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**Better accounting through professional development, Complete  
Text of Papers Presented at the 65th Annual Meeting of the  
American Institute of Accountants**

American Institute of Accountants

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American Institute of Accountants**

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**AMERICAN INSTITUTE OF ACCOUNTANTS  
270 MADISON AVENUE NEW YORK 16, N. Y.**

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*The Pennsylvania Society of Public Accountants and certain of its members took exception to part of the remarks of Robert L. Miller which were published in a pamphlet containing papers presented at the 64th Annual Meeting of the American Institute of Accountants. Accordingly, the Institute sent the letter set out below to counsel for those who made the complaint and agreed to publish the letter in this pamphlet:*

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August 26, 1952

James M. Quigley, Esq.  
Commerce Building  
Harrisburg, Pennsylvania

Dear Sir:

In your letter of April 28, 1952, written as attorney for the Pennsylvania Society of Public Accountants, you requested a public retraction and apology for the following remarks made by Robert L. Miller, C.P.A. of Lebanon, Pennsylvania, and published by the American Institute of Accountants in a pamphlet entitled, "Complete Text of Papers Presented at the 64th Annual Meeting of the American Institute of Accountants":

"... We in Pennsylvania have also learned that the leaders in the public accountants' society have been unreliable, and it would have been utter folly for us to attempt to collaborate with them for any special-privilege legislation."

In answer we wish to reply as follows:

1. The paper presented by Mr. Miller, including the remarks about which you have complained, was published by the Institute in accordance with its practice of publishing in pamphlet form the addresses presented at its annual meetings.

2. In making such publications the Institute neither indicates nor intends to indicate approval of the remarks of any speaker. In doing so it had no knowledge of the truth or falsity of the sentence quoted above from Mr. Miller's speech.

3. In making such publication the Institute intended in no way to make an attack upon the character of the officers or members of the Board of Directors of the Pennsylvania Society of Public Accountants.

4. The Institute will publish this letter after the close of its 1952 annual meeting in a pamphlet or pamphlets containing the text of papers presented at the 65th Annual Meeting of the American Institute of Accountants, and will furnish you with a copy of said pamphlet or pamphlets.

5. The Institute is willing to make similar publication of any statement of retraction and apology you receive from Mr. Miller upon your furnishing us such together with your authorization and the authorization of Mr. Miller to make such publication.

6. The Institute authorizes you to make such additional publication of this letter as the members of the Pennsylvania Society of Public Accountants deem necessary to right the wrong you claim to have been done by Mr. Miller's remarks and the A. I. A.'s publication of them.

Very truly yours,  
AMERICAN INSTITUTE OF ACCOUNTANTS  
by *J. William Hope*  
PRESIDENT



## Reserve Board Policy Viewed in the Light of Present Problems

by **Marriner S. Eccles**

Former Chairman, Board of Governors, Federal Reserve System; Now Chairman and Director, First Security Corporation, Salt Lake City

I HAVE BEEN ASKED to discuss an important but a somewhat dry, technical subject, and I am only going to touch upon the highlight of that subject because this is not a class in central banking or economics. But I do want to point out briefly the importance of economic stability to our type of system, democratic capitalism, and the necessity of avoiding the extremes of either inflation or deflation, and the relationship of the supply of money to both of those developments in our economy, and the relationship of the fiscal, monetary, and credit policy to the supply of money.

You hear a good deal said about a sound dollar. Now, what do we mean? Do we mean sound to the creditor or sound to the debtor? In a depression such as we had in the thirties, the dollar was so sound that the debtors were unable to pay, and the national income fell to 50 per cent of what it was in the latter part of the twenties. That was due to a rapid contraction of credit, bank credit in the first instance. The money was just as unsound in that deflationary

period to the debtor who had incurred an obligation in the twenties when the purchasing power of the dollar was far less than it was in the bottom of the depression, as it is unsound to the saver or creditor in the present inflationary period. I am not going to labor on the cause of the deflation. That is a subject by itself. It is enough to say that deflation was due to the very opposite situation or condition that brings about inflation. It is possibly as destructive, if not more destructive, than inflation. It brought about from '29 to the bottom of the depression, the closing of 10,000 banks and the foreclosure of tens of thousands of home and farm mortgages. It reduced the supply of money, bank deposits, through those foreclosures and through the contraction of credit on the part of the banking system, to such an extent that the national income fell from around \$82 billion to \$40 billion. That brought about an unsound dollar from the standpoint of the debtor.

