would seem to be inseparable from consideration of the data to which the procedures are being applied, and the review itself, to be genuinely effective, appears to be inseparable from continuous supervision of all the examination's phases from the earliest stages of planning to the final editing of the auditor's report. This being the case it becomes obvious that all of the functions of review except final editing of the report may best be performed in the field . . ."

Field review of the work of staff men on an engagement is conducted by (1) the in-charge accountant or (2) a principal, partner, supervisor or a specially qualified staff member. The second practice is somewhat more prevalent. Basically it depends on such factors as the size and nature of the engagement, the qualifications and experience of the in-charge accountant, and any relevant special circumstances. Where the first method is used, it also is generally considered desirable to have at least one field visit made by someone having higher responsibility for the engagement than the in-charge accountant.

Many advantages result from field visits under the second method. Some of the more obvious and important are these: Major problems encountered by the accountant in charge as the engagement progresses can be disposed of promptly. It becomes possible to give immediate consideration to and take action on changes in the original scope as their need develops. There can be immediate discussion with the client of controversial questions and of proposed adjustments. The engagement can be examined critically as a whole more effectively from the standpoint of procedures in use than by a less intimate and more remote office review after completion of the engagement.

The last statement has obvious special application to (1) out-of-town engagements, particularly when the report is required for a set date, and (2) the fact that most auditing engagements are carried out during the busy year-end season.

Basic Considerations

The initial act of a field review may be directed toward an evaluation of the work done to establish the effectiveness of the system of internal control. While great developments have been made during the past decade in establishing and installing methods of internal check and control, the fact remains that the smaller accountant rarely encounters a well-maintained internal control system and consequently he enlarges the scope of his examination to meet the conditions he finds. Internal control as a system may or may not exist in small businesses, but the fact remains that the active head of a small business has a far greater

¹ See references at end of this chapter.

knowledge of the activities than is readily conceded and the accountant making the examination recognizes this.

Many firms use the plan of having a capable senior accountant, assisted by one or more juniors, stay at the scene of the engagement until the field work is finished and then have a partner or principal arrive to "close," as it is often termed, the audit. This feature of the work is far more than a series of perfunctory questions as to the performance of the audit. To a listener the questions may sound indifferent or mechanical, but each question has a definite meaning and purpose and, if the questions are not satisfactorily answered, additional investigation is ordered forthwith. On this subject *The Journal of Accountancy*² had this to say:

"Most firms have devoted much time and thought to the development of techniques for this purpose. It has been found impossible to solve the problem by rigid rules of procedure. A method adopted in one instance might be wholly inappropriate in another. The infinite variety of circumstances and the infinite shades of difference in personal attributes of the individuals working together as principals and staff assistants preclude widespread application of a uniform pattern of procedure. It is generally believed that a principal well acquainted with the assistant who submits a draft report may by skillful questioning determine whether or not he may safely accept the assistant's representations."

To approach the question of a review of field work with a view that no reliance at all can be placed on the men doing or supervising the work would have the principal or partner re-doing all the work and this would be impossible as well as being completely unsatisfactory to the accounting firm, the client, and the staff assistants who are quick to resent an implication that they have not properly done their work or that their principal reposes no confidence in them.

The frequency of field visits to an engagement during its progress depends upon the size, scope, and complexity of the engagement, whether or not it is an initial engagement, the rapidity with which it must be completed, a knowledge of the industry in general and the client in particular, as well as the presence of special problems.

Closely connected with the question of field supervision and review is the matter of standard minimum qualifications for an in-charge accountant. Here again there must be reasonable variation related to the basic demands of each engagement. A reasonably definite specification is that he must have ability and experience adequate for the specific engagement of which he is given field charge. Many firms add to this the even more far-reaching requirement that he must have been with the principal or firm long enough and under such appropriate conditions as to have been fully tested as to competence and character.

A further essential is careful consideration as to the selection of all staff members, not only with respect to their specific assignments on individual engagements but also as to their general employment. Regard-

ing the broader scope, a minimum requirement is that staff members must have such character and education as to indicate definitely the possession of essential moral and professional integrity. Practically all firms consider this merely a preliminary requisite. They supplement it rigorously by requiring that every new staff member must work for a reasonable period under such restrictive conditions that those not possessing requisite moral and professional standards are certain to be eliminated.

Another important factor from the standpoint of supervision and review is the audit program. Its value in this respect begins with its initial preparation for it serves to guide the in-charge accountant and it is thereafter useful in checking his conduct of the engagement. Usually it is prepared by a principal, partner, or supervisor with the accountant in charge. It is prepared preferably in the client's office, where there is close contact with actual conditions. More often than not, however, it is necessary to prepare it in advance and then the in-charge accountant is given leeway to develop any special line of inquiry which may seem desirable to him. Such a possibility is, of course, another which has obvious relevance to the degree to which field visits to the engagement may be necessary.

Objectives

Field review, starting with the trial balance and the program, undertakes to determine whether the agreed-upon scope of the examination has been at least equaled. The next step is to see that the trial balance work sheet is clearly and legibly prepared and properly completed. With this as a basis, the reviewer can then begin the examination of supporting schedules: first, by comparing balances thereon with the trial balance, and second, by seeing that the items on the schedules are properly part of the account to which they have been charged.

It is at this point that it is realized anew that rules, regulations, and standardization, no matter how helpful when used judiciously, must always remain subordinate to the vigilant exercise of intelligence, knowledge, experience, and judgment as dictated by varying circumstances. No one has summed up this inescapable reality more incisively than Colonel Robert H. Montgomery in his epigrammatic "The Curse of Balancing."³ How can standardized procedures be applied effectively to the many problems that arise which in themselves are absolutely different from any other which has arisen or been reported upon? Recourse must be had, he asserts, to two basic and fundamental principles — truth and disclosure: "Tell the story and let the chips fall where they may!"

During the course of the item-by-item review of the trial balance and examination of supporting schedules, inquiry may be made into various details of the work performed. For instance, the replies to confirmation

requests may be examined. Thereafter the senior accountant will make known to his principal the special problems encountered during the engagement, so that together they can then be resolved by discussion with the client or by proper adjustment.

After reviewing the main points of the auditing procedure the principal can then undertake a broad view of the year's activities. This will often bring to light the answer to whether or not the senior accountant has applied to the examination:⁴

"That degree of vigilance, inquisitiveness and analysis of the evidence available that is necessary in professional undertaking and is recommended in all well known and authoritative works on auditing."

Questions directed toward this end often include: Are the earnings more or less than last year? What is the main reason for the increase or decrease? Are the accounts receivable good and collectible? Are they really accounts receivable? Are there any large credit balances? Is the allowance for possible losses, if one is carried, too much or too little? Was confirmation satisfactory? Are inventories comparable to last year? Are inventory records good? Is any large round amount taken from the total? Is gross profit margin in line with preceding year? Have additions to fixed properties been approved? Have corporate minutes been read and expression given to all liabilities mentioned therein? Are all known contingent liabilities developed?

These questions and many more that will occur to the reviewer may be asked for two purposes: To decide whether or not certain matters need more review, more analysis or more work, and to test the thoroughness of the senior's work and supervision.

The End Product

All field reviews of work done and papers accumulated must be conducted with the end in mind of writing the report which will contain the finished financial statements, together with their related comments, be these either explanatory or amplifying. It is in the final review that the decision is made as to the content of statements and schedules that are to appear in the report, and ever-present care should be taken to see that the working papers contain supporting information for the leading exhibits in the report.

In cases where the tax returns are to be made, the working papers must contain all information necessary to complete the various schedules that are a part of the returns. This includes such expense accounts as taxes, officers' salaries, contributions, and data regarding the disposals of capital assets.

While most authorities agree that the client's office is the proper place to make the exhibits and schedules that are to go into the report, this is not always possible. Pressure of other matters, required review at other

points, the starting of a new engagement, as well as the ever-present desire to get back home, cause the accountants to write their reports at places other than the client's offices and in many cases long after the audit has been completed.

The ideal condition is that each examination should be completely finished, with its report written, before the next engagement is started. Accountants are simply not able to meet this ideal condition and the finishing work is more often than not, especially during the peak season, done at nights and with the pressures and anxieties which accompany the conducting of two or three assignments at the same time.

After the field work has been finished, all points of the field review well and thoroughly covered and the report written, the report must have an office review, and this many times is a face-reddening experience for both the principal and the senior who have worked on the examination.

The mere realization that there is to be such an office review should in itself make what may well be termed "an afterthought audit" an extremely rare phenomenon, and yet it occurs with deplorable frequency. A review may develop that some item of essential information has been overlooked. This omission is remedied by calling again at the client's office, or by telephoning for it, or, in the case of out-of-town engagements, writing for it. The omission is thus remedied but it should not have occurred and leaves an unfavorable impression upon the client, the accountant, and the staff. It would not have occurred had the in-charge accountant asked himself and acted on one last question in the field. This is: "Has every required item of information been obtained that is needed to complete this engagement?" Where an audit program is used, each item can be checked off as finished and care taken that all are checked. Where no such program is used, a less formal check list can be prepared on which are recorded all items that are temporarily unfinished as the engagement progresses and which list receives a final checking at the end of the engagement.

Office Reviews

Whether or not there is an adequate field review, there should always be an office review before the report is released, its extent and scope depending in large part upon the scope of the field review. The records examined in an office review are the working papers and the report. Where there is a formal audit program, this is studied first and the working papers and the report related to it. Such review is conducted in accordance with definite principles of reviewing stated hereafter.

Review of the working papers is fundamental to supply reliable evidence that there is a solid foundation for the report. There are times after the submission of a report when the in-charge accountant is no longer available to answer questions that may have arisen. It is particu-

larly on such occasions that thorough, well-arranged, and properly indexed and reviewed working papers are invaluable.

The office review is not conducted by the same process in all offices. Some firms have an employee who is designated as the chief-of-staff whose normal duties consist in part of assigning the accountants to the engagements and reviewing the working papers and the report after the audit is finished. Smaller firms having more than one partner decide which partner is to control the engagement all the way through to its completion, and each partner has a series of clients for whose audits he is responsible.

There are advantages to both systems and some firms use a part of each, but usually the office review is the duty of a partner. Quite frequently this is a partner who had had no contact with the engagement or the men doing the work as it progressed. At first view this may appear to be a disadvantage, but far more frequently it is an advantage because it brings to the work an entirely new mind which has to be convinced of the thoroughness of the work and the correctness of the statements, as well as one in a better position to judge how the finished report appears from the viewpoint of the client, the firm, and third parties. The approach to the office review has been well stated to include the following attitude toward the work:⁵

"There are, then, four major points which the reviewer must keep constantly in mind: (1) he must have confidence, based on his observation, in the accountant's integrity and ability; (2) he must have adequate supporting data in orderly arrangement; (3) he must have special knowledge of the particular subject or have available for conferences associates who are familiar with the business under review; and (4) he must approach his task with a view to developing the utmost possibilities of the engagement. All these points are essential and interdependent and on them, to the extent that they are observed, depends the effectiveness of the reviewer's work."

If the review of the audit program, of the working papers, and of the finished report, is done at one time, the reviewer has an opportunity to contribute greatly to the development of the staff members and the improvement of their work.

A general discussion of sufficiency of office review of working papers would be incomplete without specific reference to the views expressed by the Securities and Exchange Commission in the Interstate Hosiery Mills case in 1939.* The Commission felt adequate review to insure integration of the original work papers with the financial statements should serve not only to disclose intentional or accidental misstatements but also as a method of internal check and control on the work of the firm's subordinates. Such review, though not necessarily done by a partner, should at least be done by one well versed in the firm's procedures and in general principles and terminology of auditing and accounting, and where

* SEC Official Release No. 2048, March 18, 1949.

not by a partner, should be made by a person independent of those actually performing or supervising the audit work, as well as of those preparing the draft of the financial statements. Such review must be more than a series of perfunctory questions as to performance of particular items in an audit program. And explanation of unusual items should not be accepted without support in detail from the working papers.

Principles of Reviewing

The degree of intensity with which the field or office review is conducted is affected by the relevant factors applying to the engagement. When the field review has been conducted by a competent supervisor, a thorough and complete check in the office thereof results only in a duplication of work. Often the papers, by their very appearance, will denote the nature and extent of the review that is required. When the working papers are neat and orderly, and properly indexed to their accompanying schedules, confirmation forms are complete, and there are no doubtful or troublesome points, the review in the office can be completed in a relatively short time.

In such cases after an inspection of the working papers the office review will prove to be of more value if it is mainly concerned with satisfactory answers to such basic questions as:

1. Has a thorough job been done?
2. Has it been found necessary to do any more work not called for originally by the audit program?
3. Are the working papers sufficiently explanatory?
4. Are there items involving possible differences of opinion as to proper accounting treatments?
5. Have consistent accounting practices been employed by the client?
6. Have the final statements been reviewed and discussed with the client before the office review?
7. What should be explained in footnotes?
8. What items are new this time and have they been properly handled?
9. What in the audit and report is different this time and why?

The smaller firms usually settle all of their debatable points during the progress of the engagement by consultation of the accountant in charge either with the partner who reviews the papers or with someone else in authority.

It has been claimed that one criterion to apply to working papers is that they may be introduced as evidence in court proceedings and must be sufficiently clear to be understood, without explanation, should it be impossible to have in support of them the testimony of the accountant who prepared them. While this unmistakably would make for clear and revealing working papers, actually only a very small percentage of audit engagements result in litigation. By far the most prevalent test of the completeness of working papers is their ability to supply the answers

to questions which often occur to clients after the final report has been typed and delivered.

In cases where, for any of the reasons that accompany public accounting, it has been found impossible to have a comprehensive field review of the engagement made by a supervisor or partner, the necessity for a more searching office review of the working papers becomes apparent. The office reviewer then serves in the place of the field reviewer and extends his review to cover all points considered to be necessary or desirable.

These extended points include:

1. Review of the items on the trial balance and the related work sheets.
2. Check of auditor's journal entries for propriety and inclusion.
3. Review of the work sheets to see that they support the figures in the financial statements.
4. Review of bank reconciliations and inspection of confirmations.
5. Review of confirmations to see that there are no liabilities, real or contingent, developed by the replies.
6. Inspection of content of petty cash count.
7. Review of inventory testing to see whether efficient checking of extensions and additions has been made; also checking to see whether client's inventory certificate has been signed.
8. Check of gross profit margin.
9. Check of papers to see whether they contain information in support of items added to fixed assets and inspection of depreciation schedules.
10. Check of insurance schedules and comparison with asset values.
11. Check to see whether capital stock has been proved and whether a complete analysis of retained earnings, contributed surplus and reserves are in the papers.
12. Review of copies of contracts and legal documents, or excerpts therefrom, to determine that they have been given effect to by the client.

This list could be prolonged considerably, and almost every firm has certain special items to which it considers the reviewer of working papers should give definite attention. Illustrations are the possible over-adequacy of the allowance for doubtful accounts, criteria used by client in fixing depreciation rates (whether definite appraisal, considered opinion of engineers, guess-work, et cetera), and scrutiny of insurance coverage to ascertain whether there are assets belonging wholly or in part to others.

Invariably the review of working papers calls for consultation of the in-charge accountant by the reviewer. Sometimes this is done while the working papers are being examined, but it is done just as frequently after their examination. More often than not the reviewer makes a written record of the questions and comments to be discussed but only infrequently is the in-charge accountant required to put his own answers and comments in writing. On occasion, however, the reviewer will record them himself.

Such variation in procedure seems, at first, inexplicable, but the basic process of becoming satisfied as to the sufficiency of the work of staff

personnel does not lend itself to inflexible standardization. Despite the seeming informality of the procedure of questioning assistants, each query is certain to have definite meaning and purpose, and unless all are answered to the entire satisfaction of the reviewer, a most significant conclusion is reached. It is that the engagement is still to be completed.

There are, naturally, many other reasons why review of working papers cannot be effectively reduced to unyielding uniformity. Clearly any rigidly fixed standard of review of working papers cannot be applied reasonably when such modifying factors as the following are to be considered: (1) the engagement reviewed is a monthly audit, instead of a quarterly, semiannual or annual one; (2) the degree and extent of skilled over-all field supervision and review of the engagement as it progresses by some competent person in addition to the in-charge accountant; (3) the working papers and reports for several previous audit periods were previously reviewed in detail; (4) no major changes have been made in the audit procedure since the previous audit; and (5) no major changes have occurred in the client's financial condition since the previous audit.

To a large extent, review is an item-by-item and question-by-question matter. As one account after another is reviewed, in the sequence of the statement items or the working paper arrangement, questions suggest themselves to the reviewer, each question being directed at the thoroughness of the analysis, the sufficiency of verification or the adequacy of the presentation. In the final analysis, under such a procedure (whether or not aided by check lists or other partly standardized approaches), the effectiveness of the review depends primarily upon the inquisitorial skill of the reviewer.

Review of Statements and Adjustments with Client

It has been found to be an excellent practice to have a discussion with the client regarding the financial statements after they have been completed. This is usually done by a principal or partner, but sometimes by the accountant in charge. While it is now generally understood that financial statements are the representations of management, nevertheless the fact remains that more often than not the balance sheet and income statement as prepared by the accountant are the first and only ones seen by the small client during the year. It is a rarity for the average small practitioner to have finished financial statements submitted to him for examination and approval. However, the factual representations contained in the statements, no matter who prepares the actual formal statements are, and of necessity must be, those of the client. The client cannot be excused for presenting statements which are known to be false any more than can the CPA, and the content of the statements should be seriously considered by the client in all cases.

During the discussions of the financial statements, the accountant is able to explain to the client the significance of the changes and develop-

ments that are being made in accounting procedure, auditing standards and statement presentation. It is at this time that the adjustments and corrections found to be necessary are explained to the client, and here too is afforded an opportunity for the client to obtain certain salient information which he may want to know.

Some accountants prefer to have this talk with the client after the report has been typed and delivered. Others take the untyped statements into the conference. Either way is satisfactory, but there is nothing that can bring an accountant and his client into closer mutual understanding than conversations of this nature and, if at all possible, they should always be held. As a matter of fact, in many cases the discussion turns into a joint review of the statements and report, stimulated by questions of the client as to the composition of items or the significance of comparisons and other relationships. Such review has in many cases brought new information to light.

Correction of Errors

During the course of the examination, the average accountant will locate errors either of principle, entry or mechanics that will require correction. The simplest and easiest method of assembling these errors is to make a list of entries for inclusion in the working papers. As a rule the errors are shown to the bookkeeper as they are found and the correcting entry made in the working papers at that time.

When the audit is finished, all of the correcting entries are entered in the general journal for posting to the proper accounts. Some firms refuse to let their accountants make entries on any of the clients' books. Others are not so particular, but the small practitioner will have to use his best judgment as to the proper means of achieving the desired result. There is no good purpose to be served in refusing, as a matter of principle, to render the necessary, proper and helpful assistance which the client wants the bookkeeper to have. The independence of the accountant is not at issue in doing such work although there are some authorities who believe that it is. (See Chapter 5.) The accountant must adapt himself to the conditions and circumstances surrounding his engagement if he is to render the service that is expected of him by his client. The reviewer will include consideration of these entries in his review and in his discussion of the engagement as a whole.

Review of Report

Distinguished from and additional to the field review and the office review is the final review of the report itself. The generally accepted term, at least among the smaller firms, for this feature of the work is report editing. The term is not entirely representative of the work done, because the review of the report extends beyond the scope of what is

usually considered as manuscript editing and includes some reconsideration of the audit work as well as a review of the report itself.

The first part of the report review is accomplished by clerical procedures of proofreading, footing, recomputing, referencing and inter-checking, following the typing. These may disclose, in addition to any mechanical errors in typing, many types of errors in the statements and report that would not necessarily be evident in field review or office review.

These clerical phases, which may precede or may follow the final analytical review of the report in its finished form, are therefore highly important. They are described in detail in an excellent article⁶ reproduced herewith:

"After a report is written and reviewed, it is submitted to the report department for typing and checking. One of the typed copies is retained in the office, and stamped with the office copy stamp. Each step in the report department checking is initialed for, in the proper space, by the person doing the work. The stamp impression is shown here:

From_____	To_____
Foot_____	Calc._____
Cross_____	Ref._____

From and *To* are for proofreading. *Foot* refers to all additions, including addition of percentage columns. *Calc.* covers all mathematical calculations not signed for as footings or cross footings. *Ref.* refers to a process described later in this guide.

The explanations which follow are intended as a guide only. Judgment and discretion are required rather than blind application of rules. Questions should be asked to resolve any doubts regarding the procedure.

Proofreading

1. The primary objective is to note and mark for correction any discrepancies between the typed copy and the draft. These may arise from typographical errors, such as striking the wrong key or from omitting part of the draft, and are fairly common even with highly competent typists. Tax returns are particularly difficult to type and proofread.
2. The secondary objective is to find errors in spelling, grammar, and so forth, which somehow have passed unnoticed to this point.
3. The procedure is to read the draft to the typed copy, word by word, and numeral by numeral. Talking to oneself, actually shaping the words with the lips, is a valuable technique in achieving accuracy. The proof-reader is entitled to *zero* errors.

Corrections and changes are not typed on the office copy (although in some offices they may be); therefore, the office copy should be marked clearly to show how the finished report was sent out. Typographical errors are corrected by marking a red X in the left-hand margin by the line with the error, and marking the correction in ink. Should an error be found in a red figure, red pencil instead of ink should be used to note the correction.

Questions of spelling, grammar, and so forth, are noted in the margin in red pencil (with a question mark) and are referred to another person for final decision.

Footing, Crossfooting, and Other Calculations

The typed office copy is next footed (including the footing of percentage columns) and crossfooted, and the stamp is initialed in the *Foot* and *Cross* spaces. All calculations other than footings and crossfootings are then checked, and the stamp initialed in the *Calc.* space. These other calculations include checking percentages, extensions, and so forth.

In some cases the draft copy will be stamped and initialed for certain work. If all calculations have been checked on the draft, the typed copy should still be footed, but only the totals need be crossfooted and the other calculations may be omitted.

Only figures in tabular or statement form are covered in this process. If multiplications or additions are buried in the comments, they are checked under referencing. For example, a paragraph in the comments contains the following sentences: 'Dividends of \$1,000 were declared on the preferred stock, and dividends of \$2,000 on the common stock. The total declared dividends of \$3,000 were paid in January.' This addition is checked in referencing.

Referencing

The minimum objective is to insure the accuracy and coherence of a report. To achieve this, figures, titles, dates, and so forth, are checked against their appearance in another part of the same report, or in a related report. Discrepancies are questioned and referred to another person for explanation or correction. The use of check marks in this work is essential. A workable code of check marks is presented at the end of this guide.

Referencing a report is not a routine matter, although a routine procedure is applied. One individual must assume complete responsibility, and in assigning work to his assistants, if any, this responsibility must be considered. Beyond the minimum objectives which were stated, additional responsibility is usually assigned to the person doing the reference work. In a report for the SEC, for example, he may be held responsible for seeing that all required information is included and that statements and footnotes are in the proper form. Most firms, therefore, assign an employee of senior rating to this work. The steps in referencing are indicated below:

1. Check each page to see that the proofreading and calculations have been signed for.
2. Compare with last year's report and raise questions: Examples:
 - A. Last year's certificate reads ' . . . , in accordance with generally accepted accounting principles . . . , ' while this year's reads: ' . . . in accordance with accepted accounting principles. . . . ' Question the omission of 'generally.' Note the question in the margin with the check mark which indicates its source.
 - B. Depreciation for furniture is shown at the same amount as last audited period. Try to reconcile from last period's reserve to this period. See if the asset is carried at the same amount. Perhaps last period's figure was accidentally copied into this period's report.
 - C. Last year's report reads ' . . . we have checked or tested . . . ' while this year's reads ' . . . we tested and checked. . . . ' No question.
3. Start with the letter of transmittal or first page of the comments and check every date, figure, or explanation to its appearance in the statements and schedules, or another part of the comments. Examples:
 - A. Comments read 'In the comparative balance sheet, ' Check the balance sheet to see if it is 'comparative.'

B. Comments read '... resulted in a profit before taxes stated at \$_____.' Check the figure to the income statement. Suggest wording or punctuation that will clear the sentence's ambiguity.

4. Set aside the balance sheet, income and surplus statements. Take the supporting schedules and, starting with the last one, check each schedule to the main statements, the supporting schedules, and the comments.
5. Take the main statements and check them to each other.
6. Scan the entire report for items which remain unchecked. Read for meaning and explore the significance of check marks or their absence. See if questions can be eliminated now that the completed referencing has developed a well-rounded picture. Initial for referencing.
7. Submit the questions to the head of the report department, or to the senior or to a partner.

Note: In many organizations, checking from the report back to the working papers would be included as a step in the referencing work of the report department. In others, this check is the responsibility of the senior in charge of the audit and is not part of the report department's referencing work.

Always show the code of check marks on the back of the first page. (Questions, when raised, are noted in the margin with the check mark which shows their source.) A usable basic code follows:

- ✓ Checked to prior year.
- ✗ Checked to prior year (after wording means approximate and after amount means derived by calculation).
- ✓ Checked from comments to statements or vice versa.
- ✓ Checked from comments to statements or vice versa (after wording means approximate, and after amount means derived by calculation).
- ✗ Checked from comments to comments or within one statement."

Basically, final report reviews are divided into two phases. The first is a subjective analytical examination of the various steps taken and the procedure followed in the engagement. The second is an objective overall study of the engagement as a whole to develop fully its significance, value, and application. In smaller engagements both phases are apt to be covered simultaneously and by the same reviewer.

Report reviews are made almost invariably by a principal or a partner. This is particularly true of the objective phase where only very rarely is a supervisor or some eminently qualified staff member given such an assignment. However, no matter what the official status of the reviewer is, one requirement is always enforced. He must be so qualified by knowledge of accounting principles, familiarity with the special accounting practices and procedures of the particular industry, and acquaintance with the major problems of the client that searching inquiry by him of the in-charge accountant and his examination of the significant items in the report and related papers will produce formulation of an independent and reliable judgment as to the adequacy of the work done and the clarity and basic soundness of the financial statements.

Generally, the basic steps of the objective part of the report review are these: (1) the report and the statements are read and studied carefully; (2) the audit program is considered in relation to the report; (3)

the preceding report for the client, if any, is examined and compared with the current one to make certain that all essential data and pertinent qualifications have been covered; (4) notes are made during the examination of the report of items requiring explanation or further investigation; (5) questions and comments as to the report are discussed with the in-charge accountant and with any previous reviewer of any phase of the engagement; (6) the report reviewer makes definitely certain that the certificate prepared is adequate; and (7) changes in the report, other than typographical or grammatical, are made but only after conference with the in-charge accountant and others who have supervised or reviewed specific phases of the engagement.

A very important part of the report review is that pertaining to the textual or comment part of the report. Much has been written and said regarding this section of the report: that it is the place where the accountant really justifies his services; that here he can offer constructive criticism or beneficial suggestions; and that here is the place to inform the management of accounting inaccuracies. Whether or not this is so is not the purpose of this chapter to discuss. What is notable here is that, first of all, the comments should be accurate. Acrimonious or poorly-founded statements about the financial condition of the business or of its records can result only in stirring up strife and discord. The comments should be entirely factual and the accountant should be sure of the facts. Hopeful predictions and congratulatory statements, while reading nicely to the client, have no place in a report and should be deleted by the reviewer.

Most of the reports rendered by the small and moderate-sized accounting firms are those which have come to be termed "long-form reports." These consist of a textual or comment section, balance sheet, income statement, and surplus statements, with schedules supporting certain items when necessary or desirable. While there is no standard order of arrangement, each firm has or should have a uniform method of report construction.

Clients who desire a long-form report for management and special uses may also request the accountant to prepare a short-form report to be used in connection with their published report to stockholders. Where both forms of report are being prepared, based upon the same audit, the reports should be reviewed in close comparison with each other to safeguard against the possibility of inconsistencies and to guard against the possibility of a later claim that the condensed report suppressed material information or that it should have been qualified by some of the details disclosed in the long-form report. This possibility is discussed in some detail in Chapter 6 under the State Street Trust Company case.

Under the American Institute of Accountants' Statements on Auditing Procedure No. 23⁷ (revised December 1949 and now embodied, in substance, in the Codification of Statements on Auditing Procedures)⁸ the

accountant who permits his name to be associated with financial statements should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as "*Prepared from the Books Without Audit,*" appearing on each page of the financial statements is considered sufficient. As to a disclaimer, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements.

More extended reference to and further discussion of Statement No. 23⁷ will be found in Chapter 13 entitled "Professional Standards."

Careful report reviewers have been particularly alert to these requirements since their adoption. Occasionally there will be found in the comment section of a report a statement that certain work required under generally accepted auditing standards has not been done, with no reasons furnished for this omission, which often is material. The accountant has little control over the desires of the client to have, or not to have, complete work done, but he does have sole and entire control over his own certificate or opinion.

It is in this field that the reviewer is called upon to make difficult decisions, to the extent either of overruling the field supervisor or going contrary to the wishes of the client. Also in the field of difficult decisions are those relating to disclosure. Full, fair, and straightforward disclosure of all facts necessary to make the statements informative and not misleading are not only required, but also are a "must" of good report writing and reviewing. Every accountant of seasoned experience can recall cases in which the full force of a strong personality was exercised by a client to withhold disclosure of a material fact. It will never be known how many of these appeals were denied, for accountants are rarely complimented for meeting their responsibilities.

From the standpoints of the client and interested third parties, the reviewer in the final analysis should have these queries in mind:

1. Exactly what does the report tell them?
2. Have their specific needs and problems been taken fully into account?
3. Precisely what can they determine from the report?
4. Does it give them sufficient factual evidence for effective decision and action?

And from the standpoint of the accounting principal or firm, the following points call for the reviewer's determination:

1. Has the engagement been completed with professional accuracy and competence in full compliance with all its terms?
2. Do all comments in the report convey exactly what is intended?
3. Have all exceptions and qualifications been set forth clearly?

Only when these questions have been satisfactorily answered is the report ready for release.

REVIEW QUESTIONNAIRE

Some firms have adopted a formalized approach to review procedures, as a guide or aid to the reviewers. Where there is such a formalized procedure for over-all review of working papers and reports, some firms have embodied this in a written questionnaire. Others follow the same general pattern without actually using a written questionnaire.

Generally the review questionnaire, written or oral, has four main subdivisions. The first covers basic data, the second representations by client, the third the working papers and report, and the fourth release of the report.

Basic Data

Under basic data, some of the initial points covered are the actual nature of the engagement, the agreement concerning it, its exact scope, the specific purpose of the report, nature and extent of any special arrangements, and so on. Later some other elements taken up are discussion with the client of the statements as finally prepared, discussion with the client of any required adjustment entries, and whether a separate letter should go to the client regarding recommendations, exceptions and other matters not normally included in reports.

Representations by Client

During the course of an examination many representations regarding assets, liabilities, or revenue items are made to the accountant by the client or by his representatives. Usually these are made orally, in which event the accountant makes appropriate record of them in the working papers. However, written representations by the client are usually required when they relate to the more material items, such as accounts receivable, inventories, liabilities, and contingencies, but the practice as to this is not uniform.

There are variations among accounting firms in what is covered in writing and in the method of expressing the representations. Probably the two most important governing factors are materiality of the representation and the importance of avoiding any future misunderstanding

regarding it. Generally only the larger firms have preprinted standard forms for written representations as moderate-sized and smaller firms have relatively much less use for them.

The subject also was fully treated in the American Institute of Accountant's Statement on Auditing Procedure No. 4 entitled "Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters"⁹ (also incorporated in the Codification of Statements on Auditing Procedures).¹⁰ While this statement dates back to March 1941, its provisions are fully applicable to current practice, and contain suggested forms for written representations.

Written representations are not to be regarded as relieving the accountant of any of his audit functions or responsibilities. They secure the active participation of the client and their main purpose is to substantiate the information developed by inquiries.

Many times when a form is used it must be extended to cover other items, if, in the judgment of the accountant in charge of the engagement or of the reviewer, the inclusion of such items is necessary or desirable. Hence where a report questionnaire is used, it makes certain with respect to representations by clients that all significant and material ones have been put in acceptable written form and that all those as to accounts receivable, inventories, and liabilities (including contingent) are adequate.

Audit Working Papers and Reports

This subdivision of the review questionnaire is certain to be the most extensive. Its length will vary, naturally, according to importance of the engagement, but the following items will give a representative idea of its contents.

1. Has receipt of needed confirmations been reviewed and approved as to (a) accounts receivable; (b) accounts payable; (c) cash; (d) inventories, and (e) assets held by others?
2. Where the client's representations as to physical inventories were subjected to physical tests by the accountants, have the adequacy and findings of such physical tests been reviewed and approved?
3. Have the elements and the total of current assets been reviewed and approved?
4. Have the elements and the total of current liabilities been reviewed and approved?
5. Have all significant and material exceptions, problems or weaknesses in the system of internal control been set forth in a summary statement or schedule in the working papers by the in-charge accountant?
6. Have all said exceptions, and so forth, in (5) above been reviewed, commented upon, or disposed of?
7. Has audit procedure used in lieu of confirmations been reviewed and deemed adequate as to accounts receivable and accounts payable?
8. Has appropriate disclosure been made of the valuation and depreciation basis underlying the fixed assets?

Report Release

Before the report is ready for signing and release, the following final questions provided by the questionnaire must be answered:

1. Are the report and the scope of the work performed in accordance with the customary or agreed-upon terms of the engagement?
2. Has a sufficient and reasonable review of the working papers been made?
3. Are the form, content, and terminology of the report satisfactory?
4. Has the need for footnotes or amplifying comments been carefully considered, and has appropriate disclosure been made?
5. Have the statements in the report been prepared according to appropriate standards for disclosure?
6. Are any qualifications or exceptions such as to raise a question as to the appropriateness of giving an opinion?

A precaution often taken with respect to review questionnaires is to frame the questions in such a way that affirmative answers are normally necessary in order to insure that satisfactory action has been taken on the points involved. A further safeguard enforced when it sometimes is nevertheless impossible to make an affirmative answer is that all negative answers must be supplemented by a satisfactory explanatory statement.

Clearly, where review questionnaires are used, each firm will have special questions of its own in the light of the general nature of its engagements, its policies, and its particular practices and procedures. And it will also presume that any relevant queries will be made that occur to the reviewer when such a questionnaire is applied to the review of each engagement. The following response from a firm, asked what it added on each occasion, is revealing: "Just many little things. The report is our finished product. Nothing is left undone that comes to mind at the time."

Material in Appendix

In the discussion in this chapter the over-all procedure of review has been broken down into three separate categories:

- Field review by accountant in charge
- Field or office review by supervisor, principal or partner
- Report review, being the final review of the report before release

The combination of these several phases of review should include thorough coverage of the scope of the work, the effectiveness of analysis and verification, the correctness of classification and methods of presentation, and the adequacy of disclosure of all essential information.

The review questionnaires used by practitioners vary greatly because of differences in emphasis on the various steps in review, although the over-all coverage is always intended to be thorough and in total is relatively uniform. As illustrations of review practices, the appendixes include the following combination of material actually used by accounting firms:

Appendix A — An Illustrative In-Charge Accountant's Review Questionnaire

Appendix B — An Illustrative Office Review Questionnaire

Appendix C — An Illustrative Statement of Report Review Policy for an Accounting Firm; and an Illustrative Checklist for Report Review

Appendix A is designed for use by the accountant in charge of the engagement and, when completed, is turned in with the working papers and draft of the report. It is intended to be a checklist of responsibilities and work in addition to that provided automatically by the trial balance and working papers themselves.

Appendix B is usable as a questionnaire or checklist for the office or field review of the working papers by the principal or partner. This, too, is supplementary to questions normally arising from the review of the working papers and statements themselves.

Appendix C deals with the review of the report as distinguished from the working papers. It contains both a statement of policy for report review and a checklist. It assumes that if all of this material is recognized in the review of the report before typing, the mechanical procedures of interchecking and proofing by the clerical staff will accomplish substantially all of the additional safeguards required, and the final issuance of the report will then involve merely the reading and signing by a partner or principal.

This material is all illustrative and no practitioner should adopt it as his own without determining that it fits the requirements of his practices and his organization.

REVIEW PROCEDURES FOR OTHER WORK

Tax Returns

All modern accountants possess a working knowledge of Federal and state income tax laws and regulations. Not all accountants have or pretend to have knowledge of the tax laws adequate to handle protested cases. As a rule there is in every firm one person, usually a partner, who makes a sincere effort to keep abreast of the continual changes in the law, the regulations and the decisions of the courts as they affect income taxes. This in itself is a full-time work, difficult and often troublesome, but it does equip one person not only to handle most of the tax matters of his firm but also to review the tax work of others in the firm.

It is desirable as far as the organization will permit to have only men skilled in tax knowledge prepare the original returns, on the assumption that staff men who are engaged principally in auditing work are not "tax-minded." It is impracticable, however, in smaller firms to have tax men prepare all of the returns that now are required to be filed. This extends not only to income tax returns but to the many other returns, such as property returns, intangible returns, capital returns, and declaratory returns.