At that time, about 20 years ago, I had occasion to make a speech, and a

quotation from it I happened to put in a book that I wrote during the last year and a half before I left Washington. The title is *Beckoning Frontiers*. It is largely an economic history of the last two decades. This is what I said:

Personal security can be had by too few people through individual effort and saving alone. The average person's security is no greater than the stability of the economy in which he is a participant. Unless the income from the national product is currently spent on consumers' goods and services, or new investment, either public or private, then deflation is likely to set in. While millions of people and tens of thousands of businesses in our country receive income and decide how to use it, there is no assurance that they will make a sufficient total expenditure to distribute the total income received. The job of warding off trouble in this event is nobody's individual responsibility, but everybody's collective responsibility, acting through the organs of our government. The social problem is not whether there would or would not be government planning. In our interdependent economy, planning of some sort is a prerequisite of survival. The problem instead has become one of seeking ways out by which planning is kept at a minimum, so that the talents of each of us will not be squashed by the accumulative weight of all of us.

I was one of those people, possibly one of the leaders in the field, who believed in what is termed compensatory fiscal and credit policy on the part of the government. That meant that in periods of deflationary pressures, credit contraction, and the development of unemployment, the government should pursue a fiscal policy of unbalanced and not balanced budgets; that taxes should be reduced in that field of taxpayers where money would be spent and put into circulation. That is what was necessary.

And then in the field of credit policy, controlled by the Federal Reserve System, there should be what is termed

an easy money policy and a liberal bank examination policy so as to discourage credit contraction.

The liberal credit policy would tend to create a climate favorable for the use of credit, or at least unfavorable for a contraction of credit.

There are those who say, "That is fine. We agree with that, but when that is done, the government never knows when to stop."

I say when a principle is a right principle, it should not be discarded because men are weak and unenlightened, and especially is that true when there is no alternative. With the end of the war, there had been created the opposite of a deflationary condition, an inflationary one, which means that the supply of money, bank deposits, and currency in the hands of those corporations and individuals who would spend it exceeded the supply of goods and services available for the market.

#### Effects of War

The reason that we had an inflationary condition when the war ended was that but 44 per cent of the cost of the war was paid for out of taxes; in other words, all the government spent, not only for the war but also for other purposes, which ran from \$80 billion up to \$100 billion a year, went into the hands of individuals and corporations, and the government took back in taxes only 44 per cent. So the public, as a result of this heavy deficit financing by the government, was left with a very large supply of purchasing power in the form of money which the government did not take back from them in taxes.

Now, to the extent that the 56 per cent of money that the public had left after taxes was used to buy government securities, it merely meant that members of the public delayed their power to purchase the goods and services and turned their funds in to the government so that the government could buy the

things it needed and the services it needed for the war. But the public did not invest in government bonds all the funds it received by any means, and so the government had to create new money through borrowing from the banks the residual amount, and that was a huge amount. It was so large that it increased the supply of bank deposits and currency nearly 200 per cent during the war period.

The Federal Reserve System is composed of 12 reserve banks and 24 branches, and a Board of Governors of seven members, one of which is designated as Chairman, and one Vice Chairman. The Federal Reserve is the fiscal agent for the government. It is the underwriter of the government's credit.

It is true that it is an independent agency of the Congress, created by the Congress. It reports to the Congress, and it is responsible to the Congress, but when the Congress appropriates more money than it levies taxes to pay for, there is a deficit, there is a residual amount that must be provided by borrowing. During the war period this deficit ran more than \$50 billion in some years. The public debt covering the First World War, covering the Hoover depression, in '31 and '32, covering the entire eight years of the New Deal up to the beginning of the war, was \$44 billion. And then it grew in a period of five war years to \$270 billion.

The difference between the tax collections and the appropriations of the Congress when there is a deficit put upon the Treasury the responsibility of raising the money. My criticism of the Treasury has been that it did not carry out a financial program that would raise as much as it could or should have raised from the nonbank investors. The Treasury should have gotten more money from the public by giving it such terms on government

securities as would induce it to turn its money over to the government and thereby reduce the amount of credit that was necessary for the private banking system to provide, because you, as accountants, will know that the source of money, the sole source, except such gold or such silver as is purchased, is commercial bank credit whether to the government or public.