The practice generally employed is to have the accountant who is in charge of the engagement prepare the return and submit it for review by the men who constitute the tax department or by the one person most skilled in tax knowledge. The preparation of the return should be undertaken with the idea that it must be easy to review. Submitting a tax return with the idea that the reviewing authority will correct its deficiencies is poor workmanship and should under no circumstances be done.

In the preparation of the return the manner of presenting the information varies. Some prefer to complete the schedule appearing on the return. Others prefer to submit separate schedules. Separate schedules facilitate the review and typing of the return and this method is usually preferable.

The practice of having the accountant in charge of the engagement prepare the returns has in general proved to be satisfactory and it is the only method available to the smaller firms. Doubtful points arising in the consideration of items as they are developed are discussed with the tax department or the principal tax authority in the firm before the return is made, so that these items may receive the correct handling. An important and often neglected feature of this work is to have the accountant who is to prepare the return told just why a specific item is includable as income or not deductible as an expense. In most cases it is the accountant preparing the return who must tell the taxpayer of the decision regarding the doubtful item, and unless he can give the taxpayer the reasons governing the decision, he is at a disadvantage.

The returns as submitted for review should consist of a pencil copy of the completed returns and all schedules, completely filled in. The tax should be computed and all doubtful points resolved. It is desirable that a copy at least of the preceding year's return accompany the current return when it is submitted for review. When both Federal and state income tax returns are prepared at the same time, any difference in taxable income appearing on the two returns should be reconciled and the reconciliation sent with the returns to the reviewer. This can be further improved by showing a complete reconciliation with the book income. Some states require these reconciliations to accompany the return; others do not.

In reviewing the return the totals of all schedules are checked to their places on the return and the schedules are inspected for the purpose of seeing that all items therein are taxable income or proper deductions, as the case may be. In reviewing returns of individuals the reviewer does not have an opportunity to make a complete check because the absence of a balance sheet and analysis of surplus limits him to an examination of the schedules submitted and a recomputation of the tax liability.

Corporation returns afford an opportunity for the reviewer to make a more satisfactory check as such returns are complete as to the statement of income, balance sheet, and surplus statement. In their review the items on the income statement are determined to have their proper places in the tax return and the surplus statement is scrutinized to see whether or not the items appearing therein are properly excludable from the face of the return. The reviewer independently recomputes the tax liability.

If it should happen that the accountant preparing the return has not had an opportunity of discussing a doubtful item with the tax department prior to submitting the return for review, he should attach a memorandum to the return explaining the item and saying how it had been handled, thereby not relying on the reviewer to discover the item.

Many firms have a form containing instructions and other pertinent data to accompany the return when it is submitted for review, of which the following is a good example:

		Date Promised
Client		
Period		Fed. Income
No. of Copies: Returns	Schedules	State Income
Prepared by	Approved by	State Intangible
<input type="checkbox"/> Secured from Audit <input type="checkbox"/> Token from Books without Audit <input type="checkbox"/> Furnished by Taxpayer		Fed. Declaration
Information		State Franchise
Charge to		
Remarks		
Typed by		Verified by
Read	To	Corrected by
Assembled by		Approved by
Date Mailed		
Corrections		

(The form provides ten additional lines below for noting corrections)

After the returns are completed and reviewed they are usually typed in duplicate so that the taxpayer may be furnished with a copy. The typing of the returns and their accompanying schedules must pass through a process of verification, proofreading, and assembling of schedules in every way similar to that required for an audit report. After this the finished returns are inspected again by the reviewing authority for signature, in the cases where signature of the person preparing the return is required. It then gets a final scrutiny at his hands, is signed and is ready for delivery to the taxpayer.

It is an excellent practice in transmitting returns to the taxpayer to have a covering letter accompany them stating how and by whom it is to be signed, where it is to be filed, and the amount of taxes to be paid at the time of filing. A form letter is frequently used for this purpose and it is important that a copy thereof be retained in the accountant's office with the date of transmission shown thereon. This is an important document to have in a case where the taxpayer overlooks filing the return within the required period of time.

System Installation

The installation of a system of accounts does not readily yield itself to an office review. System work is done best when the installation is undertaken by one who is skilled at such work. The work requires the services of one who possesses imagination and an ability to see the end from the beginning. Every business has some methods that cause variations to appear in the accounts and these must be recognized and provided for.

The customary installation of accounting systems by smaller accounting firms must be what their clients term a simple system. This involves a general ledger, cashbooks, journals, and such auxiliary records as are necessary. Often the accountant has to buy from the stationer's store the blank books required, insert the required headings, and perhaps make the opening entries, after which there ensues a series of instructions to some person who is to function as bookkeeper.

Such work is not adaptable to review in the accountant's office by accountants superior to the one making the installation. A memorandum of the nature and extent of the work done is made for the files, and this consists of a written record of all pertinent information, such as the chart of accounts, the instructions left with the bookkeeper, and a brief narrative of the conditions surrounding the engagement. This, however, is mostly historical and it is impracticable to conduct an adequate office review of the work done. This omission is not serious, because if there are faults in the system they will soon be developed in the execution of the entries covering the daily work, and the necessary adjustments or alterations are made at the client's office.

Accounting firms install cost accounting systems which vary in accordance with the purpose intended. Such work is specialized and is done

at the client's office after much searching inquiry into the functions of the various operations and careful study of the methods of progress. Manufacturing companies are the most prevalent users of cost systems and cost accounting.

Here again is work that cannot conveniently be subjected to office review, at least not by a small or average-sized firm. Here, too, as in the case of the installation of a routine system of accounts, about all that can be done is to exercise care in the selection of the accountant who is to make the installation and confer regularly with him as the work progresses, either by visits to the scene of the engagement or by office conferences.

Special Investigations

A distinctive feature of the special investigations which accountants are retained to make is that their clients have an exact object in view. In some cases special investigations include the normal examinations of the financial position of a company and its operating results for a given period, but many are separate and distinct therefrom.

All work other than regular examinations, tax returns, or the installation or improvement of an accounting system may be termed special investigations, but usually this class of work is undertaken with a purpose far different than is required for the annual accounting work, and wherever possible a capable accountant with specialized knowledge of the work required to be done is selected.

Accountants are versatile men and if the special investigation has accounting or auditing as its basis, the average skilled accountant may undertake the work. Perhaps the day will come when accountants will associate an accountant from another firm with them when specialized knowledge, not possessed by themselves, is required, but there is by no means the prevalence of this action that exists among lawyers. In any event, the various peculiar conditions of the client's operations are studied and learned by the accountant in charge as he progresses with the work to such an extent that, upon its completion, he possesses a special knowledge of the work so complete that subsequent review of his work by his office superior is most difficult, if not impossible.

The review of a report which is to be rendered to the client as a result of a special investigation does not differ from that given to the report of a regular examination. Each report differs according to the information desired and results obtained. Some reports are entirely narrative, with but few, if any, financial schedules or exhibits accompanying them. Other reports are replete with financial statements of various kinds and forms, in which cases there is usually a more or less detailed recital of the salient points contained in the statements.

The working papers for a special investigation, while not necessarily

arranged in the form used for a regular examination, should be complete and their contents easily followed into the finished report. Source information and reasons supporting new, unusual or extraordinary conditions should appear in the working papers.

The review of reports on special investigations should be made with special attention to the purpose of the engagement and the clearness of the presentation of the subject matter. It happens sometimes that an accountant conducting a special investigation gets to know his subject so well that he falsely assumes that the client has knowledge equal to his and that complete or detailed exposition is not necessary. When this occurs the primary purpose of the investigation is defeated, and in such cases the reviewer should use as a test the clearness of the report to him, and where it is ambiguous or the facts are not completely presented he should have it rewritten.

In the smaller firms the practice of frequent consultations with the reviewing authority regarding points in the work is the custom and it is a salutary one often resulting in the development of ideas helpful to all parties.

Miscellaneous Work

Closely connected with the regular examinations made by accountants are the engagements which require the preparation of financial statements and their supporting schedules in the form required by governmental commissions, agencies, or bureaus. The most outstanding of these are the statements to be submitted either to the Securities and Exchange Commission or the Federal Power Commission.

Other work which accountants are called upon to perform includes the preparation of accounts for estates, trusts or guardianships, which must meet the requirements of courts or of commissioners appointed by the courts. Statements rendered for receivers or referees, or trustees in bankruptcy or receivership, also demand a presentation of facts in a specified manner. Budget preparation and projection of present financial results into the future also may occupy the attention of the practicing accountant.

Miscellaneous work, whatever may be its nature or the purpose, requires the selection of accountants best equipped to complete the work. The review of specialized work is not easy and frequently it requires consultation with the accountant in charge of the engagement, but the main principles of reviewing exist for special engagements as well as for routine or regular examination. Often a reviewer's professed lack of knowledge of a particular operation has proved to be an advantage, for in seeking enlightenment on certain items, he has developed a need for a different presentation which has resulted in an improvement to the report.

CONCLUSION

Practicing public accountants have by careful and conscientious work firmly established themselves in the confidence of the public. This confidence extends not only to the opinion expressed by the independent public accountant regarding financial statements, but it is being extended to include many other activities, some of which are only remotely connected with accounting or auditing.

The confidence reposed in public accountants places a responsibility on them which is a serious one. They must make every effort to have their findings correct and in complete accord with all established facts. This is the main purpose of having a thorough review of the work. So long as human nature is frail, errors will occur: errors of commission or of omission or errors of judgment. For this evidence of humanism accountants are blamed, with but little or no credit extended to them for the overwhelming number of cases in which they are correct.

The highest court of review of accountant's reports is the public which is served. It will take many years before the public is fully educated to the conventions accompanying the accountant's preparation of financial statements. Progress in that direction is being made every day. Every well-written carefully reviewed report contributes to the advancement of accountancy. There are no other means by which the practicing public accountant can contribute as much to the continuous advancement of his profession than by the constant use of high standards of reporting. In this objective, the processes of supervision and review are the greatest safeguard.

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10. See reference 8, pages 48-57.

Appendix A

IN-CHARGE ACCOUNTANT'S REVIEW QUESTIONNAIRE

(Used by a National Firm of Accountants)

This questionnaire is to be completed for each audit and signed by the accountant in charge before the working papers and report are submitted to a principal or partner for the firm's review. It is the sole responsibility of the accountant in charge of the assignment, and is intended to supplement his own review of all of the papers and of their co-ordination with the trial balance and the financial statements. It is expected that, for each item in the balance sheet (and the important items in the income statement), the working papers will show an analysis of the composition of the item, a description of the method of verification, any adjustments, and the amount verified by the in-charge accountant for inclusion in the statements. These questions are therefore intended to supplement the information customarily readily obtained from a review of the working papers.

If a question requires a more complete answer than space permits, or if any answer is in the negative, full details should be given on a separate sheet or in the working papers themselves, with a notation on the questionnaire as to where the answer will be found.

I. Questions Concerned with the Adequacy of the Examination

1. Has the system of internal control been surveyed and tested and the audit program completed on a basis consistent with the weaknesses and strengths disclosed? _____
2. Viewing the financial statements as a whole, are you satisfied as to their propriety, substantial accuracy, conformity with generally accepted accounting principles, and consistency with financial statements of prior periods? _____
3. Have you given adequate consideration to possible losses such as those from unfilled contract orders, purchase commitments for future delivery, and proposed dispositions of assets? _____
4. Have all unusual points or questions been summarized and properly disposed of? _____
5. Have all items on the audit program and work sheets been initialed by those doing the work? _____
6. Has the work of all assistants been thoroughly reviewed? _____
7. Has the permanent file been reviewed and have all pertinent items for the current period been inserted? _____
8. Have our correspondence files been reviewed for pertinent information or opinions? _____
9. Have the corporate minutes of current (and prior) years been reviewed and are all matters therein correctly reflected in the accounts? _____

10. Have trust indentures, loan agreements, major contracts, preferred stock provisions and similar items been reviewed for compliance with all requirements? _____
11. Has insurance coverage been tested for adequacy against the client's estimates of actual values? _____
12. Have reasons been determined and noted for any major changes in assets, liabilities or operations since the last audit? _____

II. Questions Related to the Report

1. If any assets are pledged or subject to lien or restriction, has disclosure been made? _____
2. Have all material contingencies such as litigations, dividends in arrears and other defaults, stock options, renegotiation, retained earnings restrictions, dated surplus and similar items been disclosed? _____
3. Have all intercompany profits in transactions with affiliated companies been eliminated? _____
4. Have all changes in accounting policies during the period been disclosed? _____
5. Has the basis of valuing each material asset been disclosed? _____
6. Has the treatment of profits and losses of subsidiary companies (if not consolidated) been disclosed? _____
7. Have you determined that no material changes occurred from the balance sheet date to the date of completion of the field work? _____
8. Is the report free of material deviations from firm policies or manuals? _____
9. Do you believe that we can give an unqualified certificate on the basis of our examination? _____

III. Questions Related to Pending Matters

1. If we prepare SEC reports, have all necessary data been secured? _____
2. Have suggestions for improvements in the system of internal control, or in the accounting procedures and financial reports of the client, been summarized for a letter of recommendation? _____
3. Have all necessary confirmations been received (including those relating to life insurance, assets in custody of others and liabilities, both fixed and contingent)? _____
4. Has the customary letter of representation by the client been received? _____
5. Do the corporate minutes record all actions which, in your opinion, should have been taken (salaries, dividends, major contracts and similar actions)? _____
6. If we regularly prepare tax returns for the client, have the returns been completed? _____
7. Has our tax staff been consulted in respect to all tax problems needing attention? _____
8. If the books and statements are not in agreement with tax returns, have reconciling schedules been prepared? _____
9. Are there any other items of open business which will require attention? _____

IV. Questions Related to Client Relations

1. Was the the work done without any limitations by the client? _____

2. Was the engagement conducted within the intended scope of the assignment (without a request by the client for extra services)? _____
3. Are you satisfied that the audit did not disclose any suspicions of irregularities in regard to cash or other assets or transactions? _____
4. Has the client reviewed and approved: _____
 - a. All adjustments? _____
 - b. Financial statements? _____
 - c. The report letter? _____
5. Were our relations with the client as strong at the end of the engagement as at the beginning? _____

V. Questions Related to Efficiency of our Examination

1. Did we apply interim procedures to the maximum extent possible? _____
2. Has our examination been conducted with a maximum of efficiency? _____
3. Did you give on-the-job training to your assistants? _____

Prepared by _____ Date _____

Reviewed by _____ Date _____

Appendix B

ILLUSTRATIVE OFFICE REVIEW QUESTIONNAIRE

Used by a National Firm of Accountants

This questionnaire is for the guidance of the partner or principal making the detailed review of the working papers, either in the field or in the office, after the in-charge accountant or supervisor has completed his questionnaire (Appendix A). In the event that any or all items in this questionnaire are not answered in the field, it is expected that they will be completed upon review in the office. The review of the financial statements and report is considered a separate function and is based on another questionnaire or checklist. An illustration of report review policy and procedure, including a checklist (used by a different accounting firm) appears in Appendix C.

General

1. Have you reviewed the in-charge accountants questionnaire (Appendix A) and satisfied yourself that:
 - a. The judgments of the in-charge accountant were sound? _____
 - b. His representations as to facts and work done were supported by the papers? _____
 - c. Matters requiring further attention will be taken care of at the appropriate time? _____
 - d. There are no dangerous open disclaimers by the in-charge accountant prejudicial to the interests of the firm? _____
2. Have you satisfied yourself that:
 - a. The papers contain an adequate review of the system of internal control? _____
 - b. The audit was completed in a manner consistent with the strengths and weaknesses of the system of internal control? _____
 - c. The in-charge accountant's suggestions for transmission to the client, if any, are consistent with the best interests of the client and the firm? _____
 - d. Appropriate changes in the next examination, if any, have been provided for? _____
3. Do the papers show who was responsible for preparing each schedule and who reviewed each schedule? _____
4. Is the permanent file adequate and up-to-date? _____
5. Do the papers include complete explanations as to:
 - a. Changes in accounting policies? _____
 - b. All questions requiring decisions as to conformity with generally accepted accounting principles? _____
 - c. All questions requiring decisions as to conformity with generally accepted auditing standards? _____
 - d. All matters requiring disclosure? _____
6. Do the papers substantiate an unqualified certificate? _____

Cash

1. Do the papers indicate a sufficient audit of cash and related transactions to give adequate assurance of:
 - a. Accuracy of the cash balances stated? _____
 - b. Availability of cash and absence of liens? _____
 - c. Absence of fraud? _____

Receivables

1. Do the papers show that we have satisfied the audit requirements with regard to confirmation of receivables? _____
2. Are you satisfied that the receivables are fairly valued at the amounts stated, are the property of the client, and have not been pledged without disclosure? Do the papers establish that our representations are adequately supported? _____

Securities

1. Do the papers establish the existence of the securities, that title is in the client, that they are free of undisclosed liens and that they are fairly valued at the amounts stated? _____
2. Do the papers demonstrate that the income expectable from these securities has been computed and accounted for? _____

Inventories

1. Do the papers show that we have satisfied the audit requirements of the extensions of auditing procedure with regard to physical inspection of inventories? _____
2. Do the papers establish:
 - a. An adequate test of the book inventories and cost records? _____
 - b. An adequate plan governing the physical count? _____
 - c. Adequate supervision and testing by the in-charge accountant as to:
 - (1) Quantities? _____
 - (2) Ownership? _____
 - (3) Ascertainment of cost? _____
 - (4) Clerical accuracy? _____
 - (5) Method of costing out into current operations? _____
 - (6) Ascertainment of the lower of cost or market? _____
 - (7) Obsolescence and other factors influencing value? _____
 - d. That the inventories are balanced? _____
 - e. Consistency? _____
 - f. General compliance with ARB #29? _____
3. Do the papers establish the propriety of the relationship between sales and purchase and production costs charged to operations of the period? Was the cut-off procedure adequate? _____
4. Do the papers include inventory confirmations, if appropriate, and an inventory representation? _____

Prepaid Expenses, Deferred Charges, and Intangible Assets

1. Do the papers establish:
 - a. Cost? _____

- b. Substantial accuracy, appropriateness and consistency of amortization? _____
2. Are the details sufficient for proper classification and adequate disclosure? _____

Fixed Assets

1. Are the bases of valuation described adequately in the papers? _____
2. Do the papers adequately support the division of expenditures between assets and expenses? _____
3. Do the papers establish that the assets exist, and that they are owned by the client? _____
4. Are the assets still usable? Still in use? _____

Liabilities

1. Do the papers show an adequate search for unrecorded liabilities, both fixed and contingent? _____
2. Do the papers substantiate that value has been received in connection with all recorded liabilities? _____
3. Do the papers show that the recorded liabilities of material amount have been tested? _____
4. Do the papers include a liability representation and letters from attorneys? _____
5. Do the papers establish the adequacy of the computations of accruals? _____
6. Do the papers give adequate attention to contractual provisions, liens and limitations? _____
7. Do the papers establish the proper liability for taxes and make provision for disclosure of tax contingencies? Have audit adjustments and revenue agent's reports been taken into account? _____

Contributed Capital and Retained Earnings

1. Do the papers establish to your satisfaction the quality of the examination of capital stock? _____
2. Do the papers contain an adequate analysis of capital paid in in excess of the recorded value of stock and have transactions during the period been adequately vouched? _____
3. Do the papers contain an adequate analysis of retained earnings? Have transactions been adequately vouched and classified? _____

Income and Expense

1. Do the papers establish the adequacy of the matching of cost and revenue? _____
2. Do the papers establish the propriety of revenues reported for the period? _____
3. Do the papers reveal an adequate test for unreported income? _____
4. Do the papers reveal adequate testing of expenses by analysis, comparison and relations with other accounts? _____
5. Is the determination of income consistent with last period? _____

Appendix C

ILLUSTRATIVE STATEMENT OF REPORT REVIEW POLICY FOR AN ACCOUNTING FIRM

Report review procedures as hereinafter outlined are established as a means of giving an independent review of the results of an audit engagement and the reports to be issued thereon. Report review is intended to be separate and apart from the discussions between the client and the persons responsible for the engagement and will result in an appraisal of the decisions made by these persons. In large offices a report review department can be separate and complete in itself, but report review procedures in smaller offices must be adapted to the lack of detachment from the clients that must of necessity exist in those smaller offices.

The report review department* (or whoever acts as its equivalent) is not to be considered as superior to the partners responsible for the individual engagements. Reports do not need to be changed by an originating partner against his judgment merely at the suggestion of the report review department. On the other hand, this department has been established to challenge decisions thoroughly, and where there is a difference of opinion that is more than a question of taste, that difference should be resolved by reference to another partner not directly concerned with the engagement. In important cases, differences of opinion should be reported to the senior partner, and the report review department need not accept an overriding decision without reference to the senior partner.

The report review department is the last line of protection. In all cases it shall be satisfied that the important points have been thoroughly considered and that the decisions made are supported by acceptable reasoning upon adequate facts.

The report review department also is to be responsible for uniformity of reports and for adequate presentation and for maintenance of the firm's policies. It can and should recommend improvements in report presentation and changes in audit procedures which might seem desirable in the future.

Report review works out satisfactorily if there is complete co-operation between the report review department and those responsible for the reports. Careful advance planning is essential. Co-operation is particularly important in order not to tie up unnecessarily the time of partners and supervisors. It is impossible to spell out adequately the extent of a review and the variations in review as between different engagements. It is important that the report review department direct

* Hereafter all discussion of a report review department shall also apply to anyone functioning as its equivalent.

its work to essentials and that it does not get involved in extended detailed checking.

It is the policy of the firm that *all* reports on audit engagements and all financial statements in connection with which the firm name appears shall, before being typed, be independently reviewed by a report review department or, where this is not practicable, they shall be similarly reviewed under such circumstances as will produce equivalent results.

Where an office of the firm does not have a separate report review department, arrangements will be made in advance to use such a department in another office to cover the more important or more difficult engagements. For other engagements a local partner or supervisor may make the report review if he has been sufficiently detached from the engagement to be in a position to approach it on an impartial basis. In those cases where the review is made in another office, the report review department shall have contact with the working papers to the same extent as it would in its own office. It will usually not be practicable to send the working papers to the reviewing office and the procedures to be followed will depend on the importance of the engagement and the problems involved. In some cases a special trip to the issuing office may be indicated, but where it is readily apparent that no major problems are involved, contact with the working papers may be had at a later and more convenient time, preferably in the issuing office.

The primary purpose of the report review department is to bring to bear an independent challenge of reports issued by the firm and is directed to the observance of auditing standards, the adequacy of auditing procedures, and application of accepted accounting principles on a consistent basis in accord with firm policy; one of its most important functions is to provide an impartial review and appraisal of the judgment of the persons primarily responsible for the engagement. The report review department also seeks to co-ordinate the audit procedures, accounting policies, and form of presentation of reports and financial statements, to facilitate the typing and issuance of such reports, and to assure that all data presented in the report, whether in the form of figures or statements of fact or opinion, are adequately supported in the working papers. Emphasis is ordinarily to be placed on the observance of auditing procedures, as good auditing can be relied upon to disclose the existence of accounting problems.

It is expected that when the draft report reaches the report review department it will be in completely final form and that it should not require further revision. Those who prepare or are responsible for the draft report cannot expect and must not rely on the report review department to detect clerical or mechanical errors or otherwise to put the report in such shape that it can be typed. It is not intended that the report review department will assume any of the responsibilities of a partner or supervisor or perform or participate in any of the work that would normally be done by the partner or supervisor. However, the

report review department may properly participate in the discussion of important accounting or auditing problems in advance of the completion of the engagement, but in such cases the participation would be limited to an impartial review and appraisal of the decisions of those primarily responsible.

The report review department will review the draft report, the audit program, the partner's and supervisor's memorandums, and such other memorandums and working papers as may be necessary to be satisfied with the auditing and accounting procedures which have been followed. The report review department is charged with the responsibility of seeing that all important auditing and accounting points on each audit engagement have been properly covered and that the working papers are adequate for each engagement.

The extent of the review will normally depend upon the capabilities of the supervisor and the senior assigned to the engagement and the extent of the partner's participation.

The capabilities of the supervisors and seniors are to be judged, from time to time, according to actual review of the working papers representative of their assignments.

Speaking broadly, the areas of partner participation and extent of review by the report review department (assuming no question of capabilities of the supervisor and senior) may be said to be somewhat as follows:

Partner Participation

1. A partner or partners have been currently advised of all important problems and have had frequent contacts with the clients throughout the year (no question of comprehensiveness of review by a partner or supervisor).

2. Partner's contact limited or infrequent:

No question of comprehensiveness of review by a partner or supervisor.

3. Partner's contact limited or infrequent:

Where no review of working papers was made by partner or supervisor or where there is a question as to its comprehensiveness.

Extent of Review

Draft reports, audit programs, and all important memorandums, including that of the partner.

As above, plus all important working papers and the memorandums of the senior and his assistants.

As in (2) above, plus all remaining working papers.

In the case of new engagements, a more extensive review than would ordinarily be required may be indicated, due to unfamiliarity with the affairs of a new client, although consideration may be given to a partner's participation to an unusual extent. Also in the case of a new engagement, accounting matters may require the greater emphasis.

In the case of reports and financial statements, other than tax returns,

subject to requirements of governmental bodies, the report review department will check to see that they meet the required regulations.

The report review department will prepare a memorandum outlining briefly (1) the extent of the review of the working papers and report, (2) its opinion as to the adequacy of the examination, (3) comments and conclusions with respect to unusual matters, and (4) any suggestions for improvement of the audit program for succeeding examinations. The points raised will be discussed with the partner (and the supervisor) and their disposition should be noted. If the report review department makes no review of the working papers, the memorandum should state why no review was considered necessary.

In the case of reports for the smaller companies and charitable and other nonprofit organizations, and where there are special situations present in larger companies, it is often desirable that the information contained in the reports be more comprehensive than might ordinarily be considered necessary in the case of the larger companies. The report review department should call the partner's attention to any case where it considers that the information in a report might well be more comprehensive.

Although it is intended that all reports on audit engagements are to be reviewed by the report review department, no matter how small the engagement may be, particularly where an element of more than nominal risk may exist, it is not intended that the review need be as formal for very small engagements where the risk element is not important.

The report review department may review the audit program in advance of the engagement, but in so doing no responsibility would be taken for the completeness or adequacy of the procedures proposed to be employed and the review would be limited to a determination of whether all major points have been covered in the program based upon knowledge of the particular engagement.

The report review department will note that the firm's practice of annually preparing and discussing letters of recommendation for improvements is being observed.

Independent post-reviews of working papers should be arranged for under report review department direction. This will develop a cross section of the work of top staff members and should include engagements each year for all in-charge accountants.

For filings with the SEC under the Securities Exchange Act of 1934, the report review department will function as usual, including a check that there has been compliance with SEC rules and regulations, including Regulation S-X. For filings under the Securities Act of 1933, there is an added requirement that there be an additional review by a partner from another office and that a copy of such partner's memorandum be sent to the executive partner. The report review department, in such cases, should observe that the matter of post-balance sheet transactions

to the effective date of the registration statement has been adequately covered and that statements filed with the SEC during recent years have been reviewed and retroactive adjustments investigated. Where there is a blue-sky filing with a state and where the issue is not to be registered with the SEC, the executive partner should be consulted as to whether a partner from another office should make a review.

ILLUSTRATIVE CHECKLIST FOR REPORT REVIEW

This checklist is not intended to be all-inclusive or to establish minimum or maximum procedures that are to be followed by the report review department. It has been prepared solely as an indication of the types of items that could be considered.

Has the Engagement Been Adequately Planned?

1. Audit program:
 - a. Is it sufficiently inclusive? (Separate program for branches, et cetera?) _____
 - b. Is it "tailor-made" for the engagement? _____
 - c. Has it been brought up to date? _____
 - d. Has it been currently amplified or modified after consideration of results of check of internal control or to meet new situations? _____
 - e. Was it approved by a partner? _____
2. Time budgets:
 - a. Was a time budget prepared in advanced? _____
 - b. Has actual time been compared with budget? _____

Audit Memorandums

1. Are suitable memorandums, where appropriate, on file or noted in the working papers from:
 - a. Partner? _____
 - b. Supervisor? _____
 - c. Senior? _____
 - d. Assistants? _____
 - e. Tax department? _____
2. Extent of partner's participation in engagement as indicated by memorandums written or reviewed by him, working papers reviewed, letters written, conferences attended, et cetera? _____
3. Are important phases of the engagement discussed adequately in the memorandums? _____
 - a. Internal control:
 - (1) Is statement made regarding adequacy? _____
 - (2) Is statement made regarding effectiveness with which internal control is being carried out? _____
 - (3) If weaknesses exist, has audit program or scope of examination been expanded to take care of the situation? _____
 - b. Confirmation of accounts receivable:
 - (1) Is a comment made that the responses were satisfactory? _____
 - (2) Is a comment made that differences were disposed of? _____
 - (3) Is a comment made that adequate steps were taken with respect to important accounts not replying to positive requests? _____

- c. Allowance for doubtful accounts:
 - (1) Does the memorandum fully discuss adequacy of allowance in the light of past experience, present conditions, and probable conditions in the foreseeable future, both in the industry and in business generally? _____
 - (2) Does the memorandum show what reasoning was gone through to determine that allowance was adequate? _____
- d. Inventories:
 - (1) Does memorandum adequately discuss extent of our physical observation? _____
 - (2) Does memorandum adequately discuss extent of our clerical tests? _____
 - (3) Does memorandum adequately discuss extent of our pricing tests? _____
 - (4) Does memorandum treat fully with question of obsolete and unusable materials and parts? _____
- e. What changes took place in property, plant, and equipment and depreciation policies? _____
- f. Accounts payable statements:
 - (1) Is there a comment that differences between books and statements were followed up? _____
- g. Does memorandum cover the Federal and state tax situation? _____
- h. Does memorandum cover contingent liabilities? _____
- i. What are the dividend and other restrictions? _____
- 4. Has every question raised in the memorandums been answered? (Are there any "open items"?) _____
- 5. Does it appear that the decisions reached in the memorandums were influenced by the client's wishes? (If so, state to what extent.) _____
- 6. Are any dangerous statements left unsatisfied, viz.: "reserve not adequate," "checking not satisfactory," "pricing erroneous," "no check made because point not covered by audit program," et cetera? _____
- 7. If accepted accounting principles have not been observed but no exceptions taken, is statement made of effect on net income for the year? _____
- 8. Have any disclaimers been made which appear to protect staff members rather than the firm? _____
- 9. Is indication given of review of post-balance sheet transactions to the date of our report; post-balance sheet examination of minutes; et cetera? _____

Working Papers

- 1. Can the work done be readily determined from the working papers? _____
- 2. Are there any items requiring further action or consideration that were left unanswered, viz.: criticisms, suggestions, differences, unfinished work, question marks, et cetera? _____
- 3. Are any dangerous statements left unsatisfied? _____
- 4. Are the papers dated and initialed or signed by the accountants who prepare them? _____
- 5. Do the papers indicate that the senior has reviewed all the work of his assistants? _____
- 6. Do the papers indicate that they have been reviewed by the supervisor or partner? _____
- 7. Are the papers bound and arranged in an orderly fashion? _____

8. Were negative confirmations requests used in respect of accounts receivable where no reply could be expected? _____
9. Is there any indication of superfluous work, such as duplication of work or schedules, unnecessary analyses of accounts or transactions, et cetera? _____

Letter of Representations from Client

1. Has letter signed by appropriate officials been obtained? _____

Permanent File

1. Is the outline of the system of internal control kept up to date? _____
2. Does the permanent file appear to be in good shape in other respects? _____

Letter re Weaknesses

1. Has such a letter been prepared? _____
2. What is its present status? _____
3. Where important weaknesses are indicated, has scope of examination been expanded to take care of the situation? _____

Accountants' Report

1. Does the report conform with the requirements of Statement No. 23 and other applicable statements of the committee on auditing procedure of the American Institute of Accountants? _____
2. Does the report conform to arrangements with the client as to form and scope? _____
3. Does the report conform to all practices and requirements of the firm? _____
4. Do the supplementary data include information that tends to qualify the information given in the short-form report? _____

Appendix D

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CHAPTER 12

FEEES FOR SERVICES

BASIC FACTORS

Staff Time Donated to the Work. Technical Importance of the Work. Value of Services to Client. Difficulty of Engagement; Skill Applied. Special Consideration to New Clients. Size and Character of Community. Staff Utilization. Unusual Overhead Costs.

BASIC PATTERNS IN SETTING FEES

Fees for Specific Engagements (Per Diem; Flat; and Contingent). Retainer Contracts. Unprofitable Work. Fees Set by Correspondents.

RELATED MATTERS

Competitive Bidding. Forwarding Fees and Commissions. Fees Charged Philanthropic Organizations. Dealings with Clients on Fees (Billings; Complaints; and Collections).

CHAPTER 12

Fees for Services

BY T. DWIGHT WILLIAMS

THE GENERAL BASIS for the fixing of all professional fees is the value of the service rendered to the client. This is a simple rule but difficult to apply to accounting engagements. It is affected, as between engagements, by the relative and varying importance of the several factors which must be considered. Staff time given to the work is always significant but it is rarely, if ever, the only determinant. Usually there is present one or more vital features such as technical importance of the work, unusual amounts of overhead involved, and so on. Because of such variables, all of which are listed and discussed hereafter, a fee fixed for one engagement may differ materially from the fee for what, to the uninformed might appear to be almost identical. However, there are standards, established through general application in practice, which may be used as guides in setting fees for accounting services. The purpose of this chapter is to discuss these standards.

To obtain the information needed for this chapter, a questionnaire, designed to establish current practices relating to fees, was sent late in 1951 to a substantial number of representative public accounting firms and individual practitioners. The existing practices referred to in this discussion, unless otherwise stated, are those established from the information contained in the replies to this questionnaire.

All of those replying agreed to the over-all standard that a professional attitude should be maintained in setting fees. Eighty-seven per cent considered that this means, in general, that fees should be based primarily upon the quality of the services rather than upon the time expended, and 62% felt specifically that fees based or billed wholly on a per diem basis stress the wage earner aspect and are at variance with the professional nature of accounting.

Although other factors may be of equal or greater importance, the time element plays a special role. It is the major ingredient of cost and cost provides an irreducible minimum in the fixing of fees. Properly figured on either an accumulated or estimated basis, it gives a fundamental starting point for the application of other relevant factors and the addition of a reasonable ratio of profit. Other factors may be pertinent on occasion only. Cost is always pertinent.

In both the legal and accounting professions, the ultimate objective in setting fees is to obtain for the lawyer or accountant a fair and reason-

able compensation after considering all the circumstances. Fair compensation implies that the services should be priced at their reasonable value; that is, at what they are worth. This basis is used by courts in cases involving the determination of compensation for services not fixed by contract. "Quantum meruit" ("as much as he has merited") is the applicable legal phrase.

The Treasury Department of the United States, in its regulations governing the recognition of agents, attorneys and other persons to practice before it, asserts that the reasonableness of a fee, contingent or otherwise, is a matter of judgment depending upon the facts and circumstances, which include the complexity and difficulty of the case, the time and labor required, the amounts involved, and the professional standing and experience of the attorney or agent.¹

Seventy-five per cent of those replying to the questionnaire stated that they believe that the public can be educated to accept the "quantum meruit" basis for establishing fees for accounting services, and many firms report a definite trend in that direction in cases where courts set fees.

BASIC FACTORS

Nine basic factors to be considered in setting fees are classified, in the customary order of their importance, as follows:

1. Staff time devoted to the work.
2. Technical importance of the work and the extent of responsibility assumed.
3. Value of services to the client.
4. Difficulty of the engagement.
5. Skill and experience of the principal or firm.
6. Special considerations, in the case of a new client.
7. Size and character of the community.
8. Relation of the engagement to the utilization of the staff.
9. Unusual amounts of overhead caused by the engagement.

It is not necessary, of course, to consider every one of these factors anew every time a firm sets a fee. Some are fixed rather definitely with respect to all fees of a given firm. In this class, for instance, are those relating to skill and experience of the principal or firm and the size and character of the community. Others, such as those involving special consideration for a new client, relation of an engagement to staff utilization, and unusual overhead, have limited application and require attention only when involved specifically. However, there also are those that must be considered specially in every case. These are staff time and the degree of difficulty of the engagement.

These nine basic factors are considered in further detail in the following paragraphs.

¹ See references at end of this chapter.

Staff Time Devoted to the Work

In determining the reasonable value of professional services, proper consideration should be given, of course, to the time required for the performance of the engagement as well as to the other factors. In cases involving specialized ability, the weight given to the time factor is much less than for a routine audit engagement. This is consistent with the professional attitude that fees for such services should be determined as a basis clearly distinct from that applied in an employer-employee relationship in which time expended and an agreed rate are the sole factors. Staff time devoted to the work is the factor first considered in fixing fees. This is because it is definitely measurable and is usually the controlling fee factor in routine audit engagements. Despite the fact that greater weight is frequently given to the other factors in setting fees for the more important auditing, tax and consultation engagements, staff time given to the work is the basic yardstick employed for such engagements; for routine fees established according to it are upgraded in proportion to the special nature of the services rendered.

To accumulate the time factor, it is necessary for the people working on the engagement to report the time they have spent on it. It is not proposed to discuss here methods used by accountants in accumulating this information as these procedures are outlined in Chapter 7. It is sufficient to say here that the time should be reported at least twice each month. The time devoted to the engagement will include all work done by the accountant and his staff in his own office, as well as in client's office.

Practically every engagement will require some research in the office of the accountant to determine either the generally accepted accounting principles, the auditing procedures pertaining to the engagement, or the rules and regulations of some governmental agency. Tax problems pertaining to the client's affairs may be the subject of considerable research. The time spent in such research is necessarily an element of the time factor of the engagement.

While many accountants have indicated that time spent by their typing department is not considered as an element of direct cost of the engagement, at least one accountant has pointed out that typing cost should be so included: "... it seems advisable that accountants who have been treating typing cost as incidental overhead expense should revise their ideas on the subject, because of current costs. Typists are scarce and expensive now and should be charged for accordingly." ²

When the engagement presents no unusual difficulties, a fee based entirely on the time spent upon it is most often used.

Technical Importance of the Work

All of the factors other than "staff time," while difficult to evaluate, can be effectively, though not precisely, measured by considering pertinent subfactors.

The subfactors relating to the technical importance of the work and the extent of responsibility assumed, listed in the order of their importance as indicated by the questionnaire replies, are:

1. Grade of work performed.
2. Adequacy of the records on which the work is based.
3. Intended uses of the reports rendered.
4. Amounts involved.
5. Obligations or responsibilities imposed by governmental regulations.
6. Liability of the accountants to third parties.

The evaluation of this factor requires that due consideration be given to all of these subfactors.

Important accounting services, such as accounting reports in connection with the registration of securities with the Securities and Exchange Commission, merit a larger fee than routine auditing; and certain types of tax, advisory and specialist services justify charging more substantial fees.

The adequacy of the records and the obligations and responsibilities assumed by the accountant have a bearing on the risks involved. The intended use of the accountant's report, the amounts involved, and the possibility of liability to third parties are indices of the materiality of the services rendered. Logically, fees should have a direct relation to the degree of risk involved and to the materiality of the services. The risks involved in defending possible "strike" suits in the indefinite future in connection with public issues of securities must be given consideration in fixing a fee on such an engagement.

The liability of accountants to their clients for negligence is not considered as important by practitioners, probably because they believe it is a normal responsibility for which no additional charge is necessary. The general repute of the clients also is considered as of little importance for this purpose.

Value of Services to Client

The subfactors considered in estimating the value of the services to the client for factor 3, in the order of their importance, are:

1. The intrinsic value of the work performed to the client.
2. The degree of success in attaining the purpose for which the work was required.
3. The purpose itself.
4. The ability of the client to pay.

The intrinsic value of the services to a client might be greater in cases where a new issue of securities is contemplated or a reorganization effected than where the report is to be used in connection with casual borrowing.

The client's purpose and the degree of success in attaining it are of particular significance when substantial tax refunds are sought, or proposed tax deficiencies are materially reduced or eliminated.

It is necessary to consider the client's ability to pay only if it is limited, even though there is no obvious relationship between his ability to pay and the value of the services to him. An English writer insists that the proper way to consider this subfactor is merely to perform no services for a particular client beyond those for which he can readily afford to pay.³

Difficulty of Engagement; Skill Applied

It is necessary to consider factors 4 and 5 together because the phrase "difficulty of the engagement" in this context refers to highly technical and complex problems, the solution of which requires unusual consideration by a highly competent principal and staff. Practically all firms agree that higher fees are justified where difficult problems are present in the engagement. A few consider these factors when they are involved in only part of the services performed in a particular engagement.

Obviously, it is desirable to have a difficult engagement receive the attention of a highly competent principal and staff. It follows that a client should be willing to pay for the proper value of services under such conditions and to accept the fact that both the inherent difficulties of the engagement and the special competence of the principal and staff to deal with them are closely related to such value. What is not always understood so clearly, however, is that the client, in addition to the further safeguard of consideration by a particularly competent principal and staff often obtains the definite advantage of a reduction in the time necessary for the engagement as compared with the time that would be necessary if a competent accountant, but not one specially qualified to handle the recognized difficulties, were to perform the engagement. It is quite possible, therefore, for a combination of greater experience, more specialized skill and the expenditure of less time to involve no greater financial outlay to a client than merely adequate experience, routine competence, and a greater time expenditure.

Special Consideration to New Clients

Seventy-five per cent of questionnaire replies indicate that accountants give special consideration to new clients (factor 6) only in exceptional cases. Usually, special consideration is given only to smaller businesses having prospects of future growth. The motive may be to aid them through a difficult period. When it is considered advisable to give a new client special consideration, he should be informed of that fact and advised that at a point in the future he will be charged the usual fee for the services performed. A minority of practitioners have no objection to charging a nominal fee on an initial engagement providing the client knows this fact, but most firms believe that the initial fee must never be less than a substantial portion of a normal fee. Some believe that a reduction of the fee has special justification on new engagements. In effect, obtaining familiarity with the affairs of the new client is considered

an element of cost to be borne by the accountant. There may be occasions when this is warranted; but generally, and particularly when another accounting firm is being replaced, it may be difficult to distinguish such a practice from unethical competitive bidding.

A majority of firms extends the consideration in a different way, where helpful, to new clients of small size and means. Such new clients are charged the full amount for services rendered but are allowed to make monthly or other periodic payments in line with their financial situation.

Size and Character of Community

Sixty per cent believe that the size of the community (factor 7) has an important bearing on the amount of the fees which can be charged. Smaller fees are appropriate in smaller communities. Opinions differ as to the population that should be chosen as the dividing line between low and high fee areas, the range being from ten thousand to two hundred and fifty thousand, and the average seventy thousand. The scarcity of business enterprises in a particular community was cited as a factor tending toward smaller fees. A few of the reporting firms referred to the existence of large local enterprises as a favorable factor, but some pointed out that this was not true when such enterprises were branches of national organizations which did not use local professional services.

Staff Utilization

The consideration given to staff utilization (factor 8) was established by obtaining the reactions of firms to certain pertinent propositions. Forty-five per cent of accounting firms queried assented to the following statement but the remaining firms answered no to the question.

"Where, in a slack season, an engagement permits retention of staff personnel who would otherwise be dropped, or requires the hiring of added temporary staff members who need to be paid for only the period of the engagement, such factors are considered in fixing fees."

Fifty per cent of firms approved the following:

"When an engagement procured will materially reduce idle time previously estimated for the period in which the engagement is to be performed, consideration is generally given to any such favorable result when fixing fees."

Only 40% of firms stated they intended to increase the standard charge for an engagement demanding priority during the busy period.

Unusual Overhead Costs

Ordinarily in setting fees no consideration is given to unusual amounts of overhead caused by the engagement (factor 9). Sixty-four per cent of firms reporting determine general overhead solely to fix it as an element of cost. The same number recognize such elements of overhead as typing costs directly in fixing fees by pricing typists' time with the staff time so

that any unusual amounts of typing costs caused by the engagement are automatically given special consideration. One large firm reports that it includes the time of comptometer operators.

BASIC PATTERNS IN SETTING FEES

The various types of fees may be classified as follows:

1. Fees for specific engagements:
 - a. Per diem.
 - b. Fixed (or flat).
 - c. Contingent.
2. Retainer contracts.
3. Fees set by correspondents.

Each of these types will be discussed briefly.

Fees for Specific Engagements

Per Diem Fees

Per diem fees are charges by the day or hour for actual time devoted to an engagement. The rate per day or hour varies according to the classifications of personnel used on the engagement. The usual classifications of personnel for this purpose are: principal or partner, manager, supervisor, senior, semi-senior, and junior. These classifications will vary among accounting firms, and each of the groups may be further classified.

There are two general methods of using per diem rates to arrive at fees to be charged clients. One method involves computing or fixing a standard or average hourly or daily salary cost rate (based on productive time) for each classification of personnel, including principals or partners; adding to each classification rate a factor for overhead and a factor for profit; and thus obtaining a standard billing rate for each classification, which rate is multiplied by the hours or days worked by persons in such classification on the engagement being billed. The totals for each classification are then added to obtain the total fee to be billed.

The second method requires that the actual salary cost (based on productive time) be figured for each individual employee on the engagement. To the total of such individual salary costs are added factors for overhead and profit. Under this procedure, where only employees' salaries have been figured, provision must also be made for reasonable compensation for principals and partners.

Substantially the same result is achieved by both methods. The second requires more figuring, because individual rates are used instead of standard rates; but it has the advantage of indicating salary cost and profit more precisely.

One formula used frequently to relate fees and profits reasonably to direct salary cost is to establish the fee at two and a half, or even three

times the direct salary cost. Another formula favored is to charge each staff member's time at a daily rate equal to 1% of his annual salary. These short-cut methods are applied easily and the fees arrived at by them are sufficient usually to provide adequately for overhead and a profit. The specific ratios indicated in the two formulas are suited primarily to more or less routine engagements. Where factors in addition to time expended play a part in the establishment of the fee, consideration must also be given to appropriate upgrading of charges based on the relative effect of the relevant factors, as discussed more fully hereafter.

Normally overhead on any engagement is considerably below direct salary cost; ordinarily it will range between 40% and 50% of direct cost. Assuming that it is 50%, and that the ratio of the fee to direct salary cost is two and one-half to one, the provision for overhead will be 20% of the fee. However, a variation in the overhead factor applicable to an engagement will materially affect the fee. Some firms include office salaries and other items which others classify as overhead in direct salary costs.

Ninety-six per cent of reporting firms favor use of per diem fees under certain conditions. Seventy-five per cent of these believe that they should be used generally and 20% only when specially required. The rest consider occasional use desirable. The principal advantages cited for the use of per diem rates are, in order of their importance:

1. The client receives all that he pays for and nothing for which he does not pay.
2. The accountants receive full payment for the time given to the engagement and do not suffer a loss.
3. The accountants are enabled to meet their responsibilities fully.
4. Per diem fees are an effective yardstick in measuring charges for routine auditing.

The strongest objection made to use of per diem fees is that they place undue emphasis on time spent on services regardless of their nature, quality or value. It also is urged with almost equal stress that they are particularly inadequate and inequitable where the value of services is mainly dependent upon their nature and quality.

The objections to the per diem basis are usually met by charging different rates for the various classes of personnel used and by increasing (upgrading) basic rates in proportion to the quality of services rendered. In some cases this remedy is not satisfactory because, in the highest forms of technical service, the time element may be wholly irrelevant in relation to the intrinsic value of the services. For example, discussion with a client of a proposed transaction may require only a small amount of time, but the advice given may be extremely advantageous to the client. It should be evident that the time element is relatively unimportant in fixing a fee in such a case. On the other hand, the intrinsic value of some services to the client may be less than the amount determined on a strict time basis, because staff members used are inexperienced or unfamiliar with the client's affairs, or because of inexpedient over-all handling of the engagement. One accountant has expressed the opinion that evaluation

of the services performed more often results in a write-down than in a write-up of the fee computed solely on a time basis.

A disadvantage of per diem fees considered to be of less importance is that they give the client no definite way of estimating the cost of the work in advance. Where necessary to satisfy the client, this objection is usually met by guaranteeing that the total of the per diem charges will not exceed a stipulated maximum fee.

In fixing per diem rates, the definition of "day" becomes an important factor. Eighty-one per cent of firms consider a standard working day to be seven hours. Only a few consider it as seven and one half or eight hours. In comparing per diem rates this variable must be kept in mind.

When per diem billing rates are fixed for each grade of staff personnel utilized, basic rates for each grade are those in effect for routine auditing and usually they are upgraded for other types of services by increasing them by a fixed percentage. But all rates, basic or upgraded, vary within fixed limits as to each classification of personnel and thus have a minimum-maximum range. Such flexibility has definite value in making it possible to relate charges even more closely to the nature and quality of services performed and the experience and ability of the personnel actually used.

Charges for Services Other Than Routine Auditing

To obtain upgraded rates for services of a nature other than routine auditing, most firms increase their basic rates by some percentage.

For tax services, the reported percentage of increase ranges from 25% to 100% and averages about 60%. For systems installation, the percentage of increase varies from 10% to 100% and averages about 40%. For special investigations, the range of increase is from 10% to 100% and averages about 50%. For advisory and consultative services, the range is from 25% to 150% and the average about 66- $\frac{2}{3}$ %.

In having staff members record time spent on engagements or phases of them, firms usually do not require recording of time less than a specified minimum. Usually this minimum period is fifteen minutes or half an hour. However, the reporting firms were asked whether they added to recorded time an extra time allowance to cover units of fractional time devoted to engagements but unrecorded because less than the minimum unit. About 20% answered that they did add an extra allowance, and one practitioner who replied that he did not commented thoughtfully "Seems like a good idea, but I never thought of it." Most of the firms making such extra allowance figure it in definite relation to total time actually recorded. That the relation of the extra allowance to the recorded time can be substantial is revealed by the report of two firms. One figures the extra allowance as 10% of total recorded time and the other as 15%. Actually the extent of fractional time would depend greatly upon the length of the adopted minimum time unit recorded.

Fixed (or Flat) Fees

A fixed fee is an amount charged for an entire engagement as distinguished from charges for services by the hour or day. When used, it is fixed and quoted and arranged with the client in advance of the work.

Ninety-eight per cent of the firms replying favor use of fixed fees under certain conditions. Only 8% of these believe they should be used generally, 72% when specially required and 20% occasionally.

Advantages of fixed fees are that they enable the client to know the cost in advance, that they may relate the amount of the accountant's compensation more directly to the quality of the services than to time spent, and that they are representative of the professional attitude.

Disadvantages of fixed fees, in order of their apparent importance, are as follows:

1. The accountant may receive an inadequate return or suffer a loss if he underestimates his costs either by errors in considering the known facts at the beginning of the engagement or by not making proper allowance for new facts which may develop during the progress of the engagement.
2. It may be difficult to convince the client that higher fixed fees are justified for subsequent engagements involving further services and greater expenditure of time.
3. Fixed fees quoted to a client might be used by him to secure lower competitive bids.
4. Accountants may be tempted to cut corners to avoid losses when they realize that they have underestimated their costs.
5. Clients are subjected to excessive fees where the accountants overestimate their costs.
6. Clients might consider a fixed fee as a reduction of the amount that would be chargeable on a per diem basis.
7. Misunderstandings may arise as to the exact services covered by the fixed fee.

To avoid or lessen the effect of some of the above disadvantages, a fixed fee contract may be modified. The agreement may be that the fixed fee will not be less than a stated minimum, say \$1,000, nor greater than a stated maximum, say \$1,500; with the charge not to exceed the higher amount if normal and agreed conditions prevail. Some accountants make the stated minimum fee coincide with their estimate of the actual charge. In such cases, the clients get the benefit of the stated minimum unless unexpected difficulties develop.

On an initial engagement for a new client, a good plan is to conduct it on a per diem basis, and thus gain a knowledge of the client's affairs which will serve as a basis for estimating fixed fees on subsequent engagements.

Some firms seek to avoid misunderstandings with the client by having a written agreement stipulating that the fixed fee covers only certain definitely stated arrangements and that additional charges will be made if (1) the records are not in a reasonably good condition, or (2) if there are unusual developments such as defalcations or substantial errors in the books. Other firms rely entirely upon a careful preliminary investigation

of the work that will be required, the condition of the client's records, and the adequacy and enforcement of the system of internal control.

The possibility that clients may consider a fixed fee as a reduction in comparison with per diem rates is not too serious. Many firms reported that they set their fixed fees at little, if anything, under the total per diem rates for the estimated duration of the engagement.

Seventy-five per cent of those using fixed fees determine the amount by multiplying the estimated number of days of each staff classification required by the per diem rates for the respective classifications. Seventy per cent base their fixed fees on rates varying directly in relation to (1) quality of services, and (2) classification and compensation of staff personnel. A negligible number use uniform rates for all work without regard to these factors or use on occasion rates higher or lower than their regular per diem rates.

While the practice is doubtless quite rare, it seems that there are instances where clients are permitted to set the amount of a fixed fee. The main objections to such an obviously unwise procedure are (1) the client has no adequate or competent yardstick with which to measure the proper charge, (2) the relationship involved should be that of a professional man and client and not that of employer and employee, and (3) the basic cost which is a material element of the charge is known only to the accountant.

Contingent Fees

A contingent fee is one which is payable only in case a certain event occurs. It may be a fixed amount or a percentage of amounts which the client hopes to receive as a result of the findings or work of the accountant. Eighty-seven per cent of the firms consider that, in its broadest sense, it is based upon financial or other results secured through their services.

Contingent fees are permissible only in connection with tax matters and should conform to:

1. The Rules of Professional Conduct of the American Institute of Accountants.
2. The rules of the recognized professional society or board in the accountant's region.
3. The regulations of the relevant governmental agency with respect to contingent fees.

The applicable Professional Conduct Rule of the American Institute of Accountants states:

"(9) Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving Federal, state or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule."

The United States Treasury Department prohibits persons enrolled to practice before it from entering into a wholly contingent fee agreement with a client, unless the financial status of the client is such that he would otherwise be unable to obtain the services of an attorney or agent. Partially contingent fee agreements are permissible where provision is made for the payment of a minimum fee, substantial in relation to the possible maximum fee, which minimum fee is to be paid and retained irrespective of the outcome of the proceeding.⁴

Contingent fees should not be used as a basis of compensation for accounting work not connected with taxes or court matters because:

1. They are incompatible with the obligation of public accountants to be independent and impartial in that they affect compensation to the extent of the direct benefit to the client.
2. They provide, in effect, for a profit-sharing basis between client and accountant inconsistent with the professional relationship of the accountant to the client.
3. They provide for a measure of compensation unrelated to the time spent, the nature and quality of the services, and the professional skill required and applied.

It is generally considered that a contingent fee is not involved where:

1. The fees for services engaged for are to be fixed by courts or other public authorities and are therefore indeterminate when the engagement is begun.
2. The fees are related to the amount of time devoted to the engagement, the nature and quality of the services rendered, the expected value of the services to the client, and the special experience and skill of the retained accountant and of his staff, and the expected value of the services to the client is not measured by the eventual degree of benefit actually derived by the client.

Retainer Contracts

In the United States, a retainer fee paid to accountants usually means a fee paid for all services of whatever nature or for services of a specific nature rendered during a designated period. This definition differs from the English concept in requiring that services are to be performed for the fee. In England the fee is paid so that the accountant will be available if needed whether or not services are performed, and an additional fee is to be paid for whatever services are performed.

Under the American concept providing for payment for services over a specified period, retainers are usually on an annual basis with equal monthly payments at the end of each month, regardless of actual volume of service performed during each month. A monthly retainer arrangement, which can be terminated at the end of any month, is reported as an occasional occurrence.

Types of work usually specified in these contracts are listed below in the order of their frequency:

1. Preparation of tax returns.
2. Fiscal year-end work.
3. Monthly and annual reports.

4. Conferences on matters specified in the agreement.
5. Periodic auditing.
6. Attendance at revenue agent's examinations.
7. Preparation of credit agency statements.

A few firms reported additional classifications such as attendance at directors' meetings, conferences on management policies, supervision and training of bookkeeping personnel, conferences on accounting procedures and handling of minor tax problems. In answer to a specific question as to the desirability of including advisory and consultative services in services covered by retainer agreements, 75% of the firms reported that they favored their inclusion in such arrangements.

Retainer contracts provide the accountant with some assurance of retaining clients permanently and furnish steady periodic engagements. Also, where they are restricted as to scope, they frequently lead to additional engagements not contemplated in the original agreement. They also are advantageous to the client in that they assure the availability of the accountant and, when equal monthly payments are made, automatically spread accounting costs evenly over the year.

The principal disadvantage of a retainer agreement is that it may be necessary for the accountant to render a greater amount of service in the contractual period than was anticipated when the fee was set. Equally serious is the danger of a misunderstanding with the client as to the scope of services to be performed. The client may expect certain types of service not contemplated by the accountant at the time the agreement is entered into. This latter difficulty may be avoided by having a written agreement describing in detail the service to be furnished, thus assuring a clear understanding with the client which can be referred to when additional services are needed. Such agreements can be made more effective by specifying also any types of work which might be expected, but which are excluded by mutual consent. Many accountants find it advantageous to set out their understanding of an agreement by writing a letter to the client even though it is not formalized by having the client sign it. Others simply make a memorandum of the agreement for their files.

Fifty per cent of all firms reporting favor a reconsideration procedure to prevent inadequate return on retainers after the initial year. At the end of each retainer period, a review is made of the nature and extent of services rendered and the time expended. The result is compared with the retainer fee and discussed with the client. If the fee has been inadequate, the fee is increased for the ensuing year and, in some cases, it is found possible to secure a reasonable adjustment as to the period reviewed.

Disadvantages, other than those peculiarly applicable to fixed fees and the danger of misunderstandings with the client, are minor. Fees may be less than on a per diem or fixed fee basis, but this can be accounted for by the willingness of the accountant to accept a lower fee in order to obtain the advantages of the retainer contract. Commitments

under retainer contracts sometimes cause an excessive volume of work at year-end and mid-year periods, but this difficulty can be reduced by making specific arrangements with each client in such a manner as to stagger the load.

Unprofitable Work

There will be occasions in every accounting practice when it will be found that the work being done for a client is not adequately profitable, because the fee is not sufficient to compensate for the salaries and the overhead costs incurred and leave a reasonable margin. This condition can arise either in cases of fixed fee arrangements, when the work done exceeds the fixed fee, or in the case of work handled on a per diem basis, when the client resists paying for the full time at regular rates of charge.

In every such case in which the work is thus found to be unprofitable or insufficiently profitable for the accountant, his first step, of course, is to determine whether or not the persons handling the assignment did so with reasonable dispatch and efficiency. If a new man was assigned to the work for the first time, or if there was inadequate supervision or poor planning or unnecessary attention to detail or other similar conditions, it would not be fair to ask the client to pay more than a fair fee. The experience in such case should be turned into an object lesson so that future work for the client (and, in fact, future work for all other clients) does not suffer from a repetition.

In many cases, however, the solution is not that simple. The accountant may have conducted the work efficiently and well. The fixed fee may have been set too low in the first place, or unexpected circumstances may have caused the work to exceed that originally contemplated. In such cases, the only practical thing to do is to explain the situation to the client and try to secure an adjustment — for the finished work, if possible — if that is not possible, for future assignments.

If a client is not willing to adjust a fixed fee arrangement or to recognize the accrued charges on a per diem basis, when the work has been done efficiently, the accountant's first impulse may be to tell the client to seek accounting services elsewhere. Although some cases may justify this action, it is not always the sensible course.

It is entirely conceivable that the client may have a proper idea of the maximum amount that he can afford to pay for accounting services. If this is true, and the client is reasonable, it is frequently possible to revise the arrangements to keep the client's fee in line and still make the work profitable for the accountant. A discussion with the client about the problem may develop a number of ways of accomplishing this. For example, the client may be receiving a "certified" report twice a year when once a year would be adequate. He may be receiving a "certified" report when he has no need for it, and a limited examination of the accounts by the auditor and the preparation of financial statements

without a formal opinion would be sufficient. The client may not be aware of the amount of work done by the auditor that could be done by people within his own organization at a substantial saving in auditing time. A review of the work program may disclose changing circumstances, such as a substantial reduction in inventory or an improvement in internal control, that would justify a reduction of the amount of time scheduled for the assignment.

If the client is reasonable, a working plan can usually be developed on a basis satisfactory to both parties. There are cases in which a client under financial stress should receive special consideration — either in amount of fee or in time of payment. It is perfectly ethical and proper for an accountant to take into account the financial condition of his client.

If the client is unreasonable, these possibilities will offer no solution and the accountant would be better off to terminate the relationship.

Fees Set by Correspondents

Correspondent accountants have the following methods of charging for their services:

1. A fixed fee at customary rates.
2. A fixed fee at less than customary rates.
3. Per diem fees at customary rates.
4. Per diem fees at less than customary rates.
5. A fee equal to the cost.
6. A fee equal to the cost plus a nominal amount.

Method 3 is employed by 55%, or more than all of the others combined. Where the fee is less than the customary rate, the usual reduction is a flat 15% or 20%.

RELATED MATTERS

Other matters relating to fees include the following:

1. Competitive bidding.
2. Forwarding fees and commissions.
3. Fees charged philanthropic organizations.
4. Dealings with clients in relation to fees.
5. Billing.
6. Complaints.
7. Collections.

Each of these matters will be discussed briefly.

Competitive Bidding

The attitude of the American Institute of Accountants toward competitive bidding is expressed in Rule 14 of its Rules of Professional Conduct as follows:

"A member shall not make a competitive bid for professional engagements in any state, territory or the District of Columbia, if such bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or district."

The objections to competitive bidding are that it lowers the dignity and standing of the profession, tends to cause inadequate compliance with accepted auditing standards, and results in controversy and ill feeling within the profession.

One medium-sized firm reports that it invariably refuses to quote definite amounts to prospective clients. Engagements are accepted with the understanding that the necessary services will be performed, their value then discussed with the client and any difference of opinion adjusted to the satisfaction of the client. The firm states further that the plan has proved satisfactory. Few adjustments are found to be necessary. In cases where the client requests excessive downward adjustments, they are made, but no further assignments are accepted from that client.

The English writer, Sproull,⁵ makes some interesting reflections upon "competition" and "quoting." One striking comment as to the former is that "the product delivered to the client in accounting is so individual and different from time to time or case to case that trite comparisons between accountants' products are not possible by the layman and are almost equally difficult for accountants to make." As to "quoting," he thinks refusal to quote is the soundest policy as to both new and old clients. Where it is done, he feels that all that should be given is a rough guide to what the fee may be, together with a definite statement that the amount includes a margin (not specified) for contingencies and is conditioned also upon receipt of prompt and full data and records from the client and complete co-operation from all other parties with whom it may be necessary to deal.

Two-thirds of the reporting firms state that municipalities are now tending to abandon the practice of requesting competitive bids for accounting engagements, and are presently engaging accountants on a per diem or fixed fee basis. Seventy-five per cent of all firms reporting consider that competitive bidding on municipal audits sometimes results in inadequate auditing. Forty per cent of those making this statement believe that such inadequate auditing leads frequently to bad publicity or even to suits by municipalities for losses claimed to be due to inadequate auditing. One firm highlights its objection to competitive bidding by reference to an actual instance where a fee of \$13,500 for a city audit was reduced gradually to \$3,600.

Forwarding Fees and Commissions

Less than 25% pay forwarding fees or commissions and then only to other accountants. This practice conforms to the following Rule of Professional Conduct of the American Institute of Accountants:

"(3) Commissions, brokerage or other participation in fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member."

Little information is readily available as to how much referral there is or as to the amount or method of computing the referral fees. In the legal profession, the usual rate is one-third the amount billed to the client. However, for accountants the rate appears to be much lower generally and, where there is a substantial amount of referral, it may be as low as 15%.

The ethical principle involved is that the amount billed to the client must not exceed the amount that would have been billed had there been no referral. This means that the fee paid to the forwarder must be borne by the firm or practitioner performing the engagement, not by the client.

Commissions paid staff members for securing engagements vary in different circumstances and are usually a matter of individual arrangement.

Fees Charged Philanthropic Organizations

Of the firms and practitioners included in the survey, 75% of those performing services for philanthropic organizations do so without charge or for substantially less than a normal fee. The remaining 25% charge standard fees, but make cash donations.

Where the services are performed at a reduced rate, the philanthropic organizations seldom list the accountants as donors, but they are more likely to do so when no charge is made. When there is no charge, some accountants bill the standard fee, attaching a notice that payment is not required because the invoiced amounts represent a donation to the organization.

The accountants covered by the survey, generally, did not consider the requests for special consideration by philanthropic organizations burdensome. In some communities, the possible burden is avoided by rotating charitable work among different firms on an equitable basis. This plan has been found effective in Denver, South Bend, Louisville, Chicago, Indianapolis and Meriden (Miss.).

Dealings with Clients on Fees

Sixty per cent of the firms make a written record of the essence of provisions of agreements discussed or contemplated. This is done soon enough after discussion to insure accuracy and to be acceptable in legal proceedings to refresh recollection. Somewhat less than half the small firms follow this practice; about 90% of medium and large firms do so.

Less than one-third of small and medium-sized firms and about 60% of large firms confirm to the client in writing every agreement as to services, whether verbal or written. Such communications usually set forth

clearly and fully basic data as to services arranged for, place of performance, and the amount and basis of compensation.

From the standpoint of the accountant's civil liability to his client, it may be desirable that the specific nature of every agreement between accountant and client be stated definitely. This matter is considered in some detail in Chapter 6 under the heading "Liability to Clients."

About 56% of the firms questioned state that they conform to the following practice:

"In all agreements covering services to be performed and specifying the amount and method of the compensation, specific provision is included for adjustment or variation in the charges in the event of the occurrence of conditions affecting the duration of the engagement or the extent or nature of the services required to complete it."

About 35% favor use of the following policy as to additional services and changes in scope:

"Every agreement as to an engagement or services contains a definite clause providing that all other services desired in the future or any change requiring a broadening of the scope of the services covered by the agreement are to be the subject of separate and specific agreement."

With respect to the same subject, about 80% follow this practice:

"Where there is an agreement for services which contains no clause as to additional services or changes in scope being made the subject of further specific agreement, and suggestions to the client as to further substantial services he needs are made and accepted, such suggestions are always accompanied by reference to the fact that they will be the subject of separate agreement and additional compensation."

A large majority prefer discussing billings with clients when the engagement is accepted rather than at the time the report is delivered.

Billings

Considerable variation was found in practices relating to the frequency of billings. On engagements covering a period of less than a month, 55% of firms replying to the questionnaire prefer to bill on the first of the ensuing month instead of billing immediately at the end of the engagement. Where limited engagements cover a period of more than a month, 93% prefer billing at the end of the engagement rather than billing on the first of each month throughout the engagement for work performed to that date.

Where an engagement for services is for a specified period, a majority prefer monthly billings, some quarterly and a few annually.

Four features emphasized by accountants in comments on the form and content of bills were:

1. Brevity.
2. Particular mention of any fact or development which increased charges.
3. The importance of indicating adequately the type and value of the services in consideration of possible subsequent controversy.
4. Specification of basic services designated in the agreement.

A majority consider brevity the most important feature, but a substantial number prefer invoices showing detail of services performed, but making a single charge for all of these services.

The practices of those preferring brevity are as follows:

Per Diem Billings: A brief description of the services performed, the period in which they are performed, and a single amount charged for all services rendered and a separate sum for total expenses chargeable to the client. Some of these firms also add a brief description of the services performed and the period in which they were performed.

Fixed Fee Billings: The total agreed fee, and total expenses chargeable to the client. Some add a brief description of services performed.

One speaker at the 1952 Mountain States Accounting Conference in discussing accountants' fees said there exists today a trend toward public acceptance of the actual value of services performed as a major element in fixing fees. He thinks the per diem fee should be based primarily upon the time consumed, but only as a method of arriving at the total fee. It is his definite opinion that the client's bill should not show a certain number of hours at a specified rate varying as to the classification of staff personnel, because such a method of billing does not reflect the professional attitude.⁶

The practices of most of those favoring itemization were as follows:

Per Diem Billings: For each personnel classification: the number of men, the per diem rate, total time, and total fee; plus an itemization of the chargeable expenses.

Fixed Fee Billings: A full description of each type of service rendered, the total fee, and an itemization of the chargeable expenses.

Preference for itemization as to type of services rendered was indicated more frequently in the case of billing for fixed fees.

Complaints

Few firms receive complaints. Where they do, a definite connection seems to exist between complaints and the related invoice. Large and medium-sized firms believe that this is because brevity in the invoice suggests lack of substantial value. Individual practitioners and small firms think that itemization strikes clients as constituting too much detail of little value. This phenomenon suggests that the extent of itemization might vary according to the size of the firm, but it is hardly a sound basis for a definite rule.

All firms report a policy of giving careful consideration to reasonable complaints. When complaints are considered unreasonable, about two-thirds of the firms take the precaution of making more specific any subsequent agreements with the client involved; other firms refuse subsequent engagements.

Collections

Generally favored practices relating to collections include the following:

1. Refraining from specifying on the bill when remittance is expected.
2. Following up within thirty, sixty, or ninety days.
3. Insisting on prompt payment when bills are overdue.
4. Making no adjustment in charges to induce payment.
5. Taking legal action only as a last resort and only in cases where the amount of the fee makes collection imperative.

About 92% of firms giving information record that they refrain from specifying on bills a period within which payment is expected. When payment is not received within a reasonable period, a follow-up by monthly statement or individual letter is made. A substantial number of firms do this within thirty days. An almost equal number prefer sixty days. A smaller group makes it ninety, and one firm sets it as low as twenty. Moreover, decisions as to when to send a reminder and how to word it are dependent upon such variable circumstances as (1) whether the client is new or old, (2) amount of fee due, (3) client's known financial condition, (4) whether services rendered are casual or periodically recurrent, (5) how close and friendly the tie with the client is, and so on.

Of the 8% reporting that they specify on their bills the period within which payment is expected, not one is a large firm. Further, only a few of the firms specifying a period indicate its length. However, one medium-sized firm states, "due when rendered," and two small firms stipulate ten and thirty days respectively. When the stipulated period elapses without receipt of payment, all the firms send discreet reminders which take, in general, the form of a monthly statement or an individual letter. When a letter is sent, it is dispatched usually from fifteen to thirty days after expiration of the period within which payment was required. One firm prefers, however, a personal call on the client instead of a letter, and another waits six months before supplementing monthly statements by a special letter.

There is understandable reluctance by all firms to remind a client that a payment due has been overlooked. However, 70% have experience which indicates that prompt insistence on payment when overdue yields the best results and does not unduly irritate clients.

Incisive comment by Sproull as to the experiences of English practitioners deserves careful consideration. He breaks down slow payments into two groups. The first he terms "regular slow payers who are time wasters and, in common with would-be price cutters, are not only the least profitable but generally the most unproductive as to remunerative, desirable, extra assignments or the introduction of new clients to the accountant." The second type he labels "casual slow payers." The reason for their delinquency is usually their defective control of their finances which makes them impecunious on occasions. As to them Sproull makes the apt professional observation that "they are often suitable

to benefit from budget installation work even if their businesses are small." ⁷

About 70% of firms reporting are opposed in principle to making adjustments to induce payment where collection is difficult or long-delayed. One reason for their attitude is that adjustment downward may create an impression of deliberate over-billing originally. The 30% considering it expedient to make some adjustment in appropriate cases feel probably that the specific nature of the reason for the difficulty or delay and the extent of adjustment required are highly relevant factors.

Few things are more repugnant to professional men than to have to enforce collection by resort to lawsuits against clients. Regrettably, this aversion is so well recognized that advantage is taken of it occasionally. However, less than 40% of the reporting firms have ever been compelled to take legal action. In the case of most of these firms, there has only been one such incident.

With only one exception, all firms reporting feel strongly that legal action should be taken only as a last resort and only in cases where the amount of the fee makes collection imperative. It is both interesting and significant to observe the close parallel between this attitude and the rule which the legal profession has formally adopted for its own guidance. This reads:

"Controversies with clients concerning compensation are to be avoided by the lawyer, so far as shall be compatible with his self-respect and with his right to receive reasonable recompense for his services; and lawsuits with clients should be resorted to only to prevent injustice, imposition or fraud." ⁸

As a practical matter, suing a client for an accountant's fee usually involves time and expense equal to a large part — half or more — of the amount billed. Most accountants find it less irritating to settle complaints on the client's terms and to terminate the relationship.

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Appendix A

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CHAPTER 13

PROFESSIONAL STANDARDS

PROFESSIONS

STANDARDS

ETHICS

HISTORY OF STANDARDS

AUDITING STANDARDS

General Standards (Training; Independence; and Care). Standards of Field Work (Planning and Supervision; Internal Control; and Evidential Matter). Standards of Reporting (Qualifications and Denials of Opinion; and Unqualified Reports).

NONAUDITING STANDARDS

INDIVIDUAL PRACTITIONERS AND SMALL ACCOUNTING FIRMS

Standards. Training. Independence. Care. Planning. Internal Control. Evidential Matter. Qualifications and Denials of Opinions. Non-auditing Standards.

APPENDIXES

Tentative Statement of Auditing Standards. Codification of Statements on Auditing Procedure.

CHAPTER 13

Professional Standards

BY EDWARD B. WILCOX

PROFESSIONS

Whenever anyone performs or offers to perform highly skilled and specialized services which are beyond the capacities of those who rely on him to judge or measure, he incurs an obligation which is professional in nature. In this sense, professional men are distinguished, not so much from amateurs who are not paid, as from merchants or laborers whose goods or services can be weighed or measured. This kind of professional obligation is a source of prestige to those on whom it rests, and it rests on them all the more heavily because of this. It is the obligation to render a truly sound and useful service in spite of the fact that the professional man could probably fail to do so without being caught at it. The doctrine of letting the buyer beware cannot apply to such service because the buyer must rely on the professional attainments and integrity of the person serving him rather than on readily measurable results. Quality of professional service can be maintained only by the practitioner, himself, not by his customer or client. It is in this sense that public accounting is a profession.