The basis of the growth of the supply of money through commercial bank credit is the reserves which the Federal Reserve System provides through the operation of the Open Market Committee and loans to member banks. For every dollar of high-powered Federal Reserve money that is provided, either through discounts to the member banks or through purchasing government securities in the open market, there is created a basis for bank credit expansion, or new money, of six dollars.

#### Pattern for Inflation

The point I want to make is this: that not only during the war period but also during practically any period when there is a substantial government deficit, the Federal Reserve is required to underwrite the portion not financed by nonbank investors. When the Treasury finances its deficit requirements from the nonbank investors, it means the money in existence is invested in government securities instead of being spent for something else. This enables the government to buy the goods and services it needs. When this isn't the case, the individual or the corporation is likely to take that money and go into the market to buy goods and services. Then the government has to borrow what it needs from the commercial banks, and that creates new money, which bids for goods and services.

When you get this growth in the supply of money faster than you get a growth in the supply of goods and services, you get inflation.

The Federal Reserve cannot be independent of the Congress because it is an agent of Congress. If Congress fails to provide the taxes necessary to pay for its appropriations, then the Federal Reserve has got to stand by to finance the deficit, and to the extent that it finances the deficit through the banking system, you get inflationary pressures.

The Federal Reserve should be independent in so far as the executive branch of the government is concerned, but it cannot be completely independent so far as the Congress is concerned, because it is a creature of the Congress.

We have been confronted, and are today, with a more serious situation, in my opinion, than this country has ever been confronted with before. During the war we all felt that we could see a way out. We all felt that we would win the war, and then we would win the peace, and we would have a degree of normalcy in the world—at least we would have a condition that we would be able to deal with, because it would be, we felt, largely a domestic problem.

### Failure to Solve Problems

There has been great disappointment because of what seems to me to be almost utter failure since the end of the war to meet the realistic problems that this country was confronted with, and, of course, the responsibility for that failure must be laid to those who were in a position of political power and who had the responsibility to deal with the problems.

We had an expenditure of \$400 billion to win a war—that was our expenditure—only 44 per cent of it was paid in taxes; our losses in manpower were not large compared to the rest of the world; and then we utterly failed to win the peace—utterly failed.

When the war ended, we were the only nation left in the world with great

economic and military power. We had been responsible for bringing about the organization of the United Nations. We had control of the air and control of the sea. There was no other navy except what was left of the British navy, our friends, and we even had control of the land, because we had the weapons for our army that no other nation had.

Every other nation, not only our allies but also our enemies, had been decimated. And what did we do with this great opportunity? Due to a foreign policy that neglected or failed to understand the issues, we failed to bring about peace. It isn't because we didn't know what the intentions of the Soviets were, because very shortly, almost immediately, after the war, their intentions were made very, very clear, and through the cold war which they carried out from weakness, while we had great strength, they were allowed to infiltrate Europe and to take over a substantial part of it, as well as Asia. They forced us to fly into Berlin over their blockade. It is claimed we won a victory—sheer blackmail.

We had foreign ministers' conference after foreign ministers' conference in order to settle the German and the European and Asiatic problems, and nowhere, at any time, were we able to even get an intelligent agenda, much less a satisfactory discussion. We could have enforced the conditions of peace. We had a monopoly of the atomic bomb, which we were willing to use to end the war, I believe unnecessarily, but we were unwilling to use it as a threat to enforce the conditions of peace.

And, as I said a moment ago, economically we were much stronger than we were when the war began. We weren't touched by an invading army or by an enemy plane.

Our failure to win the peace is an indictment that only those in the position of governmental responsibility can be charged with, and because of their



failure we are now confronted with a budget of \$80 billion.

With present high federal, city, county, and state taxes, we are now paying out of the income dollar more than we have ever paid in our history, even during the period of the war.

### Dollar Depreciation

There is no terminal point in sight for huge defense expenditures. That is the price we are paying for our foreign policy failure, and along with that we have gone a long way toward losing the battle against inflation. Since the war the dollar has continued to depreciate in its purchasing power. There has been a labor policy that has permitted round after round after round of increased wages to organized labor, and the effect of that has been to permit increased price after increased price, passing on to the public the effect of those increases. And then agriculture demands a program of parity so it will not be left out in the cold.