STANDARDS

Whenever such professional services are rendered, some standards of quality are present. This is true today, and it was equally true ten or fifty or a hundred years ago. It has been true since and was true before the dawn of history if such services were rendered then. These standards were not always written or printed or even acknowledged by name; they may have been high or low, adequate or inadequate, but they existed. They were the standards of skill, integrity and care of the professional practitioners. In the absence of any clearly stated and generally accepted standards, they necessarily varied greatly between different persons. They could not be very well known to those who relied on the professional services, and there could have been, and on occasion there has been, considerable misunderstanding as to what standards of quality could reasonably be expected in professional services. Nevertheless personal standards of professional work are as old as professional services.

This is not quite the same, however, as saying that the professions have had standards of quality. Professions consist of groups of prac-

tioners, and while each member of a group may set his own standard, the group, as such, may have none whatever. This distinction between individual standards, and those of a professional group, is an important one. While those persons who must rely on professional services may not be able to measure the quality of a single engagement or performance, they can, in the aggregate, observe the effective usefulness of the services of a professional group over a period of time. Since this observation is all that is readily and feasibly available to the public, it is what will be used, and all members of the profession will be judged by it. This is true particularly of public accounting because so much of its responsibility is to persons who are strangers to the individual accountants and who have had no hand in selecting them. Although it is unlikely, a man could select a doctor on the basis of personal confidence even though he had nothing but contempt for the medical profession in general. For some types of services an accountant could be so selected in spite of a lack of confidence in his colleagues. There would not be very much for public accountants to do under these circumstances, but there could be a little. Each man would have to build his own reputation from nothing, in the face of an initial handicap of identification with a despised group. But even this harshly restricted opportunity for service would be denied in the field of published opinions on financial statements because the usefulness of that field rests on widespread public confidence, not in individuals, but in the entire profession. Each member of that profession enjoys some of the prestige of the entire group, and no member of it is exempt from the penalties of failure by others. By its very nature, public accounting is an inevitably integrated profession on which the public is invited to rely, and it will stand or fall as public confidence in it is rewarded or betrayed. It is therefore incumbent on this profession to have standards which will insure a large measure of reward of confidence, and a minimum of failure.

Certain requirements and difficulties in the establishment of professional standards are obvious. These standards must be stated in some form so that all members of the profession and those who rely on it may know what they are. They must be widely applicable to many different persons with differing backgrounds doing different things, and they must be designed to lead to a uniformly high level of quality in performance by members of the profession. The difficulties seem almost insurmountable.

Quality, although of first importance, is intangible and cannot be attained merely by the promulgation of rules or pronouncements. The wide variety of circumstances encountered by public accountants sharply limits the applicability of almost any specific statement. Yet such vague generalities as the paradoxical, "be good and be careful," provide no standards at all. The answer must be sought in the painfully difficult process of seeking the optimum point between the horns of a dilemma. Since there must be statements of professional standards, they must be

in general terms so as to avoid senseless technicalities or loopholes for evasion such as can follow from an attempt at rigid definition. Yet they must be definite enough to provide a widespread understanding which can be the basis of uniformly useful professional work and responsibility. Such statements cannot be in the form of rules or statutes. They cannot say that, in all circumstances, this must be done and that must not. The nature of such statements must be descriptive, not compulsive, and observance of them can only follow from a free and comprehending desire to observe them. This desire, in turn, must follow from the realization that the prestige and the very professional existence of public accounting depend in large measure on widespread consistent performance at a uniformly high level of quality.

ETHICS

While this chapter does not deal with the subject of ethics, it is pertinent to note that the codes of ethics of the accounting profession are the earliest statements of professional standards to be found among accountants, and that they follow in some part the pattern described in the preceding paragraph. They are written and published so that all may know the ethics of the accounting profession. They represent an agreed code of behavior, not a pledge of abstract virtue, and in this they are susceptible of fairly widespread compliance and uniform observation. They describe areas of conduct which are to be observed or avoided, and these descriptions are, to varying degrees, sometimes broad and general, and sometimes specific. There is evident here the painfully difficult evolutionary quest for the optimum point between clear but rigid rules, and broad but vague generalities. True observation of the published code of professional ethics requires, not legalistic hairsplitting, but understanding of the nature of the described areas of behavior, and good faith in interpretation and observation. There is scant sympathy in professional circles for the man who deems himself safe because of a technical compliance when the spirit of his code has been violated. But basically the aim of a code of professional ethics is the adoption by an entire profession of a uniform standard of conduct. In this the ethics of the accounting profession constitute one of its professional standards.

HISTORY OF STANDARDS

Much of the history of accounting could be told in terms of recognition of the need for uniformity in quality of performance by the profession, and the efforts to attain it. In 1917 the American Institute of Accountants responded to a request by the Federal Trade Commission, resulting in the publication by the Federal Reserve Board of a pamphlet entitled, aptly enough, "Uniform Accounting; a Tentative Proposal

Submitted by the Federal Reserve Board.”¹ While this pamphlet and some subsequent revisions consisted primarily of lists of audit verification procedures, and is now considered inappropriate as a useful guide, it was an attempt to set a standard for the profession. In 1939 the committee on accounting procedure of the American Institute of Accountants referred in its first bulletin to the demand for a larger degree of uniformity in accounting which resulted from newer uses of the corporate system. The desired uniformity, the committee said, was that which “would require that different authorities, working independently on the same case, should reach the same conclusions.” This was set forth as an ideal toward which all would agree to strive, and has often been described as the objective of narrowing the areas of inconsistency in financial reporting.

In its letter of October 18, 1939, transmitting Extensions of Auditing Procedure² to the members of the Institute, the executive committee referred to the recommendations that certain procedures should be “considered as generally accepted practice.” In its early Regulation S-X the Securities and Exchange Commission referred to procedures “generally recognized as normal”, and more recently there has been substituted the requirement that “the accountant’s certificate shall state whether the audit was made in accordance with generally accepted auditing standards.” Modern corporate financial reporting reaches a large audience often far removed from management, and it is of primary necessity to its usefulness that there be the greatest possible consistency and uniformity in both verification and presentation. Accounting also reaches another large but different audience often close to management where similar standards of consistency and uniformity are equally necessary. The literature of the profession and the milestones of achievement mentioned previously, are evidence of the response to this need.

AUDITING STANDARDS

One of the greatest and most significant steps in this long process of collating and expressing standards of the accounting profession, was the issuance in 1947 by the committee on auditing procedure of its Statements on Auditing Standards. For several years accountants had been representing that their examinations were made in accordance with generally accepted auditing standards,³ but nowhere was there a statement of the standards which should be met to justify this representation. It has long been recognized that exactness and certainty are generally unattainable in accounting. Financial statements may “fairly present”, but, except in certain limited respects, they are not and by their nature cannot be exact. In verification of the basic facts underlying financial statements, even within the limits of their inherent inexactness, it is impossible to arrive at absolute certainty. Even the degree of certainty in audit verification

¹ See references at end of this chapter.

which might conceivably be attained in theory is not feasible in practice because the burden of its cost would be prohibitive. The extent and limits of audit verification must be set at an optimum point which will provide dependable assurance without excessive cost. This optimum point cannot be found, however, merely by doing so much and no more on a quantitative basis. It must be sought by qualitative selection and performance. This is the aim of auditing technique. However, without some description of auditing standards, individual judgments in the determination of the optimum point in verification will vary so widely that professional opinions on financial statements could mean almost anything or nothing.

The task of preparing the statement on auditing standards was difficult, not merely because of the inherent inexactness of the subject, but also because auditing standards deal with quality of performance. The acts performed are easier to describe. They are the procedures used in verification and reporting, but the quality of their application is intangible. It may be said as a rather fair generality that intangible qualities are more important than tangible quantities, but they are so much more difficult to describe and so impossible to measure that recourse is typically had to indicating the qualities indirectly by measuring the quantities. Thus competence of management may be the most important asset of a business, but it cannot be measured; so it is indicated by the relatively easier measurement of income. There is no comparably easy escape from the challenge of a statement of auditing standards, because the only sound evaluation of such standards is in the long-range social usefulness of public accounting. The committee's statement adopts the device of analyzing the standards it discusses, and making clear their component parts. These are discussed in terms appropriate to each, so that widely separated practitioners can more closely approximate comparable quality of performance. The expression so often used with respect to bulletins on accounting procedure, can be used more broadly here; the aim is to uphold standards and to narrow the areas of inconsistency in them. While this statement may disappoint those who yearn for the exactness of a rule, its very strength is in the fact that it does not purport to do more than it can. Recognizing this, the members of the American Institute of Accountants at their annual meeting in 1948 approved a resolution making it clear that when the phrase, "generally accepted auditing standards" is used in the opinion of an independent auditor, it shall be deemed to refer to the standards set forth in the statement issued by the committee.

The statement presents the subject of auditing standards under three main headings:

1. General standards
2. Standards of field work
3. Standards of reporting

General Standards

Each of these main headings has three divisions. Those under general standards are:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Training

The term "adequate technical training and proficiency as an auditor", does not tell how much is adequate, but it does set forth one component part of auditing standards. With attention directed to this, the area of training and proficiency which is adequate is not too difficult to find. One of the long-established standards of the accounting profession in the United States is found in the uniform CPA examinations provided by the American Institute of Accountants. These uniform examinations now are held either annually or semiannually in all forty-eight states, the District of Columbia, and four territories. They constitute a standard of recognition and, as such, a step toward the goal of uniformity. Coupled with them are state laws authorizing use of the CPA designation, and setting prerequisite educational and other requirements and placing limits on the qualifications of accountants before granting them the right to practice in the field of public accounting as a certified public accountant. These legislative requirements are not uniform today, but are in a state of evolution indicating that the trend is toward substantial college preparation and restrictions on the right to practice without such preparation and the attainment of the CPA certificate. Adequate technical training can scarcely be understood to mean less than this goal, and the practitioner who has not formally achieved it, but who nevertheless lays claim to observance of generally accepted auditing standards assumes the burden of establishing that his training is adequate.

Preliminary college training and the CPA designation are not, however, the end of education in accounting. There is no end. Accountancy is continually evolving in response to the constantly changing needs of the business world it serves, and the accountant whose education stopped ten years ago does not possess adequate technical training today. The standard of technical training is one that requires continual study and constant reading of current publications, bulletins, statements and releases by various governmental agencies concerned with accounting. The various state and national organizations of accountants provide a wealth of technical meetings and conferences, which assist in maintaining adequate technical training. For individual practitioners and principals in firms, this continuation of education must be a self-imposed task. For

staff employees it is one that is in part, at least, the responsibility of employers. It will be noted that the educational standard requires that a professional examination is to be performed by a person, or persons, having adequate technical training and proficiency as an auditor. This includes the employed staff of accountants, and the employer is charged with the duty of knowing that those to whom he entrusts work are adequately prepared. The standards to be met here combine supervision and review of the work of assistants, and more formal methods of staff training. Small organizations quite properly rely more heavily on education through supervision, whereas larger ones find staff meetings and training programs more appropriate to their needs. Committees of the American Institute of Accountants and the American Accounting Association have worked on the problem of increasing the amount and effectiveness of such training. Their work constitutes one standard of technical training and proficiency. But the responsibility does not even stop here. Every practicing accountant has a duty to know that, not only he and his employees, but also those with whom he is associated in practice or on whom he relies in any relationship are adequately prepared.

Every practical man knows that experience is the cream of education. It is only after experience has been added to formal training that the standard of proficiency necessary to full responsibility can be attained. It is a relatively easy matter for an employer to extend responsibility to members of his staff as their judgment has been ripened by experience. It is probably not too difficult to entrust varying degrees of responsibility in different fields according to the nature of the experience of the individual concerned. But it is sometimes quite difficult for a practitioner to limit himself because his training or experience has been limited. Yet this is an exercise in self-discipline which is clearly required by the standard of proficiency. In large firms with specialists in various lines, the problem is not apt to arise, but in the case of individual practitioners or small firms it is and does. Even if the practitioner has met high standards of general training and proficiency, and has developed a wealth of experience in his practice, he may have had no experience in certain fields such as for example, utilities, oil extraction, brokers, or SEC registrations. Competent as he may be in the areas of his experience he may not be sufficiently competent in some of those areas which lie outside it. In some such circumstances his general experience and training may enable him to compensate for specific inexperience by special preparation, but unless he can and does do this it would be no more proper for him to undertake such work than it would be if he had no training whatever. Unhappily, there are many cases on record where just this has been done, often in ignorant good faith, and the results are a discredit to the accounting profession and sometimes ruin to the practitioner. The standard of proficiency must be understood in part in a selective sense. It must be understood, not only as generally adequate

training and proficiency, but specifically as adequate training and proficiency for each engagement undertaken.

Independence

The second division of the general standards requires that in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. The words "independence in mental attitude" are significant. These words do not set any measure of a professional standard; they merely describe it and call attention to it. There can be no denying that independence is essentially a state of mind. Neither can it be denied that, since an independent state of mind is what really matters, independence will not be impaired no matter what the accountant does as long as such a state of mind is maintained. Because of this many people have felt that specific restrictions relating to the concept of independence are inappropriate, and that emphasis should be placed entirely on the mental attitude. The difficulty is that a state of mind is highly subjective, reflecting the variations of individual backgrounds and interpretations, and it provides no practical guide to standards of conduct. Yet our quest is for uniform standards.

Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily the representations of management. If the accountant were not independent of the management of his clients, his opinion would add nothing. Those who rely on the credibility he furnishes are apt to be creditors or investors, or sometimes employees, customers, or governmental agencies. It is for their assurance that the independent expert opinions are provided, and the accountant incurs a profoundly professional obligation to this unseen audience even though he does not know who they are. He must fulfill this obligation even when it means opposing and denying the wishes of those who have employed him, and who, he knows, may cease to do so. It is a requirement unparalleled in any other field. It places such demands on the integrity of the accountant that there are those who doubt that it is or can be achieved, yet the very prestige of the accounting profession today is evidence that it is achieved. The continued prestige and usefulness of accounting depends in large measure on its continued achievement. It is therefore primarily a matter of professional ethics, and we must turn to the ethics of the profession for a better understanding of the standard of independence.

Without going into the specific paragraphs in the Rules of Professional Conduct of the American Institute of Accountants,* which deal with the concept of independence, the point emerges that the rules are designed first to guard against an appearance or presumption by others that there

* Rules of Professional Conduct are reproduced in Appendix B of Chapter 5 of this Handbook.

has been a loss of independence by the accountant, and only secondarily to require conduct conducive to independence or at least not conducive to its absence. These rules provide specific standards of behavior which are at least indicative of independence. It is interesting to note that there is a close parallel to this approach in the rulings of the Securities and Exchange Commission. While the Commission requires that the accountant be "in fact, independent", thus essentially calling for an independent state of mind, it also lists, particularly in Accounting Series Releases Nos. 22 and 47,^{4,5} a number of situations in which the accountant will be presumed to be not independent. Clearly independence is recognized as a subjective immeasurable quality, but observance of overt indications of it are required standards. This conclusion is borne out by the following final paragraph of a statement on independence adopted by the council of the American Institute of Accountants at its spring meeting in 1947:

"Rules of conduct can only deal with objective standards and cannot assure independence. Independence is an attitude of mind much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and stature."

Specific problems in the application of the standard of independence most often arise in connection with financial interests in clients, too great dependence on one client, employee or quasi-employee relations with clients, or close family, social, or official relations with members of their organizations. The Rules of Professional Conduct of the American Institute of Accountants are clear with respect to financial interests. There can be no doubt that observance of the standard of independence precludes the accountant from being an investor in or creditor of his client. Of course the accountant inevitably has a financial interest in his client to the extent of his fee, and he is a creditor of his client until the fee is paid, but it is ordinarily assumed that the independent attitude of mind of the accountant will not be affected adversely by this fact. It is sometimes more difficult to support a presumption of independence if an individual practitioner or a small firm has one large client and not much else. In an extreme case an accounting firm might owe its very existence to one client. Even in such a case it is of course possible to maintain a truly independent state of mind, but the appearance of independence may not be so clearly evident, and this fact calls for especially vigilant observation of the standard of independence.

Close family relationships such as those in which the accountant is the father, son, husband, brother, cousin, or uncle of an officer, director, or even bookkeeper in a client's organization have been held by the Securities and Exchange Commission to disqualify the accountant as inde-

pendent. If the relatives concerned live under the same roof the situation is aggravated, and financial interests in a client, held by relatives of the accountant, would also cast doubt on his independence. Accounting Series Release No. 42⁶ by the Securities and Exchange Commission lists a number of cases in which accountants served as officers or directors of client corporations, and it was held that they could not be regarded as independent. In practice most accountants avoid such relationships or, if they exist, then the accountants do not complicate the situation by attempting to act as independent auditors. Some state societies have incorporated in their codes of ethics provisions covering these relationships, and the committee on professional ethics of the American Institute of Accountants has urged avoidance of them even in the absence of a rule covering the point.

Somewhat similar to this matter of relationships between the accountant and his client is the controversial question of the effect on independence of keeping a client's books or doing any important part of what would logically be the work of the client's internal organization. The Securities and Exchange Commission has taken the position that such service impairs independence. The soundness of this position rests on the fact that the public accountant is presumed to be furnishing an independent expert opinion on financial statements which are primarily the representations of his client. If those statements and the records underlying them are the work of the accountant, he would be furnishing an opinion regarding his own work. He would be passing judgment on decisions he has already made. He would be auditing himself, and the element of a check by one mind or group on another would be absent. This check is most effective in the cases of large companies having competent accounting personnel, and which do not ordinarily employ public accountants for their internal work. In general it would therefore seem that the larger the client firm, and the more bookkeeping the outside accountant does, the more he risks the presumption of lack of independence. It is an area which he should enter, if at all, with his eyes open to the especial need for careful maintenance of his independent state of mind.

The committees on auditing procedure and professional ethics of the American Institute of Accountants have considered the question and have reached the conclusion that, if an accountant is in fact independent, and if he has performed all the auditing procedures necessary to supplement the information he has obtained through keeping the books, he should be entitled to express any opinion he may have formed, and that disclosure of the fact that he has kept the books is not usually necessary. It is certainly true that most public accountants are consulted by their clients from time to time about important accounting decisions, and often year-end adjustments in the accounts are made after such consultations. It would seem to make little difference whose hand holds the pen when these adjustments are entered on the books. In some cases, certain

types of entries are deferred during the year and are made as a part of the annual examination. Sometimes accounting firms furnish an employee to help out during vacations or sickness in clients' offices; sometimes the accountants prepare monthly closing entries and post the ledgers; sometimes they actually keep the general books of clients in their own offices. Impressive arguments have been put forth to support the view that some or even all of these services do not impair independence and should not be so regarded. The accountant who does much of his client's work, knows more about the transactions and the records than one who does not. In small organizations where such services are most often required, there is little internal check and control, and the work of the outside accountant fills this need. When the public accountant does the book-keeping, it is apt to be done better than it would be by the type of book-keeper whom a small concern could afford to employ. When the records are kept in whole or in part by persons outside the client's organization, there is apt to be greater objectivity and less managerial whim or slant in making accounting decisions. And as long as such service is supplied to a number of small concerns it provides no incentive or temptation to surrender an independent attitude of mind. Both sides of this question can be supported with considerable force which is why it is controversial.

Care

The third division of the general standards says that due care is to be exercised in the performance of an examination and the preparation of the report. If an accountant possesses adequate technical training and proficiency and a genuinely independent attitude of mind, the remaining ingredient of the general standards is care. It is the antithesis of negligence, and that sire of negligence, laziness. The independent, trained and proficient accountant knows what to do and how to do it; care is the degree of application of this knowledge. As in all the designations of aspects of auditing standards, this one does not say how much constitutes "due care," and it would be a truism to substitute for "due" such words as reasonable, appropriate or adequate. Because the following quotation by a legal authority⁷ on the subject has become a classic, it merits repeating here:

"Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is prerequisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he

is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment."

On the negative side of care there is the avoidance of negligence and the kind of laziness that is satisfied with a task only partly done or performed by rote in a reverie more appropriate to an assembly bench than to an audit examination. On the positive side there are the requirements that each person engaged in an examination must be aware of the purpose of what he is doing, must understand and perform with mental alertness, inquisitiveness, and a sense of responsibility, even those tasks which may appear to be routine, and must respond diligently by further inquiries or examinations to circumstances indicating them to be necessary. The auditor should carry out his examination with an attitude of healthy skepticism which seeks corroboration of explanations offered for matters that have aroused questions in his mind, particularly when those explanations come from persons who could have personal reasons for diverting further inquiry. Care is required even when personal acquaintanceship with the client or its employees and their unquestioned reputation in the community for the highest standards of righteousness and probity, may appear to justify complete reliance on them. In such cases it is desirable to keep three facts in mind:

1. An independent examination is a check on representations of management however honest and competent that management may be, and reliance on managerial virtues is not a check.
2. Banks sometimes make character loans, but there is no such thing as a character audit.
3. Defalcations are nearly always perpetrated by old and trusted employees of good reputation.

Standards of Field Work

Under the main heading of standards of field work are the following divisions:

1. The work shall be planned adequately and assistants, if any, are to be supervised properly.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon, and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Planning and Supervision

In planning the work on an audit engagement it is highly desirable to start early in the year or other period to be covered. Consideration of this point will indicate the difficulties which will be encountered if early planning is not possible, as in a case where the accountant is engaged near

the end of, or even after, the period. It does not follow that such engagements should be rejected, although in extreme cases that may be the only course, unless a qualified opinion or a denial of opinion in the report will be acceptable. In any case, however, lack of early planning must be compensated by methods and precautions which could otherwise be avoided. It follows that one service which the public accountant can render to his client is to urge both his own early appointment, and his freedom of access to the personnel and records of the client during the year.

The advantages of early planning are twofold: first the audit procedures can be planned so as to be appropriate to the nature of the client's operations, methods and organization, and second, changes and improvements in the methods and organization can be suggested which will facilitate the audit procedures. An early review of methods of internal check and control will indicate the degree of reliance which can be placed on them, and therefore the extent and nature of appropriate auditing procedures. It also will afford an opportunity to suggest improvements in the internal methods with resultant modification of the audit program. In many cases arrangements can be made for the client's staff to prepare analyses or other detailed information which need only be checked by the auditors, thus saving their time for other more important work. Arrangements can be made for interim work during the year, thus avoiding the dangerous haste of post-closing work in the face of deadlines, facilitating early completion of the final work, and often affording opportunities for timely conferences on procedures or policies requiring correction. In some cases such as banks, building and loan associations and similar organizations handling considerable amounts of cash, the device of interim surprise counts can be used. In others, inventory verification can be facilitated. When reliance is to be placed entirely on an over-all count at the end of the year, the auditor can take part in planning the procedures and can assure himself of their adequacy. When there are good perpetual inventory records, counts can be made from time to time during the year, preferably when the quantities are low. Such counts are not only more accurate than when large quantities are involved, but they also take less time. When there are especially difficult counting or measuring problems, early arrangements can sometimes be made which will solve them. Statement on Auditing Procedure No. 16⁸ issued by the committee on auditing procedure of the American Institute of Accountants presents two such situations in which segregation of physical material would facilitate verification which might otherwise be impossible. The alert auditor will gain many advantages from early planning, and will avoid last-minute misunderstandings with his client which could seriously impair the value of his report.

Adequate planning of an engagement must consider materiality, relative risk, relative cost and value, and timing. Obviously immaterial items should not be stressed, and emphasis should be placed on those pro-

cedures which verify items of importance. Materiality and relative risk are, however, often opposite sides of the same coin. Thus inventories may be paramount as to materiality in financial statements, and cash, or at least currency, may be negligible. Yet the risk of inventory misstatement may be small and the risk of cash discrepancies great. These problems depend on individual circumstances and on the extent to which reliance may be placed on internal methods. It should be borne in mind in planning an engagement that intimate acquaintance with the client or its personnel is not the same as knowledge of internal methods, and neither materiality nor risk can be evaluated on the grounds of friendship. The cost of any auditing procedure should be considered in relation to its value. Where the cost is high, less costly methods should be sought either in the auditing procedures or in the methods of the client, but when the examination is to result in a professional opinion on financial statements, necessary procedures should never be omitted because of their cost. It is on this point that there is often thought to be a double standard of auditing—one for the client who will pay for it and one for the client who will not. The standard of planning for opinion reports admits of no such dual character. Timing may involve surprise visits or simultaneous verifications in cases of transferable cash, securities or merchandise. It may involve access to records when they are most useful such as customers' accounts or inventory records before subsequent postings. It necessarily involves the time interval between the availability of the records at the end of the year, and the date on which reports are required, and in this connection it involves the number of men assigned to the engagement. Too few men will take too long, but too many will fail to attain sufficient familiarity with the records and will fail to achieve essential co-ordination.

Supervision of assistants is in part related to the number of accountants assigned to the engagement. Assuming that there has been adequate staff training, a large force should consist of personnel of various grades so that supervision can be delegated. In smaller engagements this problem does not arise, but it is increasingly incumbent on the senior-in-charge to exercise close supervision over his assistants. The nature and extent of this supervision should be determined by his knowledge of their capacities. In the case of small firms of accountants or individual practitioners having only a few assistants, it is sometimes felt that the problem of supervision does not arise. In these cases, however, failure can occur if the junior is left to his own devices on an engagement which, even though small, embraces many of the problems encountered in larger ones. The standard of adequate supervision, like all standards, must be met at all levels and in all circumstances. The requirement embraces both the necessary contact between a head office and a branch in a large firm, and the contact between an individual practitioner and his assistants on two or three local engagements.

Internal Control

The second division of the standards of field work says that there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon, and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted. Chapter 16 of this Handbook deals with reliance upon internal control, and the subject matter of that chapter will not be repeated here. The following comments are not intended as either a supplement or substitute for the subject of reliance, but rather as an indication of the relationship of this reliance to the observance of this particular standard of auditing quality.

It is the duty of the auditor to use his best judgment in determining the scope of his examination in view of the methods of internal check and control, and to become familiar, not only with the prescribed methods, but also with their actual effectiveness in operation. Internal auditing, where it exists, may strengthen general internal control, but it cannot be accepted as a substitute for the work of the independent auditor. In giving weight to internal auditing it is particularly important to recognize the basic differences in emphasis on objectives which are apt to exist between the purposes of internal and independent auditors. The effectiveness of internal methods is generally determined by testing and sampling. It is recognized that, though sampling is less perfect and conclusive than complete detailed examination of all transactions, the degree of reliability of internal methods can be ascertained without prohibitive cost by the application of scientific auditing techniques to the sampling program. There is here involved one of those optimum points combining a maximum of satisfaction with a minimum of cost. To approach this optimum point, care is required to avoid tests of little value, and to concentrate on those of maximum usefulness. For example, little is accomplished by ascertaining that some securities present are recorded on the books, unless it also is strongly evidenced that all securities as shown by the books are actually on hand.

Evaluation of internal check and control in small organizations presents its own problems. It is not true that there is no internal check simply because the organization is small, and accounting department work cannot be spread among many people. Daily deposits of all receipts, imprest cash funds, signed payrolls, and other devices can furnish at least some of the elements. Much can be done by enlisting the co-operation of the proprietor in opening mail and listing receipts, in approving invoices for payment and cancelling them, and in frequent review of unpaid customers accounts, payrolls, and other matters of which, in a small organization, he will have considerable firsthand knowledge. The limitation on this checking by the proprietor is that while it helps to protect him it does not protect the auditor against him. Evaluation of possible methods in small concerns which justify some measure of reliance cannot be made by reference to standard works on the subject of internal control which

generally envisage fairly large accounting departments. This evaluation must be made by the accountant in each individual case by reference to underlying principles, and by the exercise of a considerable degree of ingenuity.

One more area of the evaluation of internal methods lies, peculiarly enough, in fairly good-sized concerns located in small communities. While there are many exceptions, there also are many cases of businesses that have grown up in small towns or rural areas without much basic change in the accounting methods with which they started years ago. Of course such situations afford an opportunity for service by the independent auditor in revision of procedures, but sometimes this service is not entirely welcome. The auditor then has no choice but to extend his procedures to compensate for the lack of internal control. This auditing standard requires either dependable internal methods justifying reliance, or extensions of procedures. There is no second-class standard which can be invoked because outmoded and costly habits are well intrenched and seem adequate to those accustomed to them.

Evidential Matter

The third division of the standards of field work states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination. This standard is met by compliance with the words "sufficient" and "competent." The words "evidential matter" are not to be taken as synonymous with legal evidence which is defined in relatively rigid rules but rather as that, whether or not admissible in a court of law, which the experience and judgment of the auditor justify him in accepting as valid for his purposes. It might be designated as "accounting evidence." Sufficient competent accounting evidence to afford a reasonable basis for an opinion by an adequately trained and proficient independent public accountant, in the light of his careful examination and review of internal methods, is the standard here described, and it is not too difficult to give it reasonably accurate dimensions. It depends for its basis on a grasp of the theory and practice of auditing techniques, study of which is a part of the adequate training of the accountant.

The Tentative Statement of Auditing Standards⁹ (reproduced as Appendix A of this chapter) describes two categories of evidential matter: internal and external. Internal evidence consists of books of account and records including collateral memoranda, journal entries, checks, vouchers, invoices, bank statements, contracts and minutes of board meetings. Historically these are the old familiar materials of auditing. External evidence embraces confirmations, inspection or observation and specific inquiries. Confirmation of bank balances, inspection of securities, and general inquiries, particularly as to the recording of all known lia-

bilities or commitments, also are relatively long-established techniques. They all constitute evidential matter, vital to a basis for a professional opinion on financial statements. If, for example, there are no books, there can scarcely be a reasonable basis for such an opinion.

On September 19, 1939, the members of the American Institute of Accountants approved Statement No. 1 by their committee on auditing procedure, which was entitled *Extensions of Auditing Procedure*. This statement established two new aspects of the standard of evidential matter. It said, in brief, that, whenever practicable and reasonable, it should be generally accepted auditing procedure to inspect inventories, and to confirm accounts receivable by communication with debtors.

Extensions of Auditing Procedure, the substance of which now appears on pages 16 to 23 of Appendix B of this chapter, should be prescribed reading for all practicing public accountants, and probably should be reread at frequent intervals. Attention is directed to two points of especial significance. The first relates to the timing of the inventory inspection and confirmation of receivables. Where there are good perpetual inventory records the physical check may be made by the independent auditor at a date other than that of the balance sheet on which he is to express an opinion. Such a verification is in the nature of a test of the credibility of the perpetual inventory records. It may be regarded as a test of the effectiveness of internal methods. However, in cases where the inventory at the balance-sheet date is determined solely by means of a physical count at that time, the auditor also should make his verification then. In the absence of perpetual records, a check of an inventory at any other date is apt to tell him nothing. Similarly, receivables may ordinarily be confirmed at dates other than the balance-sheet date because ordinary books of account provide what is in substance a perpetual record of customers accounts. These distinctions clearly reflect the relative competence of the evidential matter.

The second point refers to the words "practicable and reasonable." These words were believed by some to leave the door open to omission of the procedures, simply by deciding that they were not practicable and reasonable. Statement on Auditing Procedure No. 12,¹⁰ approved by the members of the Institute on October 1, 1942, therefore required that when the procedures were omitted, even though they were not practicable and reasonable and even though other procedures had been used, the omission must be mentioned in the accountant's report. This statement said:

"It has also become increasingly evident since the issuance of 'Extensions of Auditing Procedure' that relatively few cases exist in which the application of the normal procedures with respect to inventories and/or receivables is not practicable or reasonable, so that the considerations which gave rise to the original rule are in large measure inapplicable."

The requirement for disclosure of omitted procedures has since been incorporated in *Codification of Statements on Auditing Procedure*¹¹

(Appendix B of this chapter). The situation relating to opening inventories in a first audit is mentioned in the codification as an example of the absence of practicability and reasonableness. Others might occur with respect to a work-in-process inventory not susceptible of valuation by physical count or measure, or debtors with large balances who consistently refuse to respond to requests for confirmation. In these circumstances the independent accountant must decide whether or not he can satisfy himself by such appropriate methods as he can devise. Opening balances of any kind could only be checked by reference to records. In the case of closing balances of accounts the auditor might extend his investigation of underlying data by reference to orders, correspondence, shipping records and other similar matters, or he might engage in the heroic task of taking over the incoming mail and handling the remittances until the accounts in question have been cleared. In the case of the uncounted work-in-process inventory there is sometimes an opportunity for considerable ingenuity. Probably the best way in cases where records and circumstances permit, as in those of job-costs, is to make a subsequent check on completion of an order.

Even when normal procedures are practicable and reasonable it is possible for the auditor to satisfy himself by other procedures, but the Codification of Statements on Auditing Procedure warns that such situations are rare. It seems implicit that the auditor assumes a somewhat heavier burden of proof to justify reliance on other procedures when the normal ones are practicable and reasonable than when they are not. In any case it is fundamentally important to understand that, when normal procedures are practicable and reasonable, dependence on the kind of record checking which was customary before Extensions of Auditing Procedure was adopted, is not an adequate alternative. Certainly the permissible circumstances in which reliance may be placed on other procedures, whether or not the normal ones are practicable and reasonable, cannot be continually invoked to justify circumventing Extensions of Auditing Procedure. Nor is personal acquaintance with a proprietor or responsible officer of a client and his standing in the community even the smallest part of compliance with this standard.

In recent years increasing attention has been directed to the difficult area of responsibility which the independent accountant assumes for events which take place after the balance-sheet date. When he has knowledge of such an event which materially affects the financial condition or results of operations of his client, his duty to see that it is disclosed is clear. His duty to seek such knowledge and what constitutes competent evidential matter with respect to such events are not so clear. However, one of the sources of external evidence mentioned previously, is that of inquiry, and it is doubtful that the standard of competent evidential matter would be regarded as having been fully met if inquiries were not made as to the possibility of events after the balance-sheet date, the result of which

would make the subsequent financial condition or earning power materially different from that indicated by the financial statements.

Standards of Reporting

Qualifications and Denials of Opinion

There can be proper reporting by independent public accountants even though all auditing standards have not been met. In such cases it is of paramount importance that the deviations from prescribed standards be made entirely clear. Beyond this simple and incontrovertible statement, however, there has been considerable confusion and misunderstanding. Probably this is the result of the evolutionary nature of the considerations regarding this subject. A good deal has been written on it, but a minimum of source material reading for the student should include Statements on Auditing Procedure Nos. 1, 2,¹² 8,¹³ 11,¹⁴ 12, 13,¹⁵ 18,¹⁶ 23¹⁷ and 23¹⁸ (Revised), notes by Carman G. Blough, Director of Research of the American Institute of Accountants in his Auditing Practice Forum in *The Journal of Accountancy* of the March 1950 issue¹⁹ and of the April 1951 issue,²⁰ and Codification of Statements on Auditing Procedure (Appendix B) issued by the American Institute of Accountants in 1951.

The much-quoted paragraph from Extensions of Auditing Procedure says:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations in conformity with generally accepted accounting principles when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion."

Historically this paragraph may be regarded as the foundation of the present position. Materiality with respect to inventories was recognized in the words, "a concern in which inventories are a material factor", and with respect to receivables by the words, "where the aggregate amount of notes and accounts receivable represents a significant portion of the current assets or of the total assets of a concern." Originally, Extensions of Auditing Procedure permitted substitution of adequate alternative procedures regarding inventories and receivables to be unmentioned, but Statement No. 12 amended this part of the former one by requiring mention of such substitution of procedures in the accountant's report, although not necessarily qualification of his opinion. The wording of the previously quoted paragraph from the original statement seemed to imply that a qualified opinion might be proper with respect to departures from generally accepted accounting principles, but not when the examination had been less in scope than the accountant considered necessary. This

possible implication gave rise to submission of questions on specific cases to the committee on auditing procedure, which it dealt with in Statements on Auditing Procedure Nos. 2, 11 and 13. In No. 11 the committee expressed the opinion that the accountant might, in some circumstances, assume the responsibility for a qualified opinion, "although a particular and important auditing procedure in respect of a major portion of the assets may be omitted." This possible area of a permissible qualification with respect to omitted auditing procedures, seemed limited to cases in which there was "considerable evidence of a weighty character", but presumably less than what would constitute adequate alternative auditing procedure. It was never entirely clear.^{20,21}

With the issuance of Codification of Statements on Auditing Procedure in 1951 the doubtful area just described has been eliminated. On page 13 of Appendix B there is reference to the general case of all auditing procedures, and on page 16 to specific cases dealing with inventories and receivables. There can no longer be any middle ground of substandard auditing procedures justifying qualified opinions such as were permissible, however rarely, under Statement No. 11. Either you are satisfied or you are not. If you are not, there can be a qualified opinion to the extent that the affected item may be important but not sufficiently material to preclude an opinion. A qualified opinion now is permissible because of the limited materiality of an item not fully verified, but not for the purpose of disclosing that the auditor is unsatisfied with respect to a material item.

In cases where no opinion could be expressed, Extensions of Auditing Procedure tacitly permitted silence in the accountant's report although it suggested that he might, if appropriate, give his reasons for omitting the expression of opinion. Statement on Auditing Procedure No. 23 as amended and adopted by the members of the American Institute of Accountants in November 1949 rescinded this tacit permission of silence and required a positive disclaimer of opinion. The previously quoted paragraph from Extensions of Auditing Procedure now is amended, extended and repeated in Codification of Statements on Auditing Procedure, as follows:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

Whenever the accountant permits his name to be associated with financial statements, he should determine whether, in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit*, appearing prominently on each page of the financial statements is considered sufficient.

It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these matters as they affect the significance of his examination and the fairness of the financial statements."

The misunderstanding which this extended revision was intended to cure was the belief held by many that Statement No. 23 limited the permissible area of qualified opinions. It did not. It referred only to the required disclaimer of opinion when, under other existing pronouncements, no opinion could be furnished. Further confusion may now exist with respect to the relationship of this statement and its predecessors by the Institute's committee on auditing procedure, to the Tentative Statement of Auditing Standards. Extensions of Auditing Procedure was issued before adoption of the term, "auditing standards", and the subsequent numbered statements on auditing procedure which amended or interpreted it, did not adopt the new term. Translated into terms of auditing standards the present position of the profession with respect to qualifications and disclaimers in reports in which the accountant permits his name to be associated with financial statements, may be summarized briefly as follows:

1. The accountant may furnish an unqualified opinion (clean certificate) if all auditing standards have been met. Auditing standards refer to both generally accepted accounting principles and adequate disclosure in the preparation of the financial statements, and the application of adequate techniques in their verification. Informatory disclosures may be included in the accountant's report without qualifying his opinion. Auditing standards will have been met and an unqualified opinion should be **given in those rare**

cases where inventories and receivables have been checked by adequate alternative auditing procedures, although disclosure of the omitted procedures must be made in the report. An unqualified opinion also may be furnished even though the auditor is not satisfied with regard to an item if it is not important enough to deserve mention, or if departures from generally accepted accounting principles are unimportant.

2. The accountant may furnish a qualified opinion if all auditing standards have been met except for deviations from generally accepted accounting principles, if these deviations, though important enough to deserve mention, are not great enough to negative his opinion, and he also may furnish a qualified opinion regarding an item with respect to which he is not satisfied, if it is important enough to deserve mention, but not sufficiently material to preclude an expression of opinion. There is nowhere any authoritative justification for a qualified opinion on the grounds of lack of satisfaction by the auditor with respect to a material item, even in cases where normal auditing procedures are not practicable and reasonable.
3. The accountant must affirmatively disclaim an opinion if auditing standards have not been met, and the deviations from generally accepted accounting principles or the materiality of items with respect to which he is not satisfied, are great enough to negative the opinion or preclude the expression of it. However, if financial statements are presented without comment by the accountant, a warning such as, *Prepared from the Books Without Audit*, appearing prominently on each page of the financial statements is considered sufficient.

Although not in itself an auditing standard, the affirmative disclaimer of opinion is one of the presently established standards of the profession. Experience in compliance with it has demonstrated that, even in the face of opposition by clients, it has been helpful in building prestige and in extending professional practices. This has been true in both large and small practices and with both large and small clients. Whatever one's personal experience may be, however, there is no more justification here than elsewhere for a double standard in quality of reporting.

Unqualified Reports

Under the main heading of standards of reporting when an unqualified opinion is to be furnished, are the following divisions:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

Accounting Principles

The subject of accounting principles is presented in Chapter 17 of this Handbook, and it would be repetitious to discuss them in detail here. In determining whether financial statements are presented in accordance

with them, the accountant must exercise judgment in the light of wide knowledge and understanding of the subject. There is no check list of generally accepted accounting principles, any more than there is a check list of auditing procedures. Usefulness is no doubt the underlying principle of accounting, and there is clearly a duty on the public accountant to determine if the statements before him are as useful as they can reasonably be made for the purposes for which they may ordinarily be expected to be used. Usefulness, however, like due care or an independent state of mind, is too general an objective to constitute a guide to conduct leading to any uniformity in standards of the profession.

Knowledge and understanding of generally accepted accounting principles must be sought in textbooks and periodicals, in the current practices of financial reporting, in the rulings and decisions of governmental agencies having jurisdiction over accounting matters, and in the studies of professional societies such as the bulletins issued by the committee on accounting procedure of the American Institute of Accountants. In all this material no clear line is drawn between principles and procedures, and it is doubtful that any such distinction should be attempted since it would have neither practical nor theoretical significance. In the literature of accounting and particularly in the bulletins on accounting procedure, certain postulates may be discerned which are, on one level, currently accepted accounting principles. Among them, for example, are the cost principle, the realization principle, the monetary principle and the going concern principle. The experienced accountant recognizes them as being in the background of his thinking and understanding even though they are not anywhere set forth in black type as rigid rules. On another level there are principles which are in the nature of procedures. Some of these present acceptable alternatives and some may be in mutual conflict. They include aspects of accounting such as inventory pricing, or classification of current assets and liabilities, or the preference for the all-inclusive income concept coupled with the possibility of exceptions, and the definite exclusion of provisions for contingency reserves.

When the independent public accountant expresses the opinion that financial statements are in accordance with generally accepted accounting principles, he refers to this entire body of material at all of its various levels.

At the more basic and fundamental levels there can be little doubt as to what is generally accepted. At the levels which involve interpretation and application in regard to specific matters of accounting presentation, there is room for greater divergency of practice. It is with the objective of narrowing these areas of difference and inconsistency that the bulletins of the Institute's committee on accounting procedure have been issued, and it is at this level that the accountant's opinion is most apt to be judged and questioned. These bulletins rest for their authority on general acceptance of the opinions they express, and while it is recognized that these opinions may be subject to exceptions, there is a presumption that de-

parting from them imposes on those who do so a burden of justification of that departure. This does not mean that there may be absolutely no diversity of practice or that application of principles or recommended procedures may not be different in varying circumstances. These are some of the areas of judgment which cannot be defined rigidly, but it should be understood clearly that the areas in which judgment may be exercised are not without limits.

In considering the bulletins of the Institute's committee on accounting procedure, it should be understood that they have been intended primarily as applicable to business enterprises of a type organized for profit. While in many respects they may be applicable to various nonprofit and governmental organizations, that applicability is incidental to their purpose. Some of them, such as those dealing with income determination, may not apply at all, and there are some basic problems of financial reporting by nonprofit organizations, such as fund accounting, which have not been considered in the committee bulletins. In many aspects of municipal and nonprofit accounting the cash basis of reporting is commonly used and may be the most appropriate method, but it is clearly not in accordance with the thinking behind these bulletins nor is it generally appropriate to problems of income determination. In these circumstances the question arises as to the propriety of the term "in accordance with generally accepted accounting principles", in connection with nonprofit organizations. In some cases such as colleges and universities, there are rather authoritatively established principles and procedures which it might seem could be referred to as generally accepted for such institutions. However, the term generally accepted has a strong connotation of relationship to the applications of principles as set forth by the committee on accounting procedure, and therefore to business enterprises organized for profit. For this reason the standard of reporting under discussion will probably be better observed by limiting the use of the term "generally accepted accounting principles", to the financial statements of business enterprises, at least until subsequent developments more clearly establish its use in other connections.

Consistency

Understanding of the standard of consistency may be facilitated by recalling that, historically, there has been a shift of emphasis from conservatism to consistency. At one time conservatism was regarded as a great virtue in accounting, and it still has validity in that the recording of profits generally awaits realization in some form whereas provision is made for certain reasonably foreseeable losses and costs which are related to the period covered, even though they may not be finally determined. The fault with conservatism as a goal was two-fold. It was extended too easily to the length of understatement, and understatement in a balance sheet could result easily in overstatement of subsequent income. The cure for

these faults was found in the increased emphasis on consistency, and the optimum point to be sought is that which results in the greatest uniformity and comparability between statements of successive years tempered by caution in the avoidance of overstatement at any point in representations as to either income or financial position.

This standard is not violated when altered conditions are reflected in proper accounting treatment. For example, a change in depreciation rates reflecting increased use or a change in estimated useful life of depreciable assets is not inconsistent with prior years. Neither is deferment of substantial charges to future periods inconsistent with a previous practice of charging off items of similar nature in current years when the amounts were not significant. On the other hand, a decision to change from FIFO to LIFO in the valuation of inventories which are significant in amount would involve an inconsistency. In general, the type of inconsistency between years which requires disclosure in the accountant's report, relates to a decision to change from one acceptable practice to another when the amounts involved are significant, and the change is not required by altered conditions.

Disclosures

Disclosures which may be required if all auditing standards have not been met or if other than normal procedures have been employed in respect to inventories or receivables, belong in the report of the accountant. Those which are necessary as an attribute to fairness of presentation belong in the financial statements, but if they are not there they may be included in the accountant's report. Fairness of presentation is a matter of judgment requiring insight into the conclusions the reader of the report may be presumed to make. Ordinarily the bases of inventory and fixed asset valuations, contingent liabilities, unpaid dividends on preferred stock, contracts, commitments, restrictions on dividends, principles of consolidation, explanations of extraordinary items, and significant events after the balance sheet date, are among the disclosures which should be included either in the body of financial statements or in footnotes. Usefulness requires as much brevity as is consistent with full disclosure since significant information buried in a mass of verbosity is seldom appreciated or understood. Sometimes questions arise as to the disclosure of confidential information which might do great harm to the company, or with respect to disclosures which might alarm readers unduly and so be more harmful or misleading than silence. There are such cases where disclosure should not be made but they do not occur frequently and the accountant must be wary of omitting important information on these grounds unless he is sure that the grounds are valid. On the other hand it is fundamental that mere disclosure does not cure improper presentation in financial statements. The standard of reporting is not met if statements are wrong, merely by pointing out that they are wrong.

NONAUDITING STANDARDS

The foregoing discussion of auditing standards has been made possible by the description of these standards by the committee on auditing procedure of the American Institute of Accountants. This description constitutes a standard for the profession as a whole, and its statement was a prodigious task. No comparable statement has been prepared relating to other services rendered by public accountants which do not lead to the expression of opinions on financial statements, but which are nevertheless professional in character. In the absence of such a formal statement, there are sure to be variations in the quality of these services, as they are furnished by different individuals. In this area as well as in the area covered by auditing standards, it is clearly in the interests of both the profession and those who employ it that these variations in quality be minimized. Without the guide of established standards, even an approach to uniform quality of service by separate and widely scattered individuals is difficult. There is here a challenge to the capacities and comprehension of professional public accountants. The degree of uniformity in the quality of these services which they may achieve indicates a measure of their response to realization of their interdependence, and the extent to which public accounting has become a united profession.

Those services other than auditing which are typically performed by public accountants are in the fields of income taxation, system installation and review, special investigations, arbitration, expert testimony, technical assistance and business advice. A brief review of these services shows strikingly how universal are the descriptions of the standards prescribed for auditing. To varying degrees these standards can be applied to non-auditing accounting services, and all may apply at some times. Certainly it is not necessary to go beyond them, or to invoke fundamentally new standards, to describe a high level of quality in the entire field of activity broadly recognized as professional public accounting.

Income tax service requires special training and proficiency. There is probably as much bad tax advice loose in the country as in any field, anywhere. While the knowledge, skill and training of the experienced public accountant undoubtedly endow him with a considerable degree of competence in this field, some of its aspects are so demanding as to require specialization by the practitioner. Here is an example of the selective sense in which the standard of proficiency must be understood. Tax work, even though it involves advocacy of a client's cause, also necessitates a degree of independent integrity. Dishonest tax practice is a disservice to the client, a road to ruin for the practitioner, and a disgrace to his profession. Application of the standard of due care to tax practice is obvious, and the standard of informative disclosure is a consequence of independent integrity.

System installation and review may in many cases relate to and actually

follow from the auditing standard of field work which requires a proper study and evaluation of internal methods. The same standard of training and proficiency applicable to auditing will apply to this kind of service. There are, however, other kinds of system installation for management purposes which are closer to the field of management engineering than internal check and control. The technical training and proficiency of the accountant are often invaluable in this work, but there are aspects of it in which he may or may not be competent. There is, therefore, an especial application of the standard of proficiency when this work is undertaken. Similarly, there are unique examples of the need for care, planning, and training and supervision of assistants. There is a need sometimes for independence where there are conflicts in the management of a client over the type of system to be designed or the results which it is hoped will be produced.

Special investigations have, of course, a wide variety of purposes, but it can be stated as a fair generality that the purposes are different from those requiring an opinion on financial statements. Many relate to fraud or defalcations. These and other special cases require specific proficiency and experience, planning, staff training and supervision. They lead to actions or decisions by those who rely on them, and should not be undertaken by accountants, however generally able they may be, who are not familiar with the techniques of the particular kind of investigation to be made. They require care in guarding against preconceived notions as to the findings, whether those notions are held by the accountant or his client.

Arbitration and expert testimony have in common the paramount demand for a high degree of independence. Basically this high ethical requirement for honest independence is a familiar one, but it is essential to quality of performance that it be recognized and observed even when presented in an unfamiliar situation. Both arbitration and expert testimony call for technical training and proficiency, care, planning, careful and complete study of the problem, and sufficient evidential matter to support statements of fact and conclusions drawn from them. These standards have an especial significance in view of arguments and cross examination which, in the absence of careful study and complete competence, could destroy the usefulness of otherwise sound and independent service.

Technical assistance and business advice cover a wide variety of services ranging from bookkeeping to top level conferences on business management. In all cases from the simplest to the most difficult it should be remembered that the client is calling in an expert who holds himself out as skilled and proficient in the required services. It is this fact which makes all accounting services professional in nature, and which brings in the standard of adequate technical training and proficiency. As in some other types of service this standard as applied here, requires that the accountant not attempt to perform services outside his competence. In general he

must avoid giving advice unless he conscientiously believes himself qualified to do so, and specifically he must avoid advising in such fields as law or engineering for which his training has not fitted him.

Professional standards in whatever field of activity become standards of the profession when there is widespread and uniform recognition and observance of them. Each member of the profession serves his clients well in proportion as his work exemplifies the standards of quality of his group. The prestige of the professional group grows in proportion as its members are representative of its standards. And as the prestige of the profession grows, so does that of each of its members, and so does his social usefulness and his opportunities for service, profit, and pride in himself and his calling.

INDIVIDUAL PRACTITIONERS AND SMALL ACCOUNTING FIRMS

In the foregoing discussion of professional standards there has been mention at various points of their relationship to the particular situation of individual practitioners and small accounting firms. These references are recapitulated under the headings of the sections in which they occur as follows:

Standards

Each practitioner, regardless of the special circumstances of his practice, enjoys the interdependent prestige of the entire profession to which he also contributes. Uniform standards of practice enhance the prestige of each practitioner.

Training

Attainment of the CPA certificate is a standard of recognition, but there is an obligation to continued self-education, and to avoidance of undertakings beyond the competence or experience of any individual.

Independence

Close personal or other relationships and a practice which may depend primarily on one large client are the threats to independence which are especially encountered by the individual practitioner or small firm.

Care

Reliance on intimate personal acquaintance is not a substitute for professional care.

Supervision

Supervision of junior assistants falls directly on the individual practitioner if there are no senior accountants to do it.

Internal Control

While some internal control is possible and should be recognized in small concerns, its evaluation generally calls for special study rather than application of general rules. Lax internal methods cannot be accepted in lieu of better ones because of either personal acquaintance with clients or because of habits prevalent in small communities. This situation provides an opportunity for additional professional services.

Evidential Matter

Inadequate records, particularly the absence of orderly accounting records, may mean that sufficient evidential matter is unobtainable. Failure to obtain sufficient competent accounting evidence cannot be justified on grounds of local conditions.

Qualifications and Denials of Opinions

When denials of opinion are in order they are required as clearly in the case of small concerns or small firms as elsewhere. Experience has demonstrated that adherence to this standard tends to build rather than diminish, practices.

Nonauditing Standards

Typically, the individual practitioner and the small firm are largely engaged with areas of accounting services other than auditing. In these areas, uniform high standards, closely comparable to auditing standards, will enhance the interdependent prestige of the members of the profession and hence of the profession itself.

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* These statements are covered in the Codification of Statements on Auditing Procedure (Appendix B of this chapter).

Appendix A

**TENTATIVE STATEMENT
OF
AUDITING STANDARDS

THEIR GENERALLY ACCEPTED
SIGNIFICANCE AND SCOPE**

1947



**Special Report by the
Committee on Auditing Procedure**



AMERICAN INSTITUTE OF ACCOUNTANTS

OUTLINE OF APPENDIX A

GENERAL STANDARDS

Training and Proficiency of the Auditor; Independence in His Mental Attitude and Approach; Due Care in the Performance of His Work.

STANDARDS OF FIELD WORK

Adequacy of Preparatory Planning; Proper Evaluation of the Examinee's Existing Internal Control for Reliance Thereon by the Auditor; Competence of Evidential Matter.

STANDARDS OF REPORTING

Adherence to Generally Accepted Accounting Principles; Observance of Consistency in their Application; Adequacy of Informative Disclosures.

REVISION OF FORM OF ACCOUNTANT'S REPORT OR CERTIFICATE

Committee on Auditing Procedure (1946-1947)

Paul Grady, <i>Chairman</i>	Edward A. Kracke	Cyril Talbot
William D. Cranstoun	Lewis Lilly	W. C. Waggoner
David B. Galloway	John A. Lindquist	Karl R. Zimmerman
Ralph H. Galpin	Ira B. McGladrey	_____
Alvin R. Jennings	Harold A. Mock	Carman G. Blough,
C. Alvin Koch	J. S. Seidman	<i>Director of Research</i>

Appendix A

TENTATIVE STATEMENT OF AUDITING STANDARDS

THEIR GENERALLY ACCEPTED SIGNIFICANCE AND SCOPE

Introduction

Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. *Auditing standards* as thus distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon. In accordance with this line of demarcation, the present pronouncement concerns itself with auditing procedures only to the extent of incidental reference thereto in connection with the discussion of the considerations of their use and the degree of such use.

Statement on Auditing Procedure No. 6 sets forth the views of the Securities and Exchange Commission concerning auditing standards; since it was upon the Commission's initiative that the representation as to standards was introduced into the accountant's report or certificate, the views of that body, as expressed in its pertinent release as well as in its discussions with the Institute's committee on auditing procedure, naturally are of guidance in the discussion of the subject:

First — as to the fact that standards and procedures are not the same — Statement No. 6 says:

"A distinction was drawn by the Commission in its discussions with the committee between auditing standards and auditing procedures. . . . The committee believes this distinction between standards and procedures has not been drawn with sufficient clarity in accounting literature and should be emphasized more than it is."

As to procedures, Statement No. 6, quoting from the SEC Release, states that, "in referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example the various accounting societies and governmental bodies having jurisdiction."

Editor's Note: The "Historical Preface" which is the first section of the booklet, has not been included. The remaining portions of the "Tentative Statement" are reproduced here in full.

Second — as to the fact that in their nature auditing standards are essentially of *two* kinds:

(1) Statement No. 6, quoting from the pertinent SEC Release, states that:

“In referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, *their application with professional competence by properly trained persons.*”

(2) Indirectly quoting the Commission (“in its discussions with the committee”), Statement No. 6 states:

“Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures . . .”

In accordance with this dual-nature concept of auditing standards, the committee on auditing procedure has adopted an over-all twofold classification as follows:

Group I. Personal or General Standards: governing both field work and the reporting thereon — reflecting the standards which require that the “generally recognized normal auditing procedures” be applied with “**professional competence by properly trained persons.**”

Group II. Standards for Field Work: (a) the conduct of the field work, and (b) the reporting thereon — reflecting those “**auditing standards (which) may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures.**”

The standards of Group I are personal in their nature; they concern the measure of the individual auditor's performance. Those of Group II are procedural; they relate to the broad objectives to be attained in the employment of the procedures undertaken. The first relate to the auditor's professional qualities, the second to his judgment exercise in the conduct of his examination and in his reporting thereon.

In accordance with this compendium, the committee presents the results of its deliberations upon the subject of auditing standards under the following designations for such standards:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

GENERAL STANDARDS

These relate to the qualifications of the auditor and the quality of his work as distinct from those other standards which relate to the broad objectives for attainment in the procedures he employs in his field work and in his reporting thereon. These personal, or general, standards—which naturally apply alike to the areas of the field work and the reporting thereon—concern the indispensable conditions for the satisfactory attainment of such other standards. As presented herewith, they are:

1. Training and proficiency of the auditor.
2. Independence in his mental attitude and approach.
3. Due care in the performance of his work.

The order in which these standards are here given does not purport in any way to reflect any idea of relative importance, but merely their natural sequence. To begin with, all that is said about observing certain standards in the employment of auditing procedures naturally concerns such procedures as they are employed by properly trained and experienced auditors; however capable a man may be in the other activities of business, he cannot satisfactorily meet the requirements of auditing standards without the equipment of training and experience in the field of auditing. The next test the auditor must undergo is that of independence; aside from being in professional practice (as distinct from being in industrial employment) he must be without bias with respect to the particular concern under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. But it is not enough for the auditor to be technically proficient and independent as well; he may be both of these, as to the undertaking at hand, and yet be lacking in due care in the performance of his work, which may even be judged the graver when chargeable against one of high qualification otherwise.

Training and Proficiency of the Auditor

Statement No. 1 of the Statements on Auditing Procedure sets forth:

"In the performance of his duties as auditor, the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure." *

The process of attaining that proficiency, which has been likened to the process of erecting a building, begins with the laying of a strong substructure of adequate technical training to provide support for the superstructure of subsequent experience. Being a professional man, the auditor must undergo a training of proportions adequate to the requirements of being a professional man, which means that his training must be adequate in technical scope and must include also an adequate measure of general education.

The laws of our various states, beginning with New York in 1896, have provided for the designation as "certified public accountants" of those individuals who have qualified under state regulations in point of education, training, and experience adequate to perform the function of auditing financial statements and their underlying records as expert or certified public accountants. In addition to these, certain of the states have likewise licensed other accountants thus to practice as public accountants; while not meeting the titular requirements of the certified public accountant, the registered or licensed public accountant (or unregistered accountants in those other states where there is no restriction on practice) in the conduct of practice as an auditor cannot claim any lower level of standard observance, without impairment of his right to hold himself out as a fully competent auditor. The business welfare of the public cannot tolerate a two-level status with respect to auditing standards any more than its hygienic welfare can tolerate a dual degree of medical service. Whatever the reasons that may operate to preclude a *public accountant* from achieving the titular recognition of the *certified public accountant*, he must expect to have his accomplishments subjected to critical judgment to make certain that they at least reach the level of common standards.

* Statement No. 1 says further of the certified public accountant: "In order to qualify himself to carry out his function, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice, he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements."

This is a matter of growing importance with the increasing number of states enacting accountancy regulatory legislation of the so-called two-class type. While there may be many persons who will be permitted to continue to practice as public accountants who will not be able to meet academic requirements for becoming a certified public accountant, a heavy duty rests on the authoritative bodies passing upon applications for registration to screen out those with merely a claim to a constitutional right without a professional justification to that claim. The fact that a man in his mature years may find the difficulty of acquiring a certain academic rating so great as to be virtually an impossibility is no excuse for inability to measure up to fair practical tests of the technical ability he has developed from his training and experience as an auditor. Individual rights do not transcend public welfare.

The question may be raised of how the young man just entering upon an auditing career as a junior assistant may measure up to the requisite of experience for professional competence. The answer to the question is, of course, proper supervision and review of the assistant's work by his experienced superior. Experience being definitely a relative matter, the nature and extent of supervision and review must necessarily reflect wide variances in practice which understandably cannot be the subject of rule-formation. Here the accountant charged with final responsibility for the engagement must exercise a ripened judgment in the varying degrees of his review of the work done and judgment exercised by those under him, who in turn must meet the varying degrees of their own responsibility attaching to the varying gradations and functions of their work.

What has just been said about experience applies, of course, equally to the accountant's education and the training received therewith. One may well be a complement of the other, and the principal exercising final authority upon any engagement naturally weighs these attributes conjointly in determining the extent of his supervision and review. The high quality of educational training with which our outstanding schools of higher education today equip their students makes for a greatly increased capacity and acceleration of experience acquisition.

The utterance of the professional auditor upon the completion of his work — variously termed "report," "opinion," or "certificate" — is the expression of his professional opinion as that of one rightfully entitled to express such opinion. In no sense is it a guarantee; the limitations of his functioning completely preclude the responsibility of the guarantor.

Moreover, the following considerations are definitely to be borne in mind in order that there shall be no misunderstanding of his function:

1. The examination or audit made by the accountant is not to be regarded as necessarily a process of specific or identic verification, or independent determination of the amounts shown in the financial statements. It is not uncom-

mon for the auditor to carry out at an interim date important phases of the examination of inventories, accounts receivable and other accounts. In such interim examination the auditor seeks to assure himself of the right of professional reliance upon the system of records and representations by management of the examinee company (or partnership, or individual) and is guided thereby in his selection of procedures as of the balance-sheet date.

2. In undertaking to observe "generally accepted auditing standards" the auditor must carefully exercise his informed judgment as a qualified professional man; but this in nowise implies — nor could it possibly imply — an infallibility of the judgment thus exercised. Conditions of an unusual nature (as, for example, in cases of collusion) may subsequently indicate error in the judgment taken but this does not necessarily reflect upon the quality of his performance, since his findings are not of the nature of a guarantee.
3. The auditor is in no sense a valuer or appraiser of goods or properties or an expert in materials or commodities, although as a part of his work he may be concerned with adjustments to, or the disclosure of, fair values *as determined by others*. Thus he may concern himself with market values — determined by others — in the case of securities and goods in connection with the amounts represented to reflect current assets. Moreover, he may prepare financial data required by others — appraisers, courts, and so forth — as a basis for their valuation judgment in the case of properties and enterprises; but aside from any such participating service, he exercises no overriding judgment as an auditor as to the valuation judgment of either directors or others charged with appraising functions insofar as long-term (or so-called permanent) investments or fixed assets, tangible or intangible, are concerned.

When he *does* undertake anything in the nature of passing judgment on the valuations of others competent to make them, or even of actually determining upon valuations himself (where, for example, he may serve as an executor) he does so, not as an auditor but — stepping out of the role of the professional accountant as such — as a businessman who is additionally qualified by reason of his accounting knowledge and experience. Thus, in such a capacity as that of executor, having \$1,000 to invest, he may exercise discriminatory judgment by preferring to buy 100 shares of A stock at \$10 to 100 shares of B stock likewise selling at \$10; and in such exercise of valuation judgment he may well be guided by his accounting knowledge.

But in his work *as an auditor*, he accepts the determination of value as made by others technically or legally competent to make them without applying corrective adjustments such as courts may deem proper in the exercise of their prerogatives. This does not, however, imply any surrender on his part of his right of judgment exercise where conflicting bases of valuation may be involved. Thus, while he may accept quoted values for securities included in current assets (or otherwise held as temporary investments only) as reflecting the authentic "voice of the market place" (though not necessarily sharing personally the temporarily prevailing optimism or pessimism of that market place) he may well decide against effectuating in the stated accounts, over any long period, value criteria of such transitoriness where fixed assets or comparable long-term investments are concerned.

Independence in the Auditor's Mental Attitude and Approach

There is probably no concept relating to the professional auditor that is today in greater need of elucidation than that of his "independence" as that term is widely used. In the profession's early days, "hanging out his own shingle" sufficed for an outward mark of independence, while the literature of his profession taught the simple virtue of complete intellectual honesty as its essence. But progress brought problems, and one of them in the auditor's realm was how the attribute of complete intellectual honesty might be recognized as something additional to the fact of his being engaged in professional public practice. So there arose a quest for signs — signs by which any lack of independence might be recognized.

As a code of its ethics, the profession has gradually compiled, through the American Institute of Accountants' Rules of Professional Conduct * and the similar pronouncements of its state bodies, precepts and conditions to guard against the *presumption* of loss of independence. "Presumption" is stressed because insofar as intrinsic independence is synonymous with mental integrity, its possession is a matter of personal quality rather than of rules that formulate certain objective tests. Over the long years lawyers have developed the expression of "presumptions of law," of which the dictionary, styling them "inferences," says that they "are *sometimes* conclusive, *more frequently* they are rebuttable." Nevertheless, insofar as such presumptions have been enacted as stipulations in the profession's code of ethics, they have the force of professional law for the auditor. Without excluding the bearing of other rules of the Institute upon the subject, those particularly concerned with the matter of the accountant's independence are in order of importance, as follows:

- Rule 5. On false or misleading statements
- Rule 9. On contingent fees
- Rule 13. On financial interest in a client's business
- Rule 3. On commissions and brokerage
- Rule 4. On occupations incompatible with public accounting

Rule 5 is reproduced hereinafter in full in connection with the discussion of "standards of reporting."

Independence in the last analysis bespeaks an honest disinterestedness on the part of the auditor in the formulation and expression of his opinion, which means unbiased judgment and objective consideration of facts as the determinants of that opinion. It implies not the attitude of a prosecutor but a judicial impartiality that recognizes an obligation on his part for a fair presentation of facts which he owes not only to

* In lieu of a detailed discussion of the various conditions and considerations affecting the auditor's independence as set forth in the Institute's Rules of Professional Conduct, specific reference is herewith made to the publication *Professional Ethics of Public Accounting* by John L. Carey.

the management and the owners of the business (generally, in these days, the holders of equity securities of a corporation) but also to the creditors of the business, and to those who may otherwise have a right to rely (in part, at least) upon the auditor's report, as in the case of prospective owners or creditors.

No exhaustive discussion of the subject is attempted here; its development will proceed in the course of the committee's dealing with pertinent questions as they arise.

Due Care by the Auditor in the Performance of His Work

The third of the personal standards is the requirement that the auditor perform his work with due care. The query as to what are the factors which indicate whether under given conditions he has or has not exercised due care serves to make this standard the gateway to the discussion of the procedural standards, namely, those for the auditor's field work and those for his reporting thereon. It is with reference to these that the question of due care or its lack will find the full answer.

Lawyers often quote *Cooley on Torts* for the applicable rule of law, which that authority has worded so lucidly that it merits quotation here:

"Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is prerequisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment."

Due care imposes a weighty responsibility on the auditor to give heed to the procedural standards, the observance or nonobservance of which spells the difference between procedures professionally applied and procedures merely perfunctorily applied; the difference between auditing by judgment exercise and auditing by rote and rule. Responsibility, within the auditor's organization, rests more upon the principal in charge of an examination than upon an assistant performing a minor part of it. With the greater equipment of sound judgment gained from a greater fund of experience, the principal must not fail to exercise due care in a critical review of the work done and the judgment exercised by those under him, for responsibility cannot be severed from authority.

These procedural standards ask of the auditor not merely whether proper procedures have been employed, but beyond that whether, under all the circumstances of a case, those procedures have been properly applied and co-ordinated. As to the field work, these questions are, of

course, directed to the auditing procedures of the auditor, whereas, in the reporting thereon, they are directed to the accounting procedures of the examinee, while in both cases they lead to the further question as to whether specific disclosures may be additionally required. The scope of these standards as they are defined in the following pages will be necessarily presented in an outline form, leaving to the committee's future activities the matter of more explicit answers to the numerous questions that may arise, through the developing cumulative record of the Statements on Auditing Procedure.

Before, however, proceeding to discuss the procedural standards, a foreword is in order. The matter of due care having two aspects — since it concerns both what the auditor does and how well he does it — comprises, therefore, considerations not only of auditing procedures but also what may be termed the mechanics of his audit working papers. Beyond such elementary requirements as the safeguarding of his papers against the possibility of unauthorized access to them and any resultant tampering therewith, due care in the matter of working papers concerns not only the completeness of their contents (with avoidance, however, of unnecessary papers) to support his representation of standard attainment, but also the designing of those papers with professional skill to the end that they effectively serve the purpose of competently informing him about the matters under audit. Merely to illustrate, mention might be made of their including such contents as permanent files for the carrying forward from year to year of necessary information about bond indentures, contracts, and the like.

Moreover, skill in the designing of working papers would extend to their embodying measures of counter or double check against clerical errors on the part of the auditor and his assistants — insuring, as it were, the attainment of an “auditing internal control” within the auditor's own fold; for example, in connection with determining an investment portfolio's market valuation, a proper awareness of clerical error possibility on the part of his staff, either in the ascertainment of market quotations or in the compiling of their extended totals (particularly where there may be related shortcomings in the examinee's internal control) might well prompt special working-paper treatment to minimize the likelihood of undiscovered error. The skilled auditor's attainment of due care in this regard may often be manifest from the construction of his analyses and other working papers so that they assist, as far as may be possible, in approaching an automatic bringing to light of errors, whether those of the examinee or of the auditor's staff. Thought expended and pains taken in such a planned layout of working papers repays the auditor not only in the help his working papers give him but in their furnishing valuable evidence, in case of need therefor, in support of his contention that he has met the standard of due care; in other words, being properly “working-paper minded” is something to be fostered, not discouraged.

STANDARDS OF FIELD WORK

As presented herewith, these standards are:

1. Adequacy of preparatory planning of the field work.
2. Proper evaluation of the examinee's existing internal control for reliance thereon by the auditor.
3. Competence of evidential matter.

These standards to a great extent are interrelated and interdependent, as becomes readily apparent from even a brief study of the Statements on Auditing Procedure already issued, in the light of the instant discussion. Moreover, the same circumstances which would be germane to a determination of whether one of such standards has been met may be equally applicable to a test of a second. For example, the elements of "materiality" and "relative risk" are pertinent to all of the procedural standards, both those of field work and those of reporting as well. A brief reference to them here may be helpful.

Materiality

There should be stronger grounds to sustain the auditor's informed opinion in respect of those items which are relatively more important and in respect of those in which the possibilities of material error are greater. For example, in an enterprise with relatively few, but large, accounts receivable, the individual items themselves are more important, and the possibility of major error is also greater, than in another enterprise which has a vast number of small accounts aggregating the same total. In industry and merchandising, inventories are of relatively great importance in both the balance sheet and the statement of income, and may accordingly entail a much greater expenditure of the auditor's time than, say, the cash on hand; or again, than the inventories of a utility company. Similarly, accounts receivable will receive more attention than prepaid insurance. However put in words, the principle of materiality is inherent in the work of the auditor.

Relative Risk

The degree of the risk involved also has an important bearing on the nature of the examination. In the light of possible irregularities cash transactions are more vulnerable than inventories and the work undertaken on cash may require it to be carried out in a more conclusive manner, without, however, necessarily implying a greater expenditure of time. Titles to properties, again, may be as valuable as marketable securities owned, but they are not negotiable instruments and thus the standards of audit procedure in their examination are less exacting. Arm's-length transactions with outside parties are usually subjected to less detailed scrutiny than those relating to intercompany transactions or those with officers and employees, where the same degree of disin-

interested dealing cannot be assumed. Or from another angle, more attention may be given to repair charges in the case of a company with profitable operations, where the tendency may be to charge improvements as repairs, than in one which is unprofitable, where the tendency may be to capitalize repairs. In the latter case, closer scrutiny of items capitalized may be necessary.

The effect of internal check and control on the scope of an examination is the outstanding example of the influence on auditing procedures of a greater or lesser degree of risk of error. The primary purpose of internal check and control is to minimize the risks of errors and irregularities, and the more adequate and effective the system, the smaller the risk and the less extensive the detailed examination and testing required. The auditor's reliance upon internal check and control is based upon the belief that if a number of persons take part in initiating, carrying through, recording, and controlling a transaction, the probabilities are strong that the transaction is a real one and is properly recorded, especially if the individuals are independent of one another. On the other hand, where the internal check and control are necessarily limited or severely restricted, the examination to be made should be more comprehensive in character because of the relative risk involved.

As already mentioned, a characteristic of accounts receivable in certain types of businesses, as, for example, public utilities, is the existence of a relatively large number of accounts, as those arising from residential service, where ordinarily the balance in any individual account is small. The risk of material error being manifestly much less than in those cases where the total of accounts receivable is represented by relatively few accounts with large individual balances, circularization of consumers in public utility examinations is undertaken as a test upon the functioning of the internal control of the company rather than for determining the correctness of individual account balances. Those matters which could be most material necessarily require the greatest degree of certainty. This does not necessarily mean that the most material items will require the greatest expenditure of audit time nor, conversely, that the least material items can be substantiated most quickly, for it not infrequently happens that the auditor is confronted with a condition in which the exercise of due care makes necessary an extended program of work which, superficially, might seem out of proportion to the amount of money involved. In all these situations, the underlying considerations are not only the time devoted by the auditor but often also the degree of concentrated effort and thought expenditure.

It is standard procedure for department stores and other retail establishments to deliver merchandise to customers without requiring receipts evidencing such delivery. This procedure leaves the seller very little useful evidence which he could produce to defeat claims of nondelivery. Such practices are not the results of oversight but result from an election to assume a calculated risk. The effort and expense involved in alterna-

tive procedures, which are most satisfactory from the point of view of protection, have been determined to be excessive and out of proportion to the economic benefits to be gained by their adoption.