But what is happening to those people who are depending upon insurance, who are depending upon pensions and annuities and fixed incomes? For them, you have an unsound dollar on the inflationary side. They are being forced more and more to depend upon the government as they get old, or they become retired, or, as the vicissitudes of life overcome them, to take care of their needs because of inflation, when they thought they were able to take care of themselves.

The result is that the great middle income group, the backbone of our type of society, a system of capitalistic democracy, is depending upon and is looking to, maybe against its will, more and more, the federal government. As the group depending on the government increases and the middle income group, the great savers of our

society, decreases, we become closer and closer to state socialism, and further and further from capitalistic democracy.

I want to read this. Paul Douglas made this statement in the Senate on February 22 when he was defending the Federal Reserve:

By wiping out the middle class and separating society into two classes, of the propertyless on the one hand, and the rich speculators on the other, inflation paved the way for fascism and communism on the Continent of Europe. It is a destroyer almost as evil as war itself. In the eyes of those who want to destroy democracy and capitalistic institutions, it is a cheap way of achieving their collapse. It costs the enemy nothing in lives and treasure. It is really a supreme folly for a nation which is arming against the threat of invasion from without, to let this invader of inflation bring ruin from within.

There are the indictments of losing the peace and of losing a substantial part of the battle against inflation, and, along with them, a third indictment of a budget today that will leave a deficit of approximately \$7 billion after the greatest tax bill in our history has been paid, during a time when there is no unemployment and during a time when our facilities are being utilized to full capacity.

### Lack of Integrity

This latter indictment of operating a deficit under present conditions, in my opinion, is largely due to the lack of integrity, not the taking of a few bribes, a few million dollars in cash for personal use, but the lack of integrity to use the public funds as they would be used by individuals in their own business or in their own personal interest. We build up and continue to build up bureaucracy on an appalling scale. Every effort is made throughout government, in every department of

government, including the military, to get the largest possible appropriation for each and every particular division and branch of government. Every effort is made to prevent the elimination of any activity, long after its usefulness is gone. Every effort is made to prevent the consolidation of bureaus, or to reduce the number of personnel within a department.

We have throughout government an appalling condition of inefficiency and waste, which is due to a lack of basic integrity.

Now, I say we cannot expect capitalistic democracy, free enterprise, to survive in this country—which is the arsenal and the keystone of democracy throughout the world—unless there is a change in our approach to these basic problems, and I won't take time to discuss what I think could and should be done in that regard.

I have some very definite ideas, and I know that we can accomplish what has to be done if we have the enlightened self-interest, if we are willing to elect people to public office, city, county, state, and federal, who have the basic intelligence, who have the courage, who have the integrity that is needed; and I should like to appeal to this very powerful and representative group of great Americans to take a

real interest in politics, to take an aggressive and a vocal, an unselfish and an enlightened interest in these problems, because it is the most important thing, the most important issue before you today.

There is nothing in your business, there is nothing in your professional or your personal life that is more important for your future and that of your children and your grandchildren, than to understand these issues and to take an aggressive part in dealing with them. It may be a matter of life and death—at least of life or death for democracy.

Our objectives must be to prevent war, because today no nation can win an atomic war. It would destroy our type of society. Our objective must be to prevent further depreciation of the dollar. We must defend the purchasing power of the dollar as we would defend our country. And to accomplish those objectives, it is important, it is essential that we get men in office who have the integrity and who have the public interest so completely and so thoroughly at heart that it is the most important thing in their lives. We must cease hacking away at the branches and get at the root of the real evil that is undermining our system of capitalistic democracy.

# Some Present Day Aspects of Public Accountancy in the United Kingdom

by **T. B. Robson**

President of The Institute of Chartered Accountants in England and Wales and an International Associate of the American Institute

**F**OR THIS PAPER ON some present day aspects of public accountancy in the United Kingdom I have selected the following four subjects which I hope may be of interest to accountants in the U.S.A.: (a) Status and activities of the profession; (b) Taxation services of public accountants; (c) Relations with the legal profession; (d) Recruitment, training and admission to membership.

These selected topics in no way represent a full or adequate survey of the many-sided aspects of the profession in my country. They have been chosen because in almost all of them there is something different in the development or position of the profession in the United Kingdom from that which, according to my understanding, prevails in North America.