It is one thing for establishments of the kind mentioned to forego full protection based upon consideration of the expense attaching to alternative procedures. It is quite another for the auditor to base his judgment on the same factors. It is doubtful that the failure by an auditor to undertake a required procedure could be excused solely on the ground that "it cost too much." Nevertheless, one of the circumstances which may be justifiably considered in determining "required" procedures is the economic factor of expense involved, particularly when this factor is properly evaluated in relation to the elements of risk and materiality.

Observation of material amounts of inventories in many examinations might well be required procedure even though the inventories be located at points which are difficult and costly to reach. On the other hand, the procedure of observation, inspection, or counting should not be applied blindly to all inventories wherever located. The auditor, in establishing his program and deciding upon the points at which that procedure should be applied, properly may consider the element of expense. In general, the factor of expense should be considered in selecting one of several alternative procedures but should not be relied upon to justify failure to obtain reasonable grounds for an opinion. As a guiding rule, it may be stated that there should be a rational relationship between the *cost* and the *value* of the benefit acquired, or the protection provided, by the work undertaken.

Adequacy of Preparatory Planning of the Field Work

In Statement on Auditing Procedure No. 1 this first consideration of field work standards found recognition — brief but weighty — in the following:

"It is suggested that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year."

The brevity of this recommendation is in no sense a measure of its significance. In the committee's deliberations, it received important attention, for it was realized that in a number of respects the proper execution of procedures depended on early arrangements therefor. Particularly was this recognized to be true with regard to the auditor's functioning in connection with physical inventories, where early consideration of preparatory measures is frequently vital.

Of the subsequently issued Statements on Auditing Procedure, Numbers 8, 10, and 16 — as to all four of the cases embraced in the last-named — clearly reflect the need of observing this standard of adequate preparatory planning. Possible situations like those in the first and second examples given in No. 16 can often be effectively met only through

careful arrangements made beforehand. As to the first example, if the undesirability (from an audit viewpoint) of certain operating procedures is brought to the attention of the management early enough, remedial measures may be instituted in time for their beneficial effects upon the situation which the auditor will face later on. The second example illustrates the need of the auditor's participation in the formulation of plans for the taking of the physical inventory.

This standard has to do particularly with the *timeliness* of procedures and the *orderliness* of their application.

The timeliness with which auditing procedures are undertaken concerns the proper timing or synchronizing of their application. It thus raises the question — all with reference to the degree of internal control existing — of simultaneity in the examination, for example, of cash on hand and in banks, of securities owned, and of bank loans, et cetera. It may — or may not — require the element of surprise; the need of establishing audit control over assets readily negotiable, effective co-ordination of various phases of audit work, and the establishment of a proper cut-off at a date other than the effective date of the examination likewise are involved.

Combined with this matter of proper timing is the need of orderliness with which procedures are carried out, as is apparent, for example, in the application of the auditing procedures for inventory observation and testing to preclude the perpetration of fraudulent devices otherwise possible. Proper preliminary review of proposed physical inventory procedures, as planned by the company, is as essential for this purpose as is proper co-ordination between the receipt and the shipment of goods, and goods on consignment, et cetera, and their treatment in the books of account and the physical inventories. In the matter of examining securities, where these are of considerable volume, proper preparatory planning may be necessary to guard against deliberate substitution of securities already counted for those not yet counted.

From what has been said in the preceding, the question may well be put as to whether it implies that the auditor is precluded from accepting an engagement which comes to him at or after the fiscal year closing date (or other effective date for his audit). The answer, of course, is in the negative with an admonition, however, that a particular duty is incumbent upon him to make certain that the circumstances permit his proper functioning, whether his report can be given without qualification or whether a duly qualified report may be acceptable — as well as possible. Even if physical inventory, for example, may not yet have been taken, the fact that the auditor had not participated in the preparation therefor might militate against its acceptability when taken; or the situation might be met either by a postponement of its taking to permit of the auditor's participating in the instructions therefor, or, where already taken, by a new inventory to remedy the audit defect.

In the important matter of field work allotment as between preliminary

work performed before the effective date (or the closing of the accounts therefor) and the final work performed thereafter, much valuable experience has been gained in the recent years, mothered by the wartime necessity of meeting a required time for final reporting with all the difficulties inherent in manpower and other problems. The auditor has found that much of his work which previously had been done after the closing of the accounts could be done even more satisfactorily as a part of his preliminary work. Aside from that relating to inventories and plant accounts, it has been found that work performed in connection with receivables and cash (but not excluding other items as well) in checking upon management's representations as of an earlier date yielded even better results than when performed in the stress of post-closing work.

Without any exhaustive explanation for this ascertained advantage, it may suffice here to make mention of one simple aspect of the matter. Taking for illustration an audit engagement requiring, say two hundred man-days of field work for its performance, it is not difficult to understand — just to stress one point alone — why five men working forty days would have the advantage over ten men working twenty days by reason of the resultant greater degree of familiarity, in the case of the former, with the records under audit. Problems, of course, are involved in this timing readjustment, such as a maintained audit control over securities that have been inspected, but they have by no means been insuperable. In this portion of the field alone there is much fertile soil for future cultivation.

Proper Evaluation of the Examinee's Existing Internal Control for Reliance Thereon by the Auditor

The reliance which the auditor places upon the examinee's internal accounting control influences both his selection of the appropriate auditing procedures and his determination of the extent of the tests to which such procedures are restricted.

In Statement on Auditing Procedure No. 1, this standard of field work received great stress. Pertinent excerpts therefrom are as follows:

"The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. . . . It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises — a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry."

"It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of

internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination."

In formulating his program, the auditor is entitled to give appropriate weight to the degree of internal control in force. The function of internal control is to provide some measure of assurance that errors and irregularities may be discovered with reasonable promptness, thus minimizing risk. Adequate evaluation of a system of internal control requires not only a knowledge of the procedures and methods in use and an understanding of their function and limitations but also a reasonable degree of assurance that the procedures actually are in use and are operating as planned. The matter of determining the extent of reliance upon the testing technique is not always something solely for initial determination at the time of the audit's beginning. The extent as originally fixed may be predicated upon assumptions with regard to the actual functioning of the internal control which the auditor's testing may show not to be as represented; with the premises thus altered, an expansion of the testing scope may be called for.

The review of internal control is one of the most important of the steps in proper planning of the audit and must not be casually undertaken or carelessly performed. Insofar as the circumstances permit, the auditor should independently acquire a personal familiarity with the procedures and methods in use. A systematic and clear record should be made of the facts developed by the review. In his record, the prudent auditor will make a clear distinction between those facts which he has independently established and those which, by force of circumstances, he has accepted based upon oral representations.

Assurance that the internal control is functioning as planned should be obtained as the audit procedures adopted are applied. For this reason many auditors prefer not to make a separate task of evaluating the internal control as a whole but rather to make their review of the controls applicable to the various activities while the related accounts are being audited. This correlated approach makes it possible to amend the program of audit to suit prevailing conditions.

One approach frequently employed in checking on the effectiveness of the system of internal control is by tests made in relation to particular accounts and records. For example, certain expense accounts may be selected and an assistant instructed to procure and examine all of the evidence supporting the entries in such expense accounts for a stated period; or, to use another illustration, one of the books of original entry for a selected period may be subject to detailed examination. Extensive insight into a system of control also can be obtained by investigating a series of related transactions. For example, review of the data supporting the various steps arising from a certain requisition for materials, including the preparation of the purchase order, the record

of the receipt of the material, the approval of the voucher for payment, payment therefor, and tracing the transactions to the particular accounts, is often more revealing than the examination of vouchers or checks for a specified period of time.

Where an internal auditing department exists the independent auditor very properly accords that fact appropriate weight in selecting and applying his auditing procedures. The advantages of strong internal auditing departments are becoming better recognized by many concerns of sufficient size to warrant maintaining such an organization. It may be appropriate, however, to repeat the word of caution which appeared in Statement on Auditing Procedure No. 2:

"Internal auditing departments are an important part of the system of internal check and control, particularly where a concern has numerous plants or offices. The work of the internal auditor reduces the volume of testing and checking required of the independent auditor. However, the objectives, purposes, and points of emphasis of the two are by no means parallel. An internal audit stresses particularly the accuracy of the bookkeeping records, the fact that they conform with standard accounting procedures of the concern, and the discovery of irregularities and possible shortages. The independent auditor also has these matters in mind but they are not his primary objective. He concerns himself more particularly with the soundness of the judgments of the management as reflected in the financial statements and their conformity with generally accepted accounting principles and conventions. Furthermore, one of the safeguards of an independent audit is the fact that it is made by those independent of the concern under examination. For the reasons stated, an internal audit, however efficient, cannot be considered as a substitute for the work of the independent auditor."

Without attempting any expansion of the restricted purview of this report by discussing the various elements that constitute an adequate system of internal control, it may be appropriate here to emphasize that the effective boundaries of such a system extend beyond the frequently stressed desirability of a sharp division between the handling and the recording of transactions in a concern's accounting and financial departments. The proper area of such a system will include the duly co-ordinated functioning not only of the receiving department for materials and the shipping department for product, but of the purchase department and the sales department as well. It will, moreover, properly extend to a system of plant construction authorizations or systems of operating budgets; where such systems are adequately devised and conducted, they may well justify the auditor's reliance thereon in the planning of his audit program.

While the application of audit procedures by tests in lieu of complete check fully conforms to the requirements of auditing standards when the extent of such tests rests upon carefully exercised judgment and, therefore, provides a proper basis for the auditor's expression and opinion, it must be borne in mind that while the testing technique is justified on the ground of the general impracticability of a complete check, manifestly it does not afford the same degree of assurance; and

it follows that where a complete check entails little or no additional effort or expense, testing may lose its justification.

The testing technique thus rests for its justification upon its reasonableness, which in turn involves a variety of circumstances. What might be termed the volatility of assets would be another consideration; the fact that the inventories of a certain concern are unquestionably in the testing technique area is no reason for extending that area to its portfolio of investment securities.

While relative risk is properly to be given due consideration in the matter of the selection of items for testing, the mere matter of difficulty involved in testing a particular item is not a valid basis for its omission. A case in point many years ago concerned a situation where well over a third (in aggregate value) of the inventories were carefully subjected to the physical testing technique, giving an assurance of acceptability of the entire inventory which was subsequently found to be unwarranted because the omitted items were wholly in a warehouse in which both the arrangement of the goods and the complexity of the records presented such added difficulties that the examiners had decided against their inclusion in the testing program; a shortage existing in that warehouse by reason of official manipulations facilitated by those difficulties was of amount sufficient to place the concern in bankruptcy. The very fact of those difficulties, entailing the possibility of serious discrepancy, should, of course, have given that warehouse a definite preference in the selection of items for testing.

Of the previously issued Statements on Auditing Procedure, a number have dealt with considerations involved in this standard of the proper evaluation of the system of internal control. Besides Numbers 3, 8, 10, and 14, for instance, the first, third, and fourth cases of No. 16 are pertinent.

Competence of Evidential Matter

Considerations of the competence of the evidential matter on which the auditor relies to sustain his opinion were given much attention in Statement on Auditing Procedure No. 1 for extended procedures set forth therein were predicated on the same recognition of the truism that "circumstances alter cases," which was later further emphasized, in the accountant's report or certificate, by specifically relating the standards followed or procedures employed to those that were "applicable in the circumstances." In no phase of the auditor's work is this of greater importance than in the case of inventories and receivables, as to both of which Statement on Auditing Procedure No. 1 makes its recommendation of the procedures described therein subject to the qualifying clause "wherever practicable and reasonable." The exceptions where such procedures may not be practicable and reasonable may be important ones which, therefore, may require the substitution of carefully considered alternative procedures.

In the extended procedures which that Statement prescribes for inventories, for example, a line of demarcation is indicated between cases of physical inventory-taking where the observation thereof alone may suffice and cases where the auditor may additionally "require physical tests of inventories to be made under his observation"; in the case of inventories in public warehouses, existing conditions may or may not require the auditor to "make supplementary inquiries."

So, too, with the extended procedures in regard to receivables — aside from the question of cases where confirmation might be found to be not practicable and reasonable — there is visioned a wide variety of different situations so "that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment."

Evidential matter may be divided into two categories. The first would include data available internally, or within the examinee's organization. The second would embrace the type of evidence developed by the auditor himself outside the sphere of such normal organization records and routines.

Internal evidence would be the books of account and all of the collateral memoranda and documents incidental to and supporting recorded transactions, such as journal entries, checks, vouchers, invoices, bank statements, contracts, and minutes of board meetings. The auditor's examination of the internal evidential matter is accomplished through his tests. There is no magic formula by which a proper degree of testing may be established any more than there is a uniformly satisfactory method of selecting the audit procedures which are appropriate. Tests made haphazardly are without significance and will be of little comfort to the auditor who is called upon to demonstrate that he has exercised due care in his examination. The objective of testing is to determine whether reliance may be placed upon the examinee's representations as expressed in the books of account and financial statements. The appropriate degree of testing will be that which may reasonably be relied upon to bring to light errors in about the same proportion as would exist in the whole of the record being tested.

External evidential matter may be taken to embrace whatever evidence the auditor adduces himself in supplementation of the internal evidence. Besides confirmations requested from various sources, it would thus also include inspection or observation by the auditor of the physical existence of assets, as he does when he counts cash and securities and attends the taking of physical inventories; inquiries directed by the auditor to various officials and employees in connection with required liability certificates, et cetera. A few words illustrative of certain procedures, with particular reference to the varying considerations involved in their conformance or nonconformance with auditing standards, may assist in a comprehension of this phase of the subject.

Confirmations: Substantiation of material amounts of cash on deposit requires the obtaining of direct confirmations or certifications from the depository. Determination of the bona fides of the depository (where such may not otherwise be relied upon) and of the availability of the cash balances are inherent in a proper procedure. Examination of receivables requires direct communication with debtors, where such procedure is practicable and reasonable, the method and extent thereof being dependent upon the circumstances. Where securities and portions of inventories are held by outside custodians, confirmations obtained from custodians are valueless unless there is reasonable evidence of the bona fides of the custodians. Liabilities to banks, trustees, and mortgagees (and to others where deemed necessary in the circumstances) require confirmation by direct communication with the creditors; likewise, outstanding stocks and bonds are confirmable by communication with registrars, transfer agents, and trustees where such exist.

Inspection or Observation: The substantiation of cash and securities on hand and of inventories on the premises is usually accomplished by means of inspection or observation procedures. Materiality of amounts and the practicability and reasonability of application of the procedure are factors which demand careful judgment and they are determinants of the steps which may be applicable under the circumstances.

Specific Inquiries: One of the auditor's most difficult tasks is the ascertainment of any unrecorded liabilities to which no direct reference appears in the accounts. Most auditors ask the examinees (and in instances their attorneys) for written assurances to the end that all known liabilities may be taken as properly accounted for in the books. Inquiries are also standard procedure to elicit the existence of contingencies and recourse to pledging of assets. Such inquiries, and the responses obtained, are not to be considered as a substitute for, but rather as a complement of, a proper examination. The auditor should avail himself of every practicable means of substantiation of information developed by inquiries.

Mention has been made in the preceding remarks about exceptions to the prescribed inventory and receivable procedures in instances where such procedures would not be "practicable" or "reasonable." While future statements on auditing procedures should further clarify such exceptions, two situations may be discussed here which bring out the necessity of the auditor's assuring himself, in regard to evidential matter, that the procedures he selects have real evidential competence in the particular circumstances of the case he is dealing with. The first of the ensuing illustrations — that dealing with a type of in-process inventory — serves to bring out the meaninglessness of a so-called physical inventory corroboration where the conditions largely deprive that procedure of real evidential competence for determination of proper

costs. The second deals with the real objective — sometimes not too well understood — inherent in the confirmation procedure.

The in-process inventory of a concern which manufactures a variety of products and determines their costs on a job — or production — order basis illustrates a situation where the requirement of physical inventory-taking by “weight, count, or measure” would be unreasonable because any quantitative determination would be purposeless; for, since the costs as thus compiled — looking only to the final finished product — do not purport to determine costs at the various stages of incompleteness (as opposed to those of a standard or process system of costs), no ultimate satisfactory valuation of the quantities physically inventoried would be possible.

But this would not warrant the auditor’s accepting the book values of such in-process inventories as shown by the cost records, without some alternative or supplementary procedure. He can, in any event, establish “physical contact” with such inventories by accounting for all the jobs in process, as called for by the cost records, through identification thereof with tags or labels or other record accompanying the unfinished product in its various places throughout the plant.

While this would assure the bona fide existence of the job orders as such, the absence of any feasible “weight, count, or measure” might, of course, operate against a conclusive corroboration of their aggregate dollar cost as called for by the cost records; it might still be possible, for instance, for materials issued from stores and improperly diverted to have been charged to such job orders without such impropriety coming to light. It may be found, however, that a final check of the total job-order costs upon the subsequent completion of all such jobs might be practicable, through a comparison of such ultimate costs, for example, with original engineering estimates.

In each situation of this type it is incumbent upon the auditor to study the existing conditions to ascertain what means are at hand for his becoming fully satisfied to accept such book inventories unsubstantiated by any “weight, count, or measure” physical inventorying. Indeed, where conditions permit of any such ultimate corroboration as that just indicated — a concluding comparison, upon completion, with the initiating engineering estimates — the resultant valuation may be even better than in some inventoried cases; for it not infrequently occurs, where a full physical inventorying by weight, count, or measure has taken place, that the specification costs for all the intermediate processes are so difficult of adequate proof against substantial under — or over — absorption of labor and overhead that the finally determined inventory valuation is less reassuring than in the best type of job-order case instanced above.

The confirmation procedure in the case of receivables is essentially one of establishing the bona fides of the receivable as a valid claim against the indicated debtor and as a test of internal control rather than any determination of the debtor’s credit-worthiness. In cases where the

auditor may require the internal evidence as to its credit-worthiness (such as the debtor's record of payment, et cetera) to be supplemented by external evidence, he may have recourse to mercantile ratings, bank references, his financial statements, or the like, though at times the confirmation procedure does assist in that respect; usually, however, the reliance placed on that procedure is to serve the purpose of determining that the receivable is neither a fictitious one in its inception nor one that, though bona fide in its origin, is actually less in amount than that shown by the books because collections made have been manipulated through some kind of "kiting" irregularities.

Where situations are encountered in which debtors with large balances persistently refuse to honor confirmation requests, the use of negative confirmations would not constitute compliance with auditing standards. Instances during the war were receivables owing by the United States Government, though there occur other examples where large customers with many scattered purchases (certain merchandising concerns, for instance) assert that their manner of account-keeping precludes the possibility of correctly replying to confirmation requests. In such instances of the impracticability of the confirmation procedure other measures must be resorted to. By way of illustrating one such, the auditor may find it practicable during the period of his field work to have customer remittances cleared of record through his staff, so that these remittances may be properly identified with respect to the items comprised in the aggregate balance of each such important customer, with a view to detecting any "kiting" irregularities.

The full attainment of compliance with generally accepted auditing standards in the matter of selecting and applying procedures that will constitute evidence that is competent in the circumstances to sustain the auditor's opinion is a matter for careful judgment exercise. In the case of confirmation requests covering accounts receivable, on the one hand, and accounts payable, on the other, there are these elements, for example, to be considered. In the case of accounts receivable, the asset may generally be regarded as stated *at least* in its entirety, the objective of confirmation being to reveal any possible *decrease* of the claimed asset; there are, of course, exceptions but in most cases of irregularity this is true. In the case of accounts payable, however, the strong probability, if there are irregularities, is that liabilities have been *omitted*, so that even a 100 per cent confirmation of all *recorded* payables might prove nothing with regard to the substantial omission from the books of a liability that was not recorded but should have been.

On the other hand, in the case of the available *internal* evidence for one or the other, it may be found that such evidence affords a check of the accounts payable (the examinee's canceled bank checks and related creditors' invoices, for example) that is more reliable than the corresponding internal evidence for the receivables (whether sales or shipping data or evidence as to collections). The functioning of the system of

internal control may often supply the answer to such questions as these.

In making his decision, the auditor may further need to consider such pertinent matters as the widely scattered record of a given creditor's whole account (where a voucher register is used without any efficient over-all summary of items) as well as the practicability of negative confirmations to cover a wide range of receivables (as against the lesser utilization of positive requests for payables). Large accounts might, in any event, be subjected to confirmation but in the case of smaller balances the auditor might decide for the external confirmation procedure for receivables and the internal checking procedure for payables.

Merely to further instance — without any attempted elaboration herein — the kind of problems whose solution will indicate the attainment of this standard: One such concerns the necessity or non-necessity of checking the numerical identity of securities, in connection with their inspection, against the possibility of improper substitution. Another is the use of the so-called "second bank reconciliation," where such a reconciliation, if made too detached from the first, might not serve its real purpose — corroborating the outstanding or reconciling items of the first reconciliation.

The bulk of an auditor's work in obtaining information upon which he may base his opinions is in the examination of accounting evidence. The test of the validity of such evidence lies in the experience and judgment of the auditor; in this respect it differs from legal evidence which is circumscribed by rigid rules. In appraising the value of available evidence, the auditor must consider its historical background. Information which is developed as a matter of routine ordinarily may be accorded more reliance than might attach to casual memoranda.

To discharge the requirements of due care, the auditor should defer final determination as to his procedures until he has obtained a dependable understanding of the available evidence and — of equal importance — formed some judgment as to its reliability. Although he does not profess to be an expert on forgeries, he must be alert to recognize inconsistencies and apparent alterations which would reflect upon the value of the data.

The instances where previously issued Statements on Auditing Procedure have had to deal in one way or another with the "competence of evidential matter" are fairly numerous. Statements Nos. 3, 4, 8, 9, 14, 17, 18, 19, as well as the first case of No. 16, are in point.

STANDARDS OF REPORTING

The ultimate objective of the examination of financial statements by the independent certified public accountant is the expression of an opinion respecting the statements. The report or "certificate" is the medium through which he expresses his opinion on the financial statements subjected to his auditing procedure. In this discussion only the

corroboration of stock-pile records, and this fact should be suitably disclosed if the amount is material and there is not adequate supporting evidence of some other character by means of which the independent auditor can satisfy himself.

II. Inventories of Packaged Materials (Barrels, Boxes, Or Bags)

Stacked in Solid Formation

What, if any, special procedures should an independent auditor adopt in the case of large quantities of packaged materials stacked in solid formation?

Where packaged materials contained in barrels, boxes, or bags are stacked in a solid formation of considerable width and depth a condition is created which is conducive to fraud by means of a so-called "hollow square" within the allegedly solid formation.

It should be borne in mind that physical stock-taking is not the sole evidence on which the auditor bases his opinion. The physical stock-taking and the records are complementary and each is corroborative of the other. Where the records are defective or are not supported by adequate internal control, the physical inventory is the principal source of reliance. On the other hand, where the records and internal control are good and especially where staggered inventory checks are made, the physical inventory is primarily a check on the records. The possibility of fraud under such conditions is minimized.

Such a situation is illustrated by the case of a sugar refinery which kept its raw sugar, in bags, in separate piles for each lot and had received into its bonded warehouse within two weeks of the inventory date a cargo of raw sugar. Here the independent auditor had the evidence of the stock records, the receiving records, the invoice, and other documents as to the quantities involved. He was also satisfied from his inquiries in the warehouse that the sugar had only recently been received and put in its present location. By means of this evidence and his own inspection he was able to satisfy himself without further precautions against a hollow square.

In other circumstances, where the amount of the inventory involved is material and where the corroborative evidence is not so strong, it may be the inescapable duty of the independent auditor to inspect the merchandise from above or to require the client to move enough of the goods in solid formation, preferably before count, to preclude the possibility of the existence of a hollow square. This type of inventory situation emphasizes the need for planning by the independent auditor with the client as far in advance of the inventory date as possible.

It is not feasible to set up uniform inventory procedure which will apply in all cases.

The procedure must be determined by the exercise of judgment in the light of the circumstances of each case.

III. Chain Stores

What audit procedures have been followed by independent auditors in their observation of the taking of physical inventories of: (a) grocery chain stores; (b) chain stores selling miscellaneous merchandise at prices from five cents to one dollar and generally known as variety chain stores?

In considering the inventory problems which arise in examinations of the accounts of all types of chain stores, distinction must be made between chains with a relatively efficient system of internal control through head office organization and records or other means, and chains whose system of internal control is limited. The scope of the examination will depend to a considerable extent on this factor.

In chain store organizations with a large number of stores or units, it is not practicable and reasonable for the independent auditor to observe inventory-taking at many locations. He must, therefore, adopt a plan through which he can satisfy himself as to the authenticity of the inventory records.

Practically all the larger grocery chain store organizations maintain inventory controlling records at their head offices and have close control by dollar amounts of inventories at individual locations. The procedures outlined below were adopted in an examination of the accounts of a grocery chain which operated over eight hundred stores served by a single central warehouse, and had an adequate system of internal check and control. It maintained control of the store inventories by the retail method, charging each store's inventory account with the selling price of merchandise shipped to the store and crediting it with sales proceeds, price reductions, et cetera. In this instance the company employed inventory crews who at least three times a year visited all the retail stores without previous notification to the store managers and inventoried the stocks at retail prices. The total amount of the inventory as reported by the inventory crews was compared at the head office with the store's inventory account. If a large shortage or overage developed, further investigation was made. In addition, at the end of the fiscal year each store manager under the general supervision of a district manager took a physical inventory, also at retail prices.

The independent auditors satisfied themselves as to the existence of the stores by noting evidence of the deposit of store sales, by reference to inventory crew reports on inventories taken, by review of tax records, or by other available means.

Having in mind the average store inventory of not more than \$5,000, the reliability of the book-inventory records, and the continuous check made by inventory crews, the independent auditors did not consider it necessary to visit the retail stores to satisfy themselves further as to the authenticity of the records, but, for the sole purpose of observing inventory methods followed, they did visit a few of the stores during stock-taking. At the fiscal year-end they also observed the taking of the central

warehouse inventory, which comprised a large percentage of the total inventory.

Their examination at the head office included a test-check of store inventory accounts, particularly the controlling account, to determine that goods shipped had been charged to the stores and that goods reported as sold and credited to the stores had been properly accounted for in cash or otherwise.

On the basis of the operating methods followed and the evidence provided by the foregoing tests the independent auditors were satisfied as to the reliability of the inventory records.

Inventory procedures followed in the examination of the accounts of a grocery chain operating about two hundred stores were somewhat similar to those outlined above. The average store of this chain had an inventory of about \$2,000 while the supermarkets had an inventory of from \$10,000 to \$15,000, with rapid turnover in both types of store. In this instance the head office records and control were good but the work of the inventory crews was not so well organized as in the case of the larger chain. It was therefore deemed advisable to visit ten representative stores during the course of the periodical inventory check made by inventory crews, or during the year-end stock-listing for the purpose of observing or reviewing the inventory procedures.

Inventory procedures in variety chain stores generally differ from those used by grocery chains for the principal reason that the inventories usually consist of a much larger variety of items and have a greater value. Frequently also variety chain stores do not follow the "retail method" of inventory control, and do not as a rule utilize the services of inventory crews to make checks throughout the year. Instead they usually rely in the main upon physical inventories taken at the year-end by the store manager, assisted by office, store, and stockroom employees.

The procedures outlined below were those adopted in an examination of the accounts of a company operating about two hundred variety stores. All store managers were notified to expect, after or during physical stock-listing, visits from head office representatives, and possibly also from the independent auditors. Head office representatives, or managers of other stores acting in their stead, visited all the stores and made test checks of quantities, prices, condition, et cetera, and mailed or delivered the inventory sheets to the head office. Store managers who visited other stores for the test check were not notified of the location of their assignments until the day of their departure. These measures were designed to provide internal control in the inventory-taking and protection against the possibility of collusion.

The independent auditors visited certain of the stores without previous notification to store managers as to the stores to be visited. In such instances, while co-operating with the company representatives who were assigned to the store to test-check the quantities and mail the inventory sheets, the independent auditors were primarily interested in observing

the methods adopted by the company and satisfying themselves that the protective measures provided were carried out. In view of the careful organization necessitated by the larger number of stores, the protective methods and control exercised by the head office in the inventory-taking, and the primary purpose of the independent auditors' attendance at the stores, visits to eight or ten of the stores were considered in this case to be sufficient.

IV. Department Stores

What audit procedures have been followed by independent auditors with respect to observation of inventories of department stores?

Inventory-taking in the large department store differs from that in grocery chain and limited-price variety chain stores principally in that the entire department store inventory is not customarily taken in a single day or even in several succeeding days. In a store whose fiscal year ends on January 31 it may be customary to inventory furniture, other heavy goods, and certain other merchandise immediately after Christmas, to inventory a number of other departments during January and to inventory the remaining departments, representing the bulk of merchandise, during the last week of January, but usually not on January 31. In addition to the merchandise on the sales floor which is inventoried at retail prices, there will be other merchandise inventoried at retail prices in the departmental reserve stock rooms in the store, as well as in one or more warehouses which may be at some distance from the store; and there may also be advance purchases for coming seasons (usually in the warehouses) which have not been marked and will be inventoried at cost. In some stores the retail inventories of a number of departments handling expensive merchandise, such as furniture and furs, are supplemented by unit-control records; in such departments the pricing may be done from the unit control records rather than from the merchandise itself.

In one large department store, before commencing his audit, the independent auditor agreed with the controller upon the plan of inventory-taking. The physical count, it was arranged, would be supervised and controlled by the controller rather than by the merchandise manager. Prior to inventory time, prenumbered sheets or tags were distributed to buyers in accordance with their requirements, based upon plans submitted showing prenumbered shelves, tables, and other fixtures. The physical count was made by teams of two employees; the one most familiar with the stock called and the other listed, the sheets being left in the fixtures until all listing was completed. When all stock had been listed a representative of the controller's office made independent test counts of a portion of the inventory, selecting the items in a manner to insure the testing of a representative cross section of the entire stock on hand. The sheets were then gathered by the buyer or his assistant under

Observance of Consistency in the Application of Generally Accepted Accounting Principles, Except Where Conditions Warrant Otherwise

Consideration of whether or not accounting principles have received consistent application requires judgment exercise as to whether a change is (a) the proper consequence of altered conditions, (b) a change to a procedure of definite preference in general practice from one not enjoying such preference, though both procedures may be acceptable, or (c) is merely the choice, when two or more alternative procedures are available, of an alternative not dictated by change in circumstances and with possibly ulterior motives. Changes of the last-mentioned type are sometimes adopted merely because they bring about more favorable showings of operating results or presentation. Consistency of application of accounting principles should not be understood as denying a recognition of consistency where changes are made necessary by changes in operating conditions or other governing circumstances.

A phase of the question of consistency in application of accounting principles is that of the significance, or materiality of the effect, of a change. With respect to this the Securities and Exchange Commission in Rule 3.07 of Regulation S-X requires that:

"If any significant change in accounting principles or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

Illustrative of a situation which involves a "change" that does not connote inconsistency is a change in the depreciation rate of plant property made because of an increase or decrease in the daily operating hours of that plant. Another is a change in the rate of the provision for uncollectible accounts made because of altered credit conditions.

Adequacy of Informative Disclosures, Whether in the Financial Statements or in the Auditor's Report or "Certificate"

This standard concerns required disclosures that may have to do either with the scope of the auditor's examination or with the financial statements. In the case of the former, such disclosures may be required only in the "scope" paragraph — where the auditor, for example, having, for some good reason, omitted such a procedure as confirmation of receivables or physical inventory observation or test, has, nevertheless, been able to satisfy himself by alternative procedures; where such an alternative procedure has not been available, disclosure may also be required in the "opinion" paragraph by way of qualifying the opinion expressed.

As to the financial statements, fairness of presentation, apart from relationship to generally accepted accounting principles, requires consideration of adequacy of disclosure of material matters, whether relating

to the form, arrangement, and content of the financial statements with their appended notes; the terminology used; the amount of detail given; the sufficiency of explanatory or descriptive matter; the classification of items in statements; the bases of amounts set forth, for example, with respect to such assets as inventories and plants; lien on assets; preferred dividend arrearages; restrictions on dividends; contingent liabilities. This enumeration is not intended to be exhaustive but indicative of the nature of the disclosures necessary in order that the financial statements be sufficiently informative.

Mere verbosity in disclosure should not be mistaken for completeness; brevity of disclosure is often more helpful to the discerning reader than amplitude of words. What constitutes material information requiring disclosure in, or in connection with, financial statements is for the auditor to determine in the best exercise of his judgment. That later events may give greater importance to matters that at the time appeared to be of minor consequence does not, of itself, impugn the soundness of his judgment. Foresight and hindsight cannot be admitted to be of equal weight in passing upon conclusions reached at the earlier time; hindsight should be eliminated from the factors by which the soundness of past conclusions are judged. Matters which the auditor deems of such importance as to require disclosure, if omitted from the financial statements or from footnotes thereto, should be included in his report or "certificate," whether these matters be qualifications or necessary explanations.

Disclosure should not be considered to require the publicizing of certain kinds of information that would be detrimental to the company or its stockholders. For example, the threat of a patent infringement suit might impel a conscientious management to set up an ample reserve for possible loss, even though it would expect to fight the issue vigorously; but publicity given to such a loss provision might inure to the harm of the company or its stockholders, for courts have held that a reserve for patent infringement constituted an allocation of infringement profits (where ready determination otherwise was not feasible) notwithstanding a refusal on the part of the company or its management to concede that such an amount might be an equitable allotment of the profits in dispute.

Somewhat related to the matter of disclosure is the subject of information which the auditor receives in confidence akin to the status of privileged communication. Without such confidence the auditor might at times find it difficult to procure information necessary for him in the formation of his opinion upon the related financial statements. If the information thus received, in his judgment, does not require disclosure in order that the financial statements be not misleading, this standard is not to be construed as requiring the divulgence of information which may operate only to the company's disadvantage with no proper, fully compensating advantage to its security holders or creditors.

Various aspects of necessary disclosure have already been dealt with in the Statements on Auditing Procedure previously issued. Among others, especial mention may be made of Nos. 7, 12, 15, 16 (Case I, for example), 17, 18, 20, 21, and 22.

REVISION OF FORM OF ACCOUNTANT'S REPORT OR "CERTIFICATE"

With the differentiation between auditing standards and auditing procedures there is naturally an accompanying recognition that auditing standards, being in the nature of "principles of auditing" (as quoted indirectly from SEC in Statement on Auditing Procedure No. 6), are, accordingly, of a breadth of extent and application extending beyond that of procedures. Because of this universality of standards, the committee on auditing procedure believes it is more appropriate to speak of "procedures applicable in the circumstances" than of "standards applicable in the circumstances"; in other words, standards as broad statements of governing principles are to be viewed as covering all circumstances, whereas a procedure may be applicable to one case but not to another. As a result of this conclusion and without regard to any other changes that may be desired, the committee recommends that in the opening or "scope" paragraph of the auditor's short form of report, or "certificate," the phrase

"Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary."

be changed to

"Our examination was made in accordance with generally accepted auditing standards and included all procedures which we considered necessary in the circumstances."

Committee on Auditing Procedure.

October 1947.

Appendix B

**CODIFICATION OF
STATEMENTS
ON
AUDITING PROCEDURE**

1951



Based on Statements 1 to 24 (1939 to 1949)

Issued by the

Committee on Auditing Procedure



AMERICAN INSTITUTE OF ACCOUNTANTS

OUTLINE OF APPENDIX B

HISTORICAL PREFACE

APPOINTMENT OF THE INDEPENDENT AUDITOR

AUDITING STANDARDS

RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR

REPORTS OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

EXTENSIONS OF AUDITING PROCEDURES

Inventories (Department Stores; Installment Houses; Chain Stores; and Other Retailers; and Interim Financial Statements and the Independent Auditor's Report Thereon).

Receivables (Methods of Confirmation — Positive and Negative; Department Stores; Installment Houses; Chain Stores; and Other Retailers; Interim Financial Statements and the Independent Auditor's Report Thereon; Receivables from the United States Government).

SUPPLEMENT

Case Studies in Inventories; Confirmation of Public Utility Accounts Receivable; References to the Independent Public Accountant in Securities Registrations; Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters; List of Statements on Auditing Procedure.

Committee on Auditing Procedure (1950-1951)

Alvin R. Jennings, <i>Chairman</i>	Walter R. Flack	Benjamin Neuwirth
Donald J. Bevis	Harry C. Grumpelt	Fred G. Page
Garrett T. Burns	Russell C. Harrington	Oliver W. Seifert
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Carman G. Blough, *Director of Research*

Appendix B

CODIFICATION OF STATEMENTS ON AUDITING PROCEDURE

BASED ON STATEMENTS 1 TO 24 (1939 TO 1949)

Issued by the Committee on Auditing Procedure
of the American Institute of Accountants

HISTORICAL PREFACE

In 1917 the American Institute of Accountants, at the request of the Federal Trade Commission, prepared a "memorandum on balance-sheet audits," which was endorsed by the Commission, published in the Federal Reserve Bulletin, and distributed in pamphlet form to banking and business interests and to accountants under the name of *Uniform Accounting: a Tentative Proposal Submitted by the Federal Reserve Board*. It was reissued in 1918 under a new title, *Approved Methods for the Preparation of Balance-Sheet Statements*, the change indicating perhaps a realization of the Utopian quality of uniform accounting as an objective.

In 1929 the pamphlet was revised in the light of the experience of the decade just elapsed. In addition to a further change in title, which became *Verification of Financial Statements* — as evidence of the growing consciousness of the importance of the earnings statement — the revision contained the significant statement that "the responsibility for the extent of the work required must be assumed by the auditor."

In 1936 the Institute, a spokesman for a profession which had by that time become well established, revised the previous pamphlets and issued under its own sponsorship a pamphlet entitled *Examination of Financial Statements by Independent Public Accountants*. Two interesting developments appear here: realization that the word *verification*, previously used in the title, is not an accurate portrayal of the independent auditor's function in the examination of financial statements; and assumption by the accounting profession of the responsibility for determination and enunciation of accounting and auditing procedures.

The profession grew rapidly and at the same time the complexities of modern business were increasing the diversity of conditions encountered by the accountant. Rather than continue the practice of revising a document which, at best, could be applicable to only a small segment of the industrial field, the Institute issued from time to time, through its committee on auditing procedure, a series of *Statements on Auditing Procedure* which represent the opinion of the committee (reinforced in the more controversial matters by membership approval at annual meetings of the Institute) on certain auditing procedures as restricted to the particular circumstances recited therein. These pronouncements in effect modified or superseded parts of the 1936 pamphlet.

When the Securities and Exchange Commission initiated the proposal that a representation as to compliance with generally accepted auditing standards be introduced into the independent public accountant's report relating to companies which file with the Commission, it became apparent that a statement was needed which would define these standards. Accordingly, the committee undertook a special study of auditing standards (as differentiated from auditing procedures) and submitted a report which was published in October 1947, under the title *Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope*. The tentative character of this brochure vanished when, at the September 1948 meeting, the membership of the Institute approved the summarized statement of auditing standards appearing therein.

By 1948 developments in auditing procedure which had taken place since the publication of *Examination of Financial Statements by Independent Public Accountants* were so extensive that it was considered advisable to withdraw it from distribution. Accordingly, it is now out of print. It has been supplanted by the statement of auditing standards, the series of case studies in auditing procedure, and this booklet, all issued by the committee on auditing procedure; by the series of accounting research bulletins issued by the Institute committee on accounting procedure; and by the booklet *Audits by Certified Public Accountants*, issued by the Institute research department.

The committee on auditing procedure also made a comprehensive study of internal control, a subject to which the scope and size of the business entity in recent years have given great importance, because of the protection it affords to business and its potency in eliminating unreasonably extensive independent audit procedures. The results of this study were published in 1949 under the title *Internal Control—Elements of a Co-ordinated System and Its Importance to Management and the Independent Public Accountant*. Publication of a series of case studies in internal control has since been instituted.

The committee on auditing procedure had its beginnings in 1939 when, on January 30, the executive committee of the Institute authorized the appointment of a small committee "to examine into auditing procedure and other related questions in the light of recent public discussion."

On May 9 of that year the report of this special committee was adopted by the council of the Institute and authority given for its publication and distribution, and in the same year the by-laws were amended to create a standing committee on auditing procedure.

In 1941 the executive committee authorized the issuance to members, in pamphlet form, of the official *Statements on Auditing Procedure*, prepared by the committee on auditing procedure, previously published only in issues of *The Journal of Accountancy*.

These pronouncements were designed to guide the auditor in those areas of specific situations encountered in practice in which he must

exercise judgment, situations outside the realm of textbooks, whose function is inherently to describe procedures in general.

Twenty-four statements have been published during the past ten years. The first dealt with extensions of auditing procedures with respect to inventories and receivables, a subject of intense public interest in the 1930's. Another, arrived at after long discussion with the Securities and Exchange Commission and the Committee on Stock List of the New York Stock Exchange, sponsored an approved form of short-form report. In general, the statements covered those subjects as to which current conditions, special studies, or developments in auditing thought have made official pronouncements advisable. In some instances the subjects dealt with were of only temporary significance. In others, statements were issued to clarify auditing concepts discussed in earlier statements.

This *Codification of Statements on Auditing Procedure* has been prepared by the committee on auditing procedure to consolidate the more valuable and currently useful features of these pronouncements. In the process of codification:

1. Ambiguities contained in Statements Nos. 1, 3, and 12 have been clarified respecting the expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion (see fifth paragraph page 16). Effect has also been given to Accounting Series Releases Nos. 62 and 70 issued by the Securities and Exchange Commission, the former relating to the independent public accountant's responsibility for earnings tables in registration statements and prospectuses and the latter to an amendment of Regulation S-X, by which Rule 2-02, quoted herein, was amended.
2. Statements Nos. 7, 9, 10, 15, 17, 20, and 21 have not been summarized herein because the material contained in them applies to special situations, such as those which arose in World War II.

Therefore, this codification presents the principles and procedures of continuing general interest included in *Statements on Auditing Procedure*, Nos. 1 to 24, inclusive. For the convenience of those interested in the detail of the statements, whether or not summarized herein, a complete list of the twenty-four statements issued to date is included in the Supplement at the end of this Appendix.

APPOINTMENT OF THE INDEPENDENT AUDITOR

The method of appointing the independent auditor and his status in relation to the client are subjects of great importance to all who rely upon his findings.

In addition to professional skill and competence, his independence must be assured if his opinions are to possess the impartiality necessary to make them dependable. To be independent he must be intellectually honest; to be recognized as independent he must be free from any obligation to or interest in management, owners, creditors — or others

entitled to rely on his report—which might influence his judgment as to the fairness of the financial statements.

To emphasize his independence of management many corporations affected by public interest follow the practice of having him engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations provide that the stockholders be given an opportunity to ratify the selection made by the directors.

Not only the method but the time of his appointment is important. Both he and his client benefit when he is engaged early in each fiscal year so that he may carry out part of his work during the year. In many respects proper execution of audit procedures depends on early consideration of preparatory measures. This is conspicuously true with respect to observation of physical inventories, where early planning is frequently vital. Considerable advantage may also accrue from the opportunity afforded him of bringing about correction of any operating procedures or accounting practices which are undesirable from an audit standpoint, in time for beneficial effects upon the situation which he will later face. And in the interest of more efficient audits, swifter completion after the year-end, and improved staff morale, too much stress cannot be placed on the opportunity which early engagement affords for performing useful preliminary work and spreading audit service more evenly over the year.

AUDITING STANDARDS

Auditing standards are the underlying principles of auditing which control the nature and extent of evidence to be obtained by means of auditing procedures. Application of generally accepted standards does not imply that in a particular case all procedures were followed which would be followed in the majority of cases. It implies, rather, examination of evidence which certified public accountants generally would consider adequate in the particular circumstances, and may call for the extension of normal procedures or the employment of additional procedures.

As the result of its special study made for the purpose of determining and explaining these standards, the committee issued in 1947 a *Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope*. The summary of the meaning of generally accepted auditing standards was approved by the membership of the American Institute of Accountants at their meeting of September 1948. The resolution reads in part as follows:

“WHEREAS the committee on auditing procedure of the American Institute of Accountants in a special report (*Tentative Statement of Auditing Standards*) issued in October 1947, among other things has stated that:

While it is not practicable, because of the wide variance of conditions encountered, to issue anything like an ‘all-purpose’ program of auditing pro-

cedures, it is possible to formulate a pronouncement with regard to the auditing standards requiring observance by the accountant in his judgment exercise as to procedures selected and the extent of the application of such procedures through selective testing.

and that

Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon.

and has presented the following brief summary of the meaning of generally accepted auditing standards:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

The resolution concludes that: NOW, THEREFORE BE IT RESOLVED, THAT: (a) The foregoing excerpts from the committee's report are hereby approved and adopted, (b) The use of "generally accepted auditing standards" in the reports or certificates of independent auditors shall be deemed to refer to the standards or principles set forth in the foregoing summary. . . ."

The foregoing action gave official status to the meaning of the term "generally accepted auditing standards" which had been used for several

years in the accountant's short-form report. For detailed exposition of the standards and of their application in practice, the booklet *Tentative Statement of Auditing Standards — Their Generally Accepted Significance and Scope* should be freely consulted.

Approved standards of reporting in the fairly extensive situations where financial statements are presented on the stationery or in a report of an independent certified public accountant without an expression of opinion are discussed in some detail in a subsequent section under the heading *Clarification of Accountant's Report When Opinion Is Omitted*.

RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR

The primary purpose of an examination of financial statements by an independent certified public accountant is to enable him to express an opinion as to the fairness of the statements, their compliance with generally accepted accounting principles, and the consistency of the application of those principles with that of the preceding period.

In the performance of the duties which lead up to this opinion the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The generally accepted standards of his profession require that technical training and proficiency be supplemented by independence in mental attitude and due professional care in the performance of the examination and preparation of the report.

In offering his opinion the independent auditor assumes heavy responsibilities. He must have made a reasonable examination of the accounts to warrant an expression of opinion. He must state his opinion clearly and unequivocally. Since he must bear the burden of justifying this opinion, it is his ultimate and inescapable responsibility to adopt such procedures as in his professional judgment are appropriate. His judgment is not expected to be infallible but is logically required to be the informed judgment of a qualified professional person.

The independent auditor's function is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations of management and employees, to the extent necessary to enable him to form an opinion as to the fairness of the financial statements as submitted.

Generally speaking, his function is limited to reporting upon situations that have taken place in the past.

Management has the direct responsibility for maintenance of an adequate and effective system of accounts, for proper recording of transactions in the books of account, and for safeguarding the assets. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. The transactions with which the accounting

records have to do and the recording of those transactions in the books and accounts are matters within the direct or primary knowledge of the company; the independent auditor's knowledge of them is a secondary one, based on his examination. Accordingly, even though the *form* of the statements may show the influence of the accountant — it can do so only if the company accepts, and adopts, the form of disclosure advised by the accountant — the *substance* of the financial statements of necessity constitutes the representations of the company. The independent auditor's representations, therefore, are confined to and expressed in his report, or opinion, upon the statements. The pronouncements of the Institute to this effect have been given the added weight of general affirmation by the Securities and Exchange Commission.

The well-established custom of making test checks of accounting records and related data and, beyond that, relying upon the system of internal control after investigation, through appropriate checks, of its adequacy and effective functioning, has with very few exceptions proved sufficient for the purpose of expressing an opinion.

The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed *and cannot be relied upon* to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organized concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to attempt to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive. It is generally recognized that good internal control and surety bonds provide protection much more cheaply. On the basis of his examination by tests and checks, made in the light of his review and tests of the system of internal control, the auditor relies upon the integrity of the client's organization unless circumstances are such as to arouse his suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In no sense is the independent certified public accountant an insurer or guarantor, nor do his training and experience qualify him to act as a general appraiser, valuer, or expert in materials. Obviously his functions do not include matters of law which require the judgment of an attorney.

Responsibilities in Connection with Registrations of Securities

The responsibility of the independent public accountant with respect to financial statements and other financial data used in registration statements and prospectuses filed with the Securities and Exchange Commission has been discussed in several opinions of the Commission and is the subject of a number of its rules. Specifically, he is responsible

for the examination and review of those financial representations contained in registration statements and prospectuses as to which he undertakes to express an opinion. His responsibility relates not only to the propriety of what is set forth, but also to the inclusion of such information as is necessary to make the statements not misleading.

Section 11 of the Securities Act of 1933 as amended provides possible liability for false or misleading registration statements on the part of: "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;" (Section; 11 (a) (4)).

However, this possible liability of the accountant may not exist when: "as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of, or extract from, a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert" (Section 11 (b) (3) (B)).

Under the Securities Exchange Act of 1934, the independent public accountant's consent to the use of his name in annual reports filed with the Commission is not required. Nevertheless, the accountant has a responsibility for misleading statements.

The financial data which may appear in a registration statement or a prospectus in reliance upon the examination or review of the independent public accountant as an expert are of two general types: (1) the financial statements, usually consisting of balance sheets, statements of profit and loss and surplus, and supplementary schedules; and (2) other financial data such as earnings summaries, sales and earnings tables, historical financial information, et cetera.

With regard to the registrant's primary responsibility for financial representations in registration statements and prospectuses the Securities and Exchange Commission has said:

"The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for man-

agement's accounting of its stewardship, but as a check upon that accounting." *

and again (in requiring certification as to observance of auditing standards):

"... accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them. ..."

In view of the gravity of the responsibilities attaching to those whose opinions are relied upon in the registration and marketing of securities it is important that the language used in registration statements and prospectuses to identify financial representations contained therein should be clear in characterizing the independent public accountant's relationship to those representations.

A more detailed delineation of the views of the Commission and illustrative wording for use in registration statements and prospectuses designed to avoid the imputation of responsibility not contemplated by the act or intended to be assumed, appears in a Supplement to this Appendix in a section entitled "References to the Independent Public Accountant in Securities Registrations."

REPORTS OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The concept that management is primarily responsible for the accuracy of the financial statements and that the independent auditor can only express his opinion on them is fundamental to an understanding of the content and wording of his report.

This report varies in form. Sometimes it includes particulars as to the scope of the work, procedures followed, details of important items in the financial statements, and other material of interest. Sometimes it is limited to a concise statement of the scope of the examination, and the independent auditor's opinion, based on such examination, as to the fairness of the financial statements it accompanies.

Whether the short or the longer form is used, the standards of reporting are the same. Briefly stated, they call for an expression as to whether the financial statements are presented in accordance with generally accepted principles of accounting and whether such principles have been consistently observed in the current period in relation to the preceding period; and the inclusion of all informative disclosures not made in the financial statements which are regarded as necessary.

To avoid uncertainties in the minds of users as to the reliance which may be placed on the financial statements accompanying an independent certified public accountant's report, the membership of the Institute went on record at the November 1949, meeting as disapproving issuance of a report containing or relating to a client's financial statements without

* 4 SEC 721 (1939).

either an expression of opinion, or a disclaimer of opinion with an indication of the reason why no opinion is given.

Short-Form Report

The short form of report is customarily used in connection with financial statements intended for publication, is often included as part of a detailed report, and may be used alone wherever a more detailed report is not required.

It calls for a minimum content consisting of a representation as to the work performed, usually expressed in an opening or "scope" paragraph, and an expression, usually in a closing or "opinion" paragraph, of the independent auditor's findings as to the financial statements examined.

The opinion should be based upon an examination whose scope conforms to generally accepted auditing standards and includes such procedures as are considered necessary in the circumstances. Auditing standards, as differentiated from auditing procedures, relate to the nature and extent of evidence to be obtained, and require that "generally recognized normal auditing procedures" be applied "with professional competence by properly trained persons." Where there are specific exceptions a qualified opinion may nevertheless be expressed, provided the exception is not of such importance as to negative an expression of opinion as to the fairness of the financial statements as a whole.

Because of the weight which the independent certified public accountant's opinion accompanying financial statements carries with the investing and lending public and the responsibilities he assumes in expressing it, the importance of a reasonable uniformity in the manner of stating the opinion, both to him and to those who rely on his findings, is apparent. Experience and discussion have evolved, and the profession in general has adopted, the following where the short form of accountant's report (sometimes described as a "certificate," an "opinion," a "report," or a "report and opinion") is used:

"We have examined the balance sheet of X Company as of December 31, 19___ and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19___, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

Although a review of the system of internal control and tests of its effective performance are an important part of the independent auditor's determination of the tests and procedures he considers necessary, specific

reference to such review was omitted from the recommended form since it was covered in the reference to generally accepted auditing standards. The statement that a detailed audit was not made of transactions, previously made in many certificates, was believed to be unnecessary in view of the emphasis placed in public and professional discussion, on the test character of independent audits and the understanding that detailed audits involve prohibitive auditing costs.

While this short-form report is not always appropriate verbatim, it is recommended that the substance of its phrases be used unless inappropriate in the particular case.

The report should be addressed to the client, or to the board of directors or the stockholders of the client if the appointment is made by them or if such address is preferred. Where the selection is made by the directors and approved by the stockholders the report may well be addressed to both.

Delineation of auditing procedures followed may be included where believed to be in the interest of clear disclosure of material fact, or where it is desired to comply with the client's request for amplification; explanations may be included, preferably in a separate paragraph, of essential matters which the client is unwilling to include in the financial statements; but where any such disclosures are made by reason of any reservation or desire to qualify the opinion they become exceptions and should be expressly stated or referred to as such in the opinion paragraph.

It is sometimes desirable that exceptions be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, a specific item in the financial statements, the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception. To the extent practicable, the effect of each such exception on the related financial statements should be given.

In all cases in which generally accepted auditing procedures are not carried out, or generally accepted auditing standards are not applied, unless the items are not material, disclosure is called for in the scope paragraph, together with either a specific qualification or a disclaimer of opinion, depending upon the relative importance of the items affected, in the opinion paragraph; except that in those rare cases in which the independent auditor has been able to satisfy himself by other methods, a disclosure in the scope paragraph is sufficient.

The matters which call for specific qualification of opinion or for a disclaimer of opinion are in the final analysis matters which rest upon the judgment of the independent auditor. He must decide whether, in the particular circumstances, the possibility of error is such that it could result in material misstatement. He should bear in mind that he

has the burden of justifying any unqualified opinion, or any qualified opinion, that he expresses and that, to express an unqualified opinion, he must have reason to believe and must believe that the financial statements fairly present the financial position and results of operations and that they disclose all material facts necessary to make them not misleading. In judging the latter, he must bear in mind that a mere recital of facts is not always enough; disclosure implies adequate indication of the significance and effect of the facts upon the financial position and operating results.

Clarification of Report When Opinion Is Omitted

The presentation of financial statements on the stationery or in a report of an independent certified public accountant without a definitive expression clearly indicating the representations he is making as to their fairness tends to create uncertainties in the minds of those who do not have special information regarding the preparation of the financial statements. In such cases, these third parties have no basis for determining what inferences are warranted by the association of his name with the financial statements and may place undue reliance upon them.

Illustrative of the practices which frequently give rise to such uncertainties are the following:

1. The presentation of financial statements on the stationery of the independent certified public accountant without comment, opinion or signature; or with the assertion that the statements are "for management purposes only."
2. The omission of an expression of opinion or of a specific disclaimer of an opinion in a report of an independent certified public accountant in which financial statements and comments on the scope of the audit are included.

In the first case it is not clear whether, by his silence, the accountant intends to express unequivocal satisfaction with the financial statements or whether he intends to disclaim any opinion at all. The assertion that the statements are "for management purposes only" leaves the reader in doubt as to whether it indicates a limitation on the scope of the examination, whether it merely designates the form in which fully-approved statements are presented, or whether it has some other significance. In the second case his procedures are described but it is not clear whether or not those procedures were sufficient to permit the expression of an opinion.

Since the independent certified public accountant cannot effectively control the use to which financial statements accompanied by his name may be put, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously in the interest of all concerned and should aid in the avoidance of embarrassment and damage to the profession. Whenever, therefore, financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the

character of the examination, if any, made by him in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When he is unable to express an over-all opinion the reasons therefor should be stated. When he considers it appropriate to comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the fairness of the statements taken as a whole, he should be careful to indicate clearly the limitations of such comments to individual items in the financial statements.

The following formal statement reflecting these views was approved by the membership at the annual meeting of November 1949:

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor. To the extent the scope of his examination and the findings thereof justify, he may also comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an opinion on the over-all fairness of the financial statements. The purpose of these assertions by the accountant is to indicate clearly the degree of responsibility he is taking.

Whenever the accountant permits his name to be associated with financial statements, he should determine whether in the particular circumstances, it is proper for him to (1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole. Thus, when an unqualified opinion cannot be expressed, the accountant must weigh the qualifications or exceptions to determine their significance. If they are not such as to negative the opinion, a properly qualified opinion would be satisfactory; if they are such as to negative an opinion on the statements taken as a whole he should clearly disclaim such an opinion. His conclusions in this respect should be stated in writing either in an informal manner, as in a letter of transmittal bound with the financial statements, or in the more conventional short-form or long-form report. However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning, such as *Prepared from the Books Without Audit*, appearing prominently on each page of the financial statements is considered sufficient.

It is not contemplated that the disclaimer of an opinion should assume a standardized form. Any expression which clearly states that an opinion has been withheld and gives the reasons why would be suitable for this purpose. However, it is not considered sufficient to state merely that certain auditing procedures were omitted, or that certain departures from generally accepted accounting principles were noted, without explaining their effect upon the accountant's opinion regarding the statements taken as a whole. It is incumbent upon the accountant, not upon the reader of his report, to evaluate these

matters as they affect the significance of his examination and the fairness of the financial statements.”

EXTENSIONS OF AUDITING PROCEDURES

At the 1939 annual meeting, the membership of the Institute approved the extension of auditing procedures to require observation of inventories and confirmation of receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. These procedures were thus established as an integral part of generally accepted auditing procedures. Failure to apply them, where they are practicable and reasonable, in general precludes expression of an opinion on the fairness of the financial statements taken as a whole.

The procedures, it will be noted, must be *both* practicable and reasonable. In the province of auditing, *practicable* means “capable of being done with the available means” or “. . . with reason or prudence”; *reasonable* means “sensible in the light of the surrounding circumstances.” For example, the observation of physical inventories at the beginning of the period or year under examination would seldom, if ever, be practicable or reasonable in initial or “first” audits. However, the independent accountant must satisfy himself as to such inventories by appropriate methods.

It is believed that there are very few cases in which the additional procedures cannot be applied to inventories at the end of the period or year under examination to the extent that will permit such tests as the independent auditor, in the exercise of his judgment, determines to be reasonable.

In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.

In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the “other procedures” to be employed he must bear in mind that he has the burden of justifying the opinion expressed.

Where the procedures are applicable but are not used and he has not satisfied himself by other procedures he should, if the amount is significant, disclaim an opinion on the fairness of the statements as a whole; except that where the amount with respect to which he is unable to

satisfy himself is not sufficiently material to preclude an expression of opinion on the statements as a whole but is nevertheless important enough to deserve mention, he may make a specific exception in the opinion section of the report as to this amount.

The singling-out of these procedures for special consideration arose out of the great interest of the public and the profession in inventories and receivables as determinants of financial position and earnings. The relative space given to them herein should not be taken to mean that they are the only important procedures or even necessarily the most important. In some cases other auditing procedures may outweigh them in significance.

Inventories

The extended procedures as to inventories are as follows:

Where the independent certified public accountant intends to report over his signature on financial statements in which inventories are a material factor, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In so doing he may require physical tests of inventories to be made under his observation.

Where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date before or after but reasonably close to that date, with adequate records supporting the changes during the intervening period), it is ordinarily necessary for the foregoing procedures to be followed at that time.

Where well-kept and controlled perpetual inventory records are maintained, supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the related inventory record at least once in each year, it is satisfactory to undertake the procedures outlined at any interim date or dates selected by the independent auditor, his purpose being to satisfy himself as to the credibility of the perpetual inventory records and the reliance that may be placed on them in supporting the inventory totals as shown in the balance sheet.

In the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from the custodians is acceptable provided that where the amount involved represents a significant proportion of the current assets or of the total assets, supplemental inquiries are made to satisfy the independent auditor as to the bona fides of the situation.

The independent auditor does not "take," "determine," or "supervise" the inventory. These operations are undertaken by management, antecedent to its primary representations concerning quantity, condition, and value. He observes and tests these procedures in his capacity as independent auditor, but he does not, and should not in his ordinary capacity as an independent auditor, make the original determination. He gives consideration to the effectiveness of the internal control as applied not only to the book records but also to the procedure of taking physical inventories. His functions do not include those of a general appraiser, valuer, or expert in materials.

Application of these procedures is greatly facilitated when concerns adopt their natural business year instead of the calendar year as their fiscal year, and use continuous, well-kept perpetual inventory records.

**Inventories of Department Stores, Installment Houses,
Chain Stores, and Other Retailers**

Notwithstanding the great variety and volume of merchandise comprehended in inventories of clients falling within these categories, it is believed to be practicable and reasonable for the independent auditor to participate by suitable observation at the time inventories are determined by physical count by the client, or to require physical tests of inventories to be made under the independent auditor's observation. The method, extent, and time of applying these procedures necessarily will vary with the circumstances, and they will be undertaken in addition to the usual auditing tests and checks of the inventory accounts and records with due consideration of the effectiveness of the internal control, as applied not only to book records but also to the procedure of taking physical inventories.

Distinction should be made between large institutions with a great number of branches or departments and the more compact organizations, because volume of transactions requires more than ordinary division of duties, affording the opportunity for more effective internal control. In the larger organizations the observation or tests of physical inventories may well be limited to a relatively small number of branches or departments. The larger the number of branches or departments and the more effective the internal control, the smaller may be the percentage to be covered. In unusual cases quite a small percentage may well be proper.

While obviously no pattern of inventory observation can be devised which will suit all situations, reference to the case studies appearing in the Supplement to this Appendix will provide illustrative material.

**Inventories in Interim Financial Statements
And the Independent Auditor's Report Thereon**

An important problem which affects a considerable segment of the profession concerns the opinion, if any, which may properly be ex-

pressed in the independent certified public accountant's report covering interim monthly financial statements in those situations where audits of the usual scope are made on either a semiannual or an annual basis in accordance with generally accepted auditing standards, but where on other interim dates one or more procedures are omitted, such as, for example, the observation of inventories or the confirmation of receivables.

The major question presented concerns the procedures necessary, in addition to the audit of intervening transactions incident to the usual periodic interim examination and to the examination of the regular semiannual or annual financial statements, in order that the independent auditor may be in a position to furnish an opinion as to the interim statements.

Where there are well-kept and controlled perpetual inventory records the observation of quantities may be undertaken at a date other than that of the balance sheet; or it may be staggered throughout the year if the client takes physical inventories of individual items from time to time so that the quantity of each item on hand is compared with the related perpetual inventory record at least once in each year. If this is done no exception as to the scope of the interim examination with respect to inventory quantities is necessary. However, where "well-kept and controlled perpetual inventory records" are not tied in with the inventory control accounts maintained in dollars, it is essential that they be so tied in as of the balance sheet date or some date reasonably close to it.

Need for exception as to the scope is also avoided where the regular inventory procedures are complied with at a date either before or after that of the interim financial statements, but within a reasonable time thereof in the light of the rapidity of turnover and adequacy of the records supporting the interim changes. Execution of the customary procedures at a date or dates other than that of the balance sheet with respect to these as well as other items, where appropriate, should be encouraged as a means of spreading the work and reducing year-end pressure.

Where an opinion is to be expressed the standards of auditing procedure applicable to regular semiannual and annual statements are likewise applicable to interim statements, not only as to inventories but as to other items in the financial statements such as securities, bank balances, liabilities, et cetera; though with the closer contact and greater familiarity with the business which periodic interim examinations provide, it may be unnecessary to carry through the customary procedures in as complete detail at interim dates as at the year-end.

Receivables

The extended procedures as to receivables are as follows: Where the independent certified public accountant intends to report over his sig-

nature on financial statements in which notes and accounts receivable are a significant factor, confirmation by direct communication with the debtors shall, where practicable and reasonable, be a part of generally accepted auditing procedures; the method, extent, and time of obtaining such confirmations in each engagement, and whether of all receivables or a part thereof, shall be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Methods of Confirmation — Positive and Negative

The *method* of confirming receivables in each engagement is among the matters left to the judgment of the independent certified public accountant.

Generally speaking, there are two types of confirmation requests — positive and negative. The positive form is a communication addressed to the debtor asking him to confirm to the independent auditor the accuracy of the balance shown, or state wherein it is inaccurate. The negative form is a communication addressed to the debtor asking him to reply only in case the amount stated is incorrect.

Where there is reason to believe that the possibility of disputes, inaccuracies, or irregularities in the accounts is greater than usual, or that the request will fail to receive consideration, or where the balance involved is of outstanding materiality, it is usually desirable that the positive method of confirmation be adopted. For example, the positive method is used in requesting confirmation of receivables of stock brokerage houses. And where a substantial portion of a client's output is sold to one customer or to only a few customers so that the balances involved are of relatively major importance, the positive method seems clearly preferable.

On the other hand it is believed that, where there are no indications that it may be inadequate, use of the negative method conforms to generally accepted auditing standards in the majority of situations.

Not infrequently both methods are used in the same engagement — the positive as to accounts where a definite reply is regarded as desirable and the negative where this need does not exist.

When positive confirmations are sought it is usually impossible to secure responses to all requests; even in audits of stock brokerage houses, where the requests are usually followed up more actively than in the ordinary case, it is rare that replies are received to all the requests mailed.

The adequacy of response to requests for positive confirmation is usually judged by comparing the number of replies received and the total amount represented by them with the number and total amount of the accounts for which confirmations were requested, after taking into account the nature of the replies and the situations they disclose. The percentage of replies, experience has shown, varies considerably with the type of customer. The independent certified public accountant must

assume the responsibility for deciding whether the nature and extent of response, taken in conjunction with his other auditing procedures, constitute a satisfactory basis for his opinion as to the bona fides of the receivables. This is a matter for the exercise of his judgment in each case. If he does not consider the confirmation results to be satisfactory he should pursue the matter further, either by communicating again with those who have not replied or by adopting alternative procedures of the nature described in a subsequent section entitled Receivables from the United States Government.

**Receivables of Department Stores, Installment Houses,
Chain Stores, and Other Retailers**

Question might justifiably be raised as to the reasonableness of applying the *positive* form of confirmation to receivables of department stores, installment houses, chain stores, and other retailers, but it is believed that no question exists as to the practicability and reasonableness of using the *negative* confirmation form which requires no reply unless the recipient challenges its showings. When dealing with housewives, as is the case in department stores particularly, the negative form is more practicable than the positive, as it does not require specific reply if the balance shown is correct, yet places the recipient definitely on notice that the independent auditor assumes the correctness of the balance unless the debtor objects within a reasonable time.

Distinction should be made between small institutions and those with receivables which may run into tens of thousands of items, because in the latter the very mass of the accounts requires more than ordinary division of duties, connoting usually more effective internal control. Confirmation of receivables by a selective test, where the conditions justify it, is within the contemplation of the prescribed procedures. The larger the mass, the smaller the average amount, and the more effective the internal control, the smaller, as a rule, may be the percentage of confirmation. In unusual cases quite a small percentage may well be proper.

**Receivables in Interim Financial Statements
And the Independent Auditor's Report Thereon**

Interim statements present a problem for a considerable number of practitioners in connection with receivables—a problem as to what opinion, if any, may properly be expressed in the independent auditor's report covering interim monthly financial statements in those situations where audits of the usual scope are made on either a semiannual or an annual basis in accordance with generally accepted auditing standards, but where on other interim dates the confirmation of receivables is omitted. As in the case of inventories, the question concerns the procedures necessary to enable the auditor to furnish an opinion with respect to the interim statements.

Frequently the conditions surrounding a particular engagement may be such as to warrant, or even make desirable, the staggering of the confirmation process throughout the semiannual or annual period. If this is done in an acceptable manner and the results are satisfactory, necessity for exception as to the scope of the interim examination respecting confirmation of receivables is removed.

Where the regular procedures in connection with receivables are complied with at a date either before or after that of the interim financial statements, but within a time considered to be reasonable on the basis of rapidity of turnover and adequacy of the records supporting the interim changes, again the necessity for exception as to the scope is eliminated. Execution of the procedures at a date or dates other than that of the balance sheet will have the incidental but valuable advantage of reducing year-end pressure.

Receivables from the United States Government

In view of the procurement conditions under which United States Government departments and agencies are sometimes required to operate they have at times expressed their inability to confirm amounts stated in requests for confirmation. The negative form of confirmation should not be used where the independent auditor has reason to believe that the request will fail to receive consideration and that he will not be notified if the amount stated in the request differs from the amount shown on the debtor's records.

In any case in which receivables from United States Government agencies or departments represent a significant proportion of the current assets or of the total assets of a concern and confirmation by direct communication with the debtors has not been accomplished, omission of the procedures should be disclosed in the general scope section of the report, and, depending upon the circumstances, may require specific qualification or denial of an opinion.

In many, and perhaps most, cases the independent auditor may be able, by reference to shipping records, contracts, correspondence, or other documentary evidence, or evidence of subsequent collection, to satisfy himself on a test basis as to the validity of these receivables. In such cases his disclosure of inability to secure confirmation may well be accompanied by a statement that he has satisfied himself by other means. Both purposes may be accomplished by changing the sentence regarding conformity with generally accepted auditing standards contained in the report so that it will read somewhat as follows:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; however, it was not practicable to confirm receivables from United States Government departments (and agencies, if applicable), as to which we have satisfied ourselves by means of other auditing procedures."

It is obvious that in these circumstances no exception need be taken in the opinion section of the report.

There may be cases in which, due to the particular circumstances, the independent auditor may not be able to satisfy himself by other methods as to such receivables. In those cases he must decide in the light of the circumstances whether the situation properly can be covered by taking a specific exception, as to the items involved, in the opinion paragraph; there may occasionally be situations in which the exception is of such a nature and so material in relation to the financial position and results of operations that he would be required to disclaim sufficient basis for the expression of an informed opinion regarding the financial statements as a whole.

CONCLUSION

As explained in the historical preface, this codification is not designed to serve as a compendium of audit procedures, since it deals only with such aspects of auditing as have from time to time, because of public interest or new developments, required special study or affirmation. It is intended to serve as a guide in certain of the many situations found in practice which call upon the independent certified public accountant for the exercise of judgment, and to supplement the material contained in other publications of the committee on auditing procedure and in the profession's considerable store of textbooks.

The case studies, comments on certain governmental regulations, and other reference material included in the following Supplement will, it is hoped, furnish further guidance.

Supplement

CASE STUDIES IN INVENTORIES

It should be recognized at the outset that no generalization can be made as to "procedures usually followed" in inventory observation. Each case is individual and is governed by circumstances. These case studies are illustrative, therefore, only for the particular conditions recited in each.

I. Materials Stored in Piles (Scrap Iron, Iron Ore, et cetera)

What can the independent auditor do to satisfy himself that quantities of materials stored in piles have been fairly determined where external measurement or survey of the piles may be inadequate for the following reasons: (1) the ground on which the pile rests may not be level; (2) the material may comprise both heavy and light metal, making it impracticable to use a common measure of weight per unit of volume; (3) the extent to which the pile has sunk into the ground may not be determinable; or (4) the density of the pile may not be uniform because a variety of shapes has caused uneven packing?

While physical tests of quantities by the independent auditor would not be practicable and reasonable in such circumstances, there may nevertheless be other factors which may guide him in either accepting or declining to accept the representations of his client.

One such factor may be the client's method of handling and accounting for the piles. A company, for instance, may operate more than one pile of material under an arrangement whereby no pile is increased by adding more material after withdrawals of materials have once started. In this way, one or more piles will continuously grow by receipts without any diminution by withdrawals, while a previously completed pile will be drawn upon. Every pile in turn will be completely liquidated, and a check can then be made upon the accuracy of the record of its content and usage.

Under such conditions the independent auditor would have available for his examination information showing adjustments which have been necessary in the past with respect to completely used piles. This will be valuable evidence bearing on the accuracy of the records and on the credibility of the management's representations based thereon. His further examination would include auditing tests and checks of the stock-pile records to the extent indicated by the internal control.

On the other hand, a company may operate one or more piles, each of which may undergo concurrently additions and withdrawals. In such a situation the company's procedure does not permit adequate periodic

corroboration of stock-pile records, and this fact should be suitably disclosed if the amount is material and there is not adequate supporting evidence of some other character by means of which the independent auditor can satisfy himself.

II. Inventories of Packaged Materials (Barrels, Boxes, Or Bags)

Stacked in Solid Formation

What, if any, special procedures should an independent auditor adopt in the case of large quantities of packaged materials stacked in solid formation?

Where packaged materials contained in barrels, boxes, or bags are stacked in a solid formation of considerable width and depth a condition is created which is conducive to fraud by means of a so-called "hollow square" within the allegedly solid formation.

It should be borne in mind that physical stock-taking is not the sole evidence on which the auditor bases his opinion. The physical stock-taking and the records are complementary and each is corroborative of the other. Where the records are defective or are not supported by adequate internal control, the physical inventory is the principal source of reliance. On the other hand, where the records and internal control are good and especially where staggered inventory checks are made, the physical inventory is primarily a check on the records. The possibility of fraud under such conditions is minimized.

Such a situation is illustrated by the case of a sugar refinery which kept its raw sugar, in bags, in separate piles for each lot and had received into its bonded warehouse within two weeks of the inventory date a cargo of raw sugar. Here the independent auditor had the evidence of the stock records, the receiving records, the invoice, and other documents as to the quantities involved. He was also satisfied from his inquiries in the warehouse that the sugar had only recently been received and put in its present location. By means of this evidence and his own inspection he was able to satisfy himself without further precautions against a hollow square.

In other circumstances, where the amount of the inventory involved is material and where the corroborative evidence is not so strong, it may be the inescapable duty of the independent auditor to inspect the merchandise from above or to require the client to move enough of the goods in solid formation, preferably before count, to preclude the possibility of the existence of a hollow square. This type of inventory situation emphasizes the need for planning by the independent auditor with the client as far in advance of the inventory date as possible.

It is not feasible to set up uniform inventory procedure which will apply in all cases.

The procedure must be determined by the exercise of judgment in the light of the circumstances of each case.

III. Chain Stores

What audit procedures have been followed by independent auditors in their observation of the taking of physical inventories of: (a) grocery chain stores; (b) chain stores selling miscellaneous merchandise at prices from five cents to one dollar and generally known as variety chain stores?

In considering the inventory problems which arise in examinations of the accounts of all types of chain stores, distinction must be made between chains with a relatively efficient system of internal control through head office organization and records or other means, and chains whose system of internal control is limited. The scope of the examination will depend to a considerable extent on this factor.

In chain store organizations with a large number of stores or units, it is not practicable and reasonable for the independent auditor to observe inventory-taking at many locations. He must, therefore, adopt a plan through which he can satisfy himself as to the authenticity of the inventory records.

Practically all the larger grocery chain store organizations maintain inventory controlling records at their head offices and have close control by dollar amounts of inventories at individual locations. The procedures outlined below were adopted in an examination of the accounts of a grocery chain which operated over eight hundred stores served by a single central warehouse, and had an adequate system of internal check and control. It maintained control of the store inventories by the retail method, charging each store's inventory account with the selling price of merchandise shipped to the store and crediting it with sales proceeds, price reductions, et cetera. In this instance the company employed inventory crews who at least three times a year visited all the retail stores without previous notification to the store managers and inventoried the stocks at retail prices. The total amount of the inventory as reported by the inventory crews was compared at the head office with the store's inventory account. If a large shortage or overage developed, further investigation was made. In addition, at the end of the fiscal year each store manager under the general supervision of a district manager took a physical inventory, also at retail prices.

The independent auditors satisfied themselves as to the existence of the stores by noting evidence of the deposit of store sales, by reference to inventory crew reports on inventories taken, by review of tax records, or by other available means.

Having in mind the average store inventory of not more than \$5,000, the reliability of the book-inventory records, and the continuous check made by inventory crews, the independent auditors did not consider it necessary to visit the retail stores to satisfy themselves further as to the authenticity of the records, but, for the sole purpose of observing inventory methods followed, they did visit a few of the stores during stock-taking. At the fiscal year-end they also observed the taking of the central

warehouse inventory, which comprised a large percentage of the total inventory.

Their examination at the head office included a test-check of store inventory accounts, particularly the controlling account, to determine that goods shipped had been charged to the stores and that goods reported as sold and credited to the stores had been properly accounted for in cash or otherwise.

On the basis of the operating methods followed and the evidence provided by the foregoing tests the independent auditors were satisfied as to the reliability of the inventory records.

Inventory procedures followed in the examination of the accounts of a grocery chain operating about two hundred stores were somewhat similar to those outlined above. The average store of this chain had an inventory of about \$2,000 while the supermarkets had an inventory of from \$10,000 to \$15,000, with rapid turnover in both types of store. In this instance the head office records and control were good but the work of the inventory crews was not so well organized as in the case of the larger chain. It was therefore deemed advisable to visit ten representative stores during the course of the periodical inventory check made by inventory crews, or during the year-end stock-listing for the purpose of observing or reviewing the inventory procedures.

Inventory procedures in variety chain stores generally differ from those used by grocery chains for the principal reason that the inventories usually consist of a much larger variety of items and have a greater value. Frequently also variety chain stores do not follow the "retail method" of inventory control, and do not as a rule utilize the services of inventory crews to make checks throughout the year. Instead they usually rely in the main upon physical inventories taken at the year-end by the store manager, assisted by office, store, and stockroom employees.

The procedures outlined below were those adopted in an examination of the accounts of a company operating about two hundred variety stores. All store managers were notified to expect, after or during physical stock-listing, visits from head office representatives, and possibly also from the independent auditors. Head office representatives, or managers of other stores acting in their stead, visited all the stores and made test checks of quantities, prices, condition, et cetera, and mailed or delivered the inventory sheets to the head office. Store managers who visited other stores for the test check were not notified of the location of their assignments until the day of their departure. These measures were designed to provide internal control in the inventory-taking and protection against the possibility of collusion.

The independent auditors visited certain of the stores without previous notification to store managers as to the stores to be visited. In such instances, while co-operating with the company representatives who were assigned to the store to test-check the quantities and mail the inventory sheets, the independent auditors were primarily interested in observing

the methods adopted by the company and satisfying themselves that the protective measures provided were carried out. In view of the careful organization necessitated by the larger number of stores, the protective methods and control exercised by the head office in the inventory-taking, and the primary purpose of the independent auditors' attendance at the stores, visits to eight or ten of the stores were considered in this case to be sufficient.

IV. Department Stores

What audit procedures have been followed by independent auditors with respect to observation of inventories of department stores?

Inventory-taking in the large department store differs from that in grocery chain and limited-price variety chain stores principally in that the entire department store inventory is not customarily taken in a single day or even in several succeeding days. In a store whose fiscal year ends on January 31 it may be customary to inventory furniture, other heavy goods, and certain other merchandise immediately after Christmas, to inventory a number of other departments during January and to inventory the remaining departments, representing the bulk of merchandise, during the last week of January, but usually not on January 31. In addition to the merchandise on the sales floor which is inventoried at retail prices, there will be other merchandise inventoried at retail prices in the departmental reserve stock rooms in the store, as well as in one or more warehouses which may be at some distance from the store; and there may also be advance purchases for coming seasons (usually in the warehouses) which have not been marked and will be inventoried at cost. In some stores the retail inventories of a number of departments handling expensive merchandise, such as furniture and furs, are supplemented by unit-control records; in such departments the pricing may be done from the unit control records rather than from the merchandise itself.

In one large department store, before commencing his audit, the independent auditor agreed with the controller upon the plan of inventory-taking. The physical count, it was arranged, would be supervised and controlled by the controller rather than by the merchandise manager. Prior to inventory time, prenumbered sheets or tags were distributed to buyers in accordance with their requirements, based upon plans submitted showing prenumbered shelves, tables, and other fixtures. The physical count was made by teams of two employees; the one most familiar with the stock called and the other listed, the sheets being left in the fixtures until all listing was completed. When all stock had been listed a representative of the controller's office made independent test counts of a portion of the inventory, selecting the items in a manner to insure the testing of a representative cross section of the entire stock on hand. The sheets were then gathered by the buyer or his assistant under

the supervision of the representative of the controller's office and were turned over to the controller for extension and footing. In large departments where the inventory was not taken in a single day, the stock in the reserve stock rooms and in the warehouses was inventoried as closely as possible to the day on which the floor stock was counted and precautions were taken to guard against a double listing by reason of the transfer of stock from reserve rooms or warehouses to the floor during the inventory process.

As a precaution against change in quantities, in departments for which the pricing was done from unit-control records, the sheets were under the supervision of the controller's office while the prices were being inserted. Pricing of advance purchases was done in the controller's office.

On the days of inventory-taking the independent auditor had present a number of representatives (the number depending on the size of the store) to observe that the inventory methods agreed upon were complied with and that test counts were made by representatives of the controller's office. The independent auditors did not make test counts themselves of any portion of the inventory, their work being limited to observing that the planned procedures outlined were followed.

In another large department store the merchandise was listed by employees of each department on inventory sheets which were then placed with the merchandise on the counter or in the bin, drawer, et cetera. Inspectors appointed from members of the store's staff not connected with the handling or sale of merchandise made test checks by comparing the quantities shown on the inventory sheets with the quantities on the counter, in the bin, et cetera, noting that the season letter, retail price, and so forth, were correctly entered.

The independent auditors visited each department of the store after the merchandise had been listed but before the inspectors had completed their test check. Certain of the items tested were listed by the independent auditors for subsequent comparison with inventory sheets and with merchandise on the selling floor. After all tests were completed, the inventory sheets were "pulled" by the inspectors, care being taken to place them in the custody of designated persons not connected with the handling of merchandise until the total amount of the inventory, by season letters, of each department could be computed. In this particular examination the inventory sheets were sent to an outside independent calculating company for computation. The calculating company furnished the independent auditors with a certificate and a summary showing the total dollar value of the inventory by departments.

The dollar amounts of the items and dollar footing of each inventory sheet were not large. Further, it was found that adequate control could be exercised through comparison of overage and shrinkage figures and other data. Under these circumstances the independent auditors deemed it necessary to make only minor test checks of the extensions and footings

of the individual inventory sheets. The total inventory for each department, at retail value, as shown by the inventory summary, was compared with the related inventory controlling account. If a substantial unexplained difference was revealed the inventory of the department was retaken.

CONFIRMATION OF PUBLIC UTILITY ACCOUNTS RECEIVABLE

The XYZ Corporation is a utility with a satisfactory system of internal control and has approximately fifty thousand residential, commercial, rural, industrial, and other customers. Is it practicable and reasonable to communicate directly with these customers as a matter of regular procedure in the examination of the company's financial statements, and if so, how extensive should the confirmation be?

The total receivables of utilities usually average 2% of all assets and about 10% of annual revenues. Accumulations of receivables materially beyond these percentages result from unusual conditions and would evoke inquiry, apart from the question of confirmation. The average account balance for all accounts receivable of utilities seldom averages more than \$10 a customer.

It is desirable to discuss the receivables under two general categories, namely:

- A. The large accounts — municipal, other utilities, industrial, and miscellaneous.
- B. The "mass" accounts — residential, commercial, rural, and merchandise.

Experience indicates that on the average a little less than half the total electric utility receivables is represented by the first group consisting of industrial and other large accounts, and that for utilities other than electric the proportion is usually smaller.

It is recognized that in many utilities these two categories are not carried in separate general ledger control accounts. However, most utilities maintain sufficient subdivisions in the detail records to permit such a classification.

A. The Large Accounts — Municipal, Other Utilities, Industrial, and Miscellaneous

The large accounts are carried with organizations which maintain adequate records and accordingly are in a position to express an informed opinion on the correctness of charges made against them. The methods of computation for service rendered to these customers are often very technical, complicated, and difficult to test check. While internal control is important and must be considered, it cannot be relied upon as greatly by the independent auditor to serve his purposes as in the case of "mass" accounts discussed later. Furthermore, because of the size of individual accounts it is possible for irregularities, if any exist, to be confined to relatively few accounts. Accordingly, the extent of confirma-

tion of these receivables should be similar to that of the accounts of an industrial enterprise where comparable conditions prevail.

B. The "Mass" Accounts — Residential, Commercial, Rural and Merchandise

Many factors distinguish this class of accounts from those of the first group. The average number of "mass" accounts of a utility is very large in relation to the gross revenues and varies from a few thousand in a small utility to hundreds of thousands in the larger organizations. Individual balances average a few dollars each; even including merchandise installment accounts, an average of under \$10 a customer is ordinary. Because utilities follow the policy of disconnecting service if the "mass" accounts are not promptly paid and in many cases grant more than ordinary discounts for prompt payment, the total amount of service receivables not derived from the current month's billings is generally not significant.

The characteristics of these accounts create a large volume of small and simple repetitive operations which require special skill and efficiency for economical performance. As a result these operations are ordinarily assigned to separate employees or departments which operate independently of one another. In the particular case under consideration it was found that the more important separation of duties among employees and departments is as follows:

1. Installation and removal of meters or stations.
2. Meter reading.
3. Billing and maintenance of receivable ledgers.
4. Receiving payment on accounts.
5. Investigation and collection of delinquent accounts.

In addition to the above segregation of major duties among independent departments or employees, further secondary checks are employed, such as rotation of meter readers among routes, checking of new accounts against those previously written off, maintenance of control accounts by employees other than those assigned to detail accounts, requirements that vacations be taken by cashiers, and approval of discounts forfeited.

These segregations of duties among disassociated employees create an internal control which prevents any particular employee from controlling a sufficient number of the operations to conceal material irregularities, and assures essential accuracy and the absence of any but minor irregularities. In reviewing such systems, the presence or absence of a particular feature of the system should not be stressed unduly unless it is likely to be the source of a fundamental weakness. It is the effectiveness of the system as a whole which is important in justifying reliance upon the accounts.

Where applicable, controls essentially comparable with the foregoing are also maintained over merchandise receivables. The company collects

merchandise installments as part of its monthly bill for service and, in addition to disconnecting service if the monthly bill is not paid, follows the practice of repossessing the merchandise after an installment is thirty days overdue. The amount of overdue accounts is consequently negligible.

Experience gained from review and test checks of systems of internal control, such as the one described, indicates that the "mass" accounts receivable balances maintained by most utilities are reliable for financial statement purposes, and that where the system in operation is good, test confirmation for the purpose of checking the credibility of the company's representations as to their authenticity is not necessary.

Where the conclusion reached in a specific case is that the system in operation is good, experience has nevertheless indicated the desirability of making a small sample circularization as an additional check upon the functioning of the internal control. In the case of the XYZ Corporation, which has a satisfactory system of control and approximately fifty thousand "mass" accounts receivable with customers, approximately half with unpaid balances, it is believed that confirmation of a few hundred accounts will be adequate for this purpose. It is also believed that, in view of the purpose of the test, which is to provide an additional check upon the functioning of the internal control, such a test confirmation is desirable even when test confirmations are made by the utility's internal auditors.

Division of duties comprising internal control will vary among utilities according to type of utility and concentration of activities. It should be borne in mind that where a satisfactory system of internal control does not exist, a larger portion of the accounts should be confirmed, the extent being dependent upon the circumstances of the particular situation.

REFERENCES TO THE INDEPENDENT PUBLIC ACCOUNTANT IN SECURITIES REGISTRATIONS

In defining its concept of the independent public accountant's responsibility the Securities and Exchange Commission has clearly indicated that it concurs in the Institute's view that the registrant is primarily responsible for the financial representations; that the independent public accountant's responsibility is limited to an expression of his professional opinion; and that he cannot properly undertake to express such an opinion except on the basis of an adequate examination conducted with professional skill and acumen.

In its statement accompanying Amendment 3 to Regulation S-X the Commission discusses in detail its requirements respecting the independent public accountant's opinion. Rule 2-02 of Regulation S-X now provides:

"(a) Technical requirements

"The accountant's certificate shall be dated, shall be signed manually, and

shall identify without detailed enumeration the financial statements covered by the certificate.

“(b) Representations as to the audit

“The accountant’s certificate (i) shall state whether the audit was made in accordance with generally accepted auditing standards; and (ii) shall designate any auditing procedures generally recognized as normal, or deemed necessary by the accountant under the circumstances of a particular case, which have been omitted, and the reasons for their omission.

“Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

“(c) Opinions to be expressed

“The accountant’s certificate shall state clearly:

“(i) The opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

“(ii) The opinion of the accountant as to any material changes in accounting principles or practices, or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and

“(iii) The nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

“(d) Exceptions

“Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.” *

It is important that language used in registration statements and prospectuses to identify financial representations presented therein should avoid imputing to the independent certified public accountant responsibility greater than that contemplated by the Act or intended to be assumed by him. When financial statements are thus referred to by the registrant, language comparable to the following should be used:

“The following financial statements and schedules have been examined by _____, independent certified public accountants, whose report with respect thereto appears on the following page.”

This statement may be supplemented, if desired, by a phrase “and such financial statements and schedules have been made a part of this registration statement in reliance upon the report of such firm as experts” or “and such financial statements and schedules have been made a part of this registration statement with the authority of the report of such firm as experts.” The purpose is to state that the accountant in his capacity as an independent expert has examined the financial statements, which are, however, the representations of the registrant, and to direct attention to the opinion of the accountant, which should be read in

* SEC Accounting Series Release No. 21.

conjunction with those representations. The language used should avoid such phrases as "has been prepared by____, independent certified public accountants," or "are stated on the authority of such firm as experts."

Earnings Summaries

Earnings summaries, sales and earnings tables, historical financial information, et cetera, as included in registration statements and prospectuses are, for the most part, extracts or summaries of information contained in financial statements included therein, or in previous reports issued by the company.

In Accounting Series Release No. 62 the chief accountant of the Commission comments as follows on the independent public accountant's responsibility for summary earnings tables:

"Summary earnings tables included in registration statements are not required by the Commission's rules to be certified by independent public or independent certified public accountants. It is, nevertheless common practice to introduce the summary with language indicating that it has been 'reviewed' by independent accountants.

This use of an accountant's name in connection with a summary earnings table is designed and tends to give added authority to the material presented. It is important, therefore, to consider the extent of the examination to be made by the accountant in such cases and the extent of the responsibility which he as an expert accountant can properly assume. . . .

Clearly, the mere summarization of detailed financial data prepared or presented by others does not involve most of the fundamental accounting and auditing skills customarily and properly relied upon as giving additional weight to financial statements certified by independent public accountants and adds nothing to the reliability of the underlying information.

In view of the foregoing it is my opinion that it is generally improper and misleading for an accountant to permit his name to be used in connection with any period covered by a summary earnings table or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. When the independent accountant has been the auditor for the company throughout the entire period covered by the summary, and his several examinations conformed to generally accepted auditing standards, he would ordinarily need to make only such additional review as would be necessary to satisfy himself as to whether any recasting of the statements originally prepared would be necessary to reflect transactions and adjustments recorded in later years but clearly applicable to prior operations. If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for him to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first two years of the

3-year certified profit and loss or income statement included in the registration statement.*

In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with a summary earnings table there remains to be considered the form in which he should indicate his opinion. Under the rules promulgated by this Commission, the customary method used by accountants in expressing their expert opinion takes the form of a certificate conforming to the requirements of Rule 2-02 of Regulation S-X. Such certificates make appropriate representations as to the work done, state the opinion of the accountants as to the fairness of the statements presented, and describe clearly any exceptions which the accountants may wish to take. Since, as pointed out earlier, summary earnings tables are a species of income statement it would appear that the accountant's certificate thereon should assume a comparable form, and should be included with the summary or made a point of his report as to the 3-year certified statement. If exceptions have been taken by the accountant with respect to any of the information contained in the summary earnings table, special care should be exercised in selecting the language used to introduce the summary to indicate clearly that such exceptions exist and to direct attention to the opinion of the accountant."

From the foregoing it appears that the independent certified public accountant should not permit reference to his name as giving weight to any part of a summary earnings table included in a registration statement or prospectus as to which he has not performed such auditing procedures as would justify his expressing an opinion; and that his opinion as to years not covered by the financial statements included in the registration statement, where expressed, may take the form of a separate certificate included with the summary or be included in the certificate relating to the financial statements.

In referring to summaries of earnings, statements such as the following may be used:

1. "The following summary of earnings, except for the unaudited data for the _____ months ended _____, has been examined by _____, independent certified public accountants, whose opinion with respect thereto is contained elsewhere herein. The figures for the _____ years ended _____ should be read in conjunction with the financial statements contained elsewhere in this prospectus."
2. "This summary of earnings is based, as to the three years ended _____, upon income statements appearing elsewhere herein, and as to the two years ended _____, upon income statements included in the company's annual reports to stockholders. The earnings figures for the _____ months ended _____ have been compiled from the books of the company (amended as indicated in Note _____) and have not been reviewed by independent certified public accountants. The summary should be considered in conjunc-

* "It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

tion with its footnotes and Notes to Financial Statements appearing elsewhere herein, and, as to the five years ended _____, is covered by the certificate of _____, independent certified public accountants, contained elsewhere in this prospectus."

3. "This summary has been prepared from financial statements included in annual reports to stockholders, as examined by _____, independent certified public accountants, and is presented herein in reliance upon the reports of said firm as experts. The figures shown for the three years ended _____ should be considered in conjunction with the more detailed information contained in the financial statements, with notes thereon, and with the report of _____ included elsewhere in this prospectus."
4. "The following summary of earnings has been prepared from financial statements previously examined by _____, independent certified public accountants, with respect to the eight years ended _____, and from financial statements included herein as a part of this prospectus with respect to the three years ended _____. The information for the three years ended _____ should be considered in the light of the financial statements and related notes in this prospectus. The summary of earnings for the eleven years ended _____ has been reviewed by _____ for the company and is included herein in reliance upon the report of such firm as experts in making such review. The figures for the _____ months ended _____ have been compiled by the company from its records."

Such language directs attention to the fact that, insofar as the data have been prepared from financial statements examined by the independent certified public accountant, they should be used and interpreted in conjunction with the complete financial statements and his opinion thereon as reflected in his reports related thereto or contained elsewhere in the prospectus. Language which suggests that the summary "has been prepared by _____, independent certified public accountants," or is given "on their authority as experts" should not be used, since it may, when linked with or specifically referred to in his consent to the use of his name, be interpreted as meaning that the accountant has responsibilities respecting the representations made other than those contemplated by the Act or than he intends to assume.

Whenever the independent certified public accountant consents to the use of his name in reference to summaries of earnings, other summaries, or historical financial information, he should take the responsibility for a fair summarization or presentation. In certain circumstances this may involve more than a cross reference to the detailed statements. The basic objective is, of course, that the summary should be so constructed that there will be no materially different interpretation thereof from that obtained in the consideration of the detailed statements. In any case where the independent certified public accountant's name is used in reference to summaries of earnings for prior years not included in the registration statement, he should review the results for those years to determine whether the information previously published requires change due to substantial retroactive adjustments and whether explanatory footnotes may be necessary.

CLIENTS' WRITTEN REPRESENTATIONS REGARDING INVENTORIES, LIABILITIES, AND OTHER MATTERS

A survey made in 1941 for the purpose of determining the form and content of written representations obtained by practicing independent certified public accountants from their clients produced considerable information which should be useful as reference material to accounting practitioners.

Fifty-two public accounting firms, large and small, partners of which are members of the Institute, contributed to the survey.

Many of the moderate-sized and smaller firms which require written representations from clients respecting inventories and liabilities do not require them in every engagement and do not use special forms. The material covered varies widely and certain aspects are covered in the inventory form of one firm and in the liability form of another. While the language used shows little similarity the purpose and desired effect are uniform.

The practice of requiring a comprehensive written representation covering practically all items in the balance sheet is limited to some of the larger firms, but those which use it are of sufficient coverage that a description of these representations is desirable.

The information shown by written representations would have to be obtained, where pertinent, either orally or in writing. Reducing it to writing provides evidence, avoids misunderstandings, and has the additional advantage of reminding the client of his primary responsibility for the correctness of the statements. There is no evidence that the representations are regarded as relieving the independent auditor of any of his audit functions or responsibilities. The purpose is rather to secure the active co-operation of the client. They complement, rather than substitute for, a proper examination, and every practicable means should be used to substantiate the information developed by the inquiries.

Information regarding liabilities obtained from the client's legal counsel, however, is in a different category. If the client's legal counsel states that he knows of no contingent liabilities in respect to litigation, it appears that the independent auditor is entitled to rely on his statement.

Preparation of standard forms for general use is not considered feasible but it is believed that a summary of practice will be useful in assisting the independent certified public accountant to compare his usage with that of other practitioners or to revise his present forms or devise others to meet his individual needs.

Presented herewith are:

1. Skeleton form of representation covering inventories and notes thereon.
2. Description of representation covering liabilities.
3. Description of comprehensive representation.

Written Representation Covering Inventories

Blank Company,
Certified Public Accountants,
Blank Street, City

Dear Sirs:

In connection with your examination of the accounts of (blank company) and more particularly in connection with your examination of the (blank company or department) as at (blank date), we hereby make the following statements and representations concerning inventories of (blank company):

- A. Quantities and Amounts
- B. Title and Ownership
- C. Prices and Calculations
- D. Commitments
- E. Condition

The foregoing constitutes a fair statement of quantities and valuations of the respective inventories as at (date as of which audit is made) to the best of the knowledge and belief of the undersigned.

(Signature)

(Date signed)

Notes On Written Inventory Representation**General**

The representation may be prepared for one or for several classifications of material, as raw materials, goods in process, finished goods, supplies, and may be subdivided, if convenient, and if the amount is sufficiently important, into separate representations for the inventories in particular departments or plants. It is preferable for the representation to specify the particular location of the inventory by plant or warehouse.

The officials and employees who sign the representation are usually asked to state that the inventory was taken under their direction. In the case of junior executives, this would mean under their direct supervision.

In the case of executive officials it would mean under their general instructions.

The items listed for attention and consideration under the various headings shown in the skeleton form for inventory representation are all reported to have been used by some of the fifty-two firms who have co-operated with the subcommittee in making this inquiry. There are some items common to the representations of practically all firms reporting while others are included in the representations of a much smaller number of firms, depending, presumably, in many cases on the nature of the practice or the particular trades or industries in which a majority of a firm's clients may operate. The list of items to be considered under each heading may therefore be regarded as a maximum rather than a minimum and it is quite likely that there will be few cases in which every item will be applicable.

A. Quantities and Amounts

The items falling under this heading are:

1. A classification of the inventory as between, say, raw materials, goods in process, finished goods, supplies, et cetera.
2. A statement that the inventories covered by the representation were taken under the direction of those signing the representation.
3. A statement that the inventories were taken in accordance with inventory instructions, copies of which had been delivered to the auditors.
4. A statement that the quantities were correct and were determined by actual count, weight or measurement under the supervision of an official of the company on a specific date.
5. A statement that the books have been adjusted to the physical inventory, that all adjustments between book values and physical inventories have been made, that any adjustments necessary because inventories were taken at a date different from the close of the fiscal year have been made and that the books have been closed on the bases of such physical inventories.
6. If a physical inventory was not taken, a statement that an adequate perpetual-inventory system is maintained and the foregoing quantities and amounts are in agreement therewith.
7. Where perpetual inventories are relied on, a statement as to the frequency and coverage of physical tests.
8. Where there are methods of inventory-taking in use which are generally considered to be physical but which are, to a certain extent, calculated or based on records (as, for instance, where the determination of the content of tanks of chemicals, fuel oil, or similar material has been made by physical or chemical tests or the calculation of a pile of coal, stone or similar material by an engineering calculation) a statement to that effect.

B. Title and Ownership

Included in the various forms of written representations submitted are statements that the inventory as shown by the books, adjusted as described above:

1. Is the unencumbered property of the company and includes no material held on consignment from others, except . . .
2. Has not been pledged as collateral, except . . .
3. Includes no items billed by the company prior to (date as of which audit is made).
4. Includes no items not paid for or for which the liability has not been taken into account.
5. Is subject to no liens or other encumbrances for duties, taxes or similar items which have not been taken into account with the specified exceptions.

C. Prices and Calculations

This caption includes statements that:

1. The inventory is priced at the lower of cost or market with a general statement of the basis on which this cost is determined, as first-in, first-out, average, last-in, first-out, or the like (where any method representing an unusual or not generally recognized practice is used, the form sometimes requests this to be described fully).
2. The basis of pricing and method of computation is the same as used for the previous period, and unless definite instructions have been given to use

different methods or principles in pricing the inventory, a statement that the inventory basis is the same as that used for the previous period; the company's own internal check and the independent audit should disclose variations from the method prescribed which were made in error, which this item is presumably not intended to cover.

3. The method described does not place a value on the inventory in excess of cost.
4. The prices used for materials are not in excess of the replacement cost at the date as of which the audit is made.
5. The replacement cost of inventory has not materially declined between the date as of which the audit is made and the date on which the representation is signed.
6. If the inventory is valued at market, where market is below cost, the market price is determined by some recognized method which is to be described.

D. Commitments

Where this item is covered by inventory representations, it is generally provided that statements should be made that:

1. No sales commitments exist below inventory prices.
2. No purchase commitments exist at prices in excess of current market as of the date of the balance sheet except . . .
3. No purchase or sales commitments exist in excess of normal requirements, with specified exceptions.

E. Condition

The forms submitted included statements to the effect that no slow-moving, obsolete, damaged, depreciated or deteriorated materials or merchandise are included in the inventory at prices in excess of net realizable value.

Signature

The number of signatures and the position and title of those signing the representations for the client company vary greatly in the different forms of inventory representations submitted. In many cases, a single signature or general approval of an executive official only is asked for, while in others, separate signatures of junior executives responsible respectively for quantities, values and prices, and condition are required in addition. In general, where officials or employees sign separately for quantities, values and prices, and condition, it is contemplated that they do so as a matter of direct personal knowledge.

The signature for general approval may or may not indicate direct personal knowledge. This signature may be that of a general executive who signs merely on the basis that he has given instructions to subordinates on whom he relies and who, he assumes, are carrying out his instructions and their duties correctly. In a smaller concern the signature for general approval will probably indicate greater specific knowledge on the part of the official signing than in a larger organization.

Written Representation Covering Liabilities

Representations obtained from the client cover all known liabilities, contingent or otherwise. Liabilities which have been reduced to definite claims against the company, or those which are evidenced by existing contracts or agreements or which will eventually become due for materials or merchandise received or included in inventory, or for services rendered, or in relation to any other obligation actually existing as of the date as of which the audit is made, will be included in the books of the company; and such liabilities are not considered here except as they are covered by the general statement in the representation that all known liabilities are provided for. The representation forms also cover liabilities of a prospective or contingent nature and these are covered in detail.

A statement is frequently required that no assets other than those of which the auditor has been informed are pledged as security for any obligation of the company and if any such pledge is made, forms submitted include provision for a description of the asset and a statement of its book value.

Where commitments are included in this representation much the same language is used as in inventory representation.

The representations also include a statement that no contingent liabilities, except those reported, exist. Some forms include, as a reminder but without necessarily limiting contingent liabilities as to those specified, a list of the more usual types of contingent liabilities encountered. Those listed include contingent liabilities relating to:

- Customers' or other notes discounted, sold, or otherwise transferred.
- Drafts negotiated.
- Federal and state income, profits, and other taxes.
- Accommodation endorsements.
- Guarantees.
- Leases (except as reflected on the books).
- Bonds or other obligations of other companies.
- Contracts or purchase agreements above current market.
- Profit-sharing arrangements.
- Pending lawsuits.
- Repurchase agreements.
- Any other agreements.
- Fair labor standards act (Federal Wage and Hour Law).
- Accounts, notes, or other evidences of debt assigned to others with a guaranty of collection or under a repurchase agreement.
- Open balances on letters of credit.
- Additional taxes for prior years of which there is present knowledge based upon formal or informal advice.
- Any other pending or prospective claims, whether or not in litigation, such as claims for injuries, damages, defective goods, other than minor items arising in the ordinary course of business, for patent infringements, and deficiency judgments on real estate bonds covering mortgaged property sold.

A comparatively small number of firms include a representation that no obligations not recorded on the books of the company exist for ex-

tension of plant and equipment or in connection with any other prospective activity of the company which are significant in amount or if such obligations exist, a description of them.

Occasionally legal counsel are requested to state whether they have any knowledge of any transfers of property made during the period under examination.

Certain features of the liability representation are clearly within the scope of the knowledge of company officials, while on others the opinion of legal counsel may be required.

There is considerable diversity in the manner in which the forms call for these representations to be signed but whether they are signed by a company official, legal counsel, or both, the evident purpose is to place the responsibility on some person who may be expected to have actual knowledge of the conditions or transactions which the representations cover.

Comprehensive Written Representations Covering the Balance Sheet in General

A comparatively small number of firms, which handle a substantial proportion of audit work done by the profession, require comprehensive written representations signed by the treasurer, controller or other executives.

The evidence available indicates that this practice is in use only to a comparatively limited extent. However, the following summary is considered to be of sufficient interest to be presented for the information of members. In each case, inventories and liabilities are covered in these comprehensive representations, but as these matters have already been dealt with separately, they are disregarded here. The following are covered in the practice of one or more of the firms referred to:

Property, Plant, and Equipment

1. All charges to fixed asset accounts represent actual additions.
2. Sales, dismantlements and abandonments have been properly accounted for.
3. The company has title to property included in plant, machinery and equipment accounts.
4. The basis on which property is carried is properly described in the statements.
5. All property, plant, and equipment are being utilized in current operations or exceptions are noted.
6. The property is maintained in an efficient working condition.
7. No obsolete machinery or equipment is included in the asset accounts.
8. All property, plant, and equipment have been paid for or liability therefor taken up on the books.
9. There are no liens or encumbrances on properties except as recorded on the books.
10. If properties are appraised the results of the appraisal in relation to the book value are fully and fairly set forth.

Reserve for Depreciation

1. In the opinion of the signer of the representation the annual provision for depreciation and depletion is adequate except as noted.
2. The total reserve for depreciation is adequate at the date of the balance sheet.
3. The basis for providing depreciation is consistent with that used in the previous year or exceptions are noted.

Accounts Receivable

1. The notes and accounts receivable of the corporation represent valid claims against customers and other debtors.
2. Indebtedness of officers, stockholders and persons directly or indirectly controlling or controlled by the corporation and persons under direct or common control with the corporation is correctly stated in the statements.
3. Accounts receivable for material or merchandise shipped on approval or on consignment are so described in the accounts receivable records.
4. Accounts receivable hypothecated or assigned are so described in the records.
5. The accounts receivable as summarized do not include any charges for material or merchandise shipped after the closing date.
6. The accounts receivable as summarized above are not subject to deductions for discounts other than cash discounts not in excess of 2%, for allowances respecting of defective material or merchandise, transportation charges, price adjustments, or for any other deductions of similar nature except as provided for by the corporation in its reserve accounts.
7. All notes and accounts receivable as at the closing date known to be uncollectible have been charged off as at that date.
8. In the judgment of the signer of the representation, the amount of \$_____ provided as a reserve for doubtful notes and accounts is adequate to provide for any losses that may be sustained in collecting the notes and accounts of customers and other debtors as at the closing date.

Minute Books

A letter from the secretary of the company stating that the minutes furnished to the auditors are true, full, and correct.

Special Provisions in Representations

One firm requires a statement that reserves are adequate for the purposes for which they are set up; that no extraordinary or nonrecurring items of income or expense are included in the profit-and-loss account except as noted; that the accounting principles and policies followed during the period are consistent with those followed during the previous period except as noted; and that officials of the company know of no additional material facts not shown on the books of account or made known to the auditors in writing.

Another firm requires a statement in regard to income taxes; a statement that there are no matters of strictly personal or private nature adversely affecting the successful continuation of the operations of the company which were known to exist at the balance-sheet date or have arisen since; and a statement that, to the best of the knowledge and belief of the company officers, no shortages or defalcations have occurred which would affect the audit.

A third firm requires a statement that no events have occurred or matters been discovered since the balance-sheet date which might render the balance sheet as of that date, or the profit and loss or expense statements, untrue or misleading; that no special matters have occurred during the period covered by the financial statements except as noted; and that there have been no shortages or irregularities not disclosed to the auditors which would have a bearing on the statements. In addition there is a statement of the understanding of the company officers of the scope of the audit and a statement that there have been no intentional omissions by the company officers to state material facts to the auditors.

List of

STATEMENTS ON AUDITING PROCEDURE

And Date They Appeared in The Journal of Accountancy

No.	Date Issued		The Journal of Accountancy
1.	Oct. 1939	Extensions of Auditing Procedure	Dec. 1939
2.*	Dec. 1939	The Auditor's Opinion on the Basis of a Restricted Examination	Dec. 1939
3.	Feb. 1940	Inventories and Receivables of Department Stores, Installment Houses, Chain Stores, and Other Retailers	Feb. 1940
4.	March 1941	Clients' Written Representations Regarding Inventories, Liabilities, and Other Matters	Mar. 1941
5.	Feb. 1941	The Revised SEC Rule on "Accountants Certificates"	***
6.	March 1941	The Revised SEC Rule on "Accountants Certificates" (continued)	Apr. 1941
7.**	March 1941	Contingent Liability under Policies with Mutual Insurance Companies	Apr. 1941
8.	Sept. 1941	Interim Financial Statements and the Auditor's Report Thereon	Dec. 1941
9.**	Dec. 1941	Accountant's Reports on Examinations of Securities and Similar Investments under the Investment Company Act	Feb. 1942
10.**	June 1942	Auditing under Wartime Conditions	Aug. 1942
11.*	Sept. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 2)	Nov. 1942
12.	Oct. 1942	Amendment to Extensions of Auditing Procedure	Nov. 1942
13.*	Dec. 1942	The Auditor's Opinion on the Basis of a Restricted Examination (No. 3)— Face-amount Certificate Companies	***

14.	Dec.	1942	Confirmation of Public Utility Accounts Receivable	Jan. 1943
15.**	Dec.	1942	Disclosure of the Effect of Wartime Uncertainties on Financial Statements	Feb. 1943
16.	Dec.	1942	Case Studies on Inventories	***
17.**	Dec.	1942	Physical Inventories in Wartime	Feb. 1943
18.	Jan.	1943	Confirmation of Receivables from the Government	Feb. 1943
19.	Nov.	1943	Confirmation of Receivables (Positive and Negative Methods)	Jan. 1944
20.**	Dec.	1943	Termination of Fixed Price Supply Contracts	Feb. 1944
21.**	July	1944	Wartime Government Regulations	Aug. 1944
22.	May	1945	References to the Independent Accountant in Securities Registrations	June 1945
23.	Dec.	1949	Clarification of Accountant's Report When Opinion Is Omitted (Revised)	Jan. 1948 and June 1949
24.	Oct.	1948	Revision in Short-Form Accountant's Report or Certificate	Nov. 1948

* These Statements have been omitted from this Codification because they are no longer considered to be of current interest.

** These Statements have been omitted from this Codification because they apply to special situations.

*** Not printed in The Journal of Accountancy.

Appendix C

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