Even to the limited selection of subjects which I have ventured to choose I cannot hope to do justice in the time at my disposal. My paper is, therefore, expressed in general terms only and is no more than a broad review of the topics with which it deals.

I should, perhaps, add that I cannot speak, except in general terms, for

United Kingdom accountancy bodies other than the Institute of Chartered Accountants in England and Wales. Much of my paper, particularly in regard to recruitment, training and admission to membership, is related directly to the regulations of my own body; but, where necessary, I have included references to the other recognized bodies and I have given brief particulars about them at appropriate places in the text.

The United Kingdom bodies to which I refer as "recognized" (which has the meaning explained later in this paper) are the following: the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland, the Institute of Chartered Accountants in Ireland, the Society of Incorporated Accountants and Auditors, and the Association of Certified and Corporate Accountants.

The latest available information indicates that out of a total membership of just over 40,000 for the five bodies, of which the largest, my own Institute, accounts for 17,000, about 20,000 members are engaged in public ac-

countancy as principals or employees in the United Kingdom, 5,000 are engaged abroad in public accountancy and other occupations, and the remaining 15,000 or so are engaged in the United Kingdom outside public accountancy. There is no evidence to show how many persons other than members of the recognized bodies are engaged in public accountancy in the United Kingdom, for any person (whether qualified or not) may so engage himself, but the fact that 20,000 members of recognized organizations are so engaged is itself an indication of the importance of public accountancy in the economy of the country.

#### **Public Recognition of the Profession**

There is ample evidence that the government of the United Kingdom, its administrative departments and the business world all accord high status to our profession and recognize its independent position and the importance of the services which it provides.

Perhaps the most obvious evidence is afforded by the Companies Act, which requires every company to appoint auditors and have its accounts audited and every prospectus or similar document issued by a company to include an auditor's report. The reliance placed by the taxation authorities and by taxpayers upon the work of the profession in relation to taxation and other duties of public importance which, as I shall explain later, fall to the lot of the accountant, are other clear indications of the trust which is imposed in the profession.

Government departments are not slow to use the services of members of the profession. Accountants find themselves appointed to membership of government committees and commissions where impartiality, financial knowledge, and experience are of importance. To cite but a few examples

in recent years, perhaps I may mention the inclusion of a chartered accountant as a member of the Board of Trade committee on company law amendment whose proposal formed the basis of our present Companies Act, the inclusion of others in the membership of the tribunals which fixed the global sum payable by the government for the coal industry on nationalization and/or are determining the division of that sum among the various interested parties, and of yet another as a member of the Royal Commission on Taxation which is now sitting. In many smaller ways than these the confidence and trust in the integrity and competence of the profession are very evident.

It is, therefore, hardly surprising that auditing, accountancy, and taxation do not by any means represent all the services which public accountants in the United Kingdom provide. Indeed, when my Institute obtained its Royal Charter in 1880, some of the duties to which I shall refer, particularly those relating to insolvency work, appear to have been of greater importance than auditing and accountancy, while duties in relation to taxation were as unimportant as taxation then was itself and were not even mentioned in the charter.

I propose to deal only very briefly with these other services, as each of them is really worth a paper to itself, but I shall deal with the profession's services in taxation matters in somewhat greater detail.

#### **Activities of the Profession**

I believe that in the U.S.A. much of the insolvency work which would be performed in the United Kingdom by public accountants is in other hands. It may, therefore, interest members of the American Institute to know that in the United Kingdom accountants undertake the duties of trustees of

bankrupt estates. Similarly, they act as liquidators of companies, not only where a company is insolvent but also where a company is being wound up in order to effect an amalgamation or other reorganization. Accountants are also appointed by the courts, or by the bondholders, to act as receivers and managers on behalf of bondholders or debenture holders or for other purposes. Although in these cases the primary duty of the receiver is to see that the creditor's claim is met, in practice the receiver may sometimes have the satisfaction of being able to reorganize the business on a sound footing and hand it back to its proprietors.

For the information of interested parties in connection with matters such as the purchase or sale or financing of a business, reconstructions and amalgamations, public accountants are often called upon to carry out investigations to ascertain and report on the financial position and earnings record of a business.

These investigations are often designed to enable the accountant himself to form and express an opinion on the value of the business or the shares in a company, to formulate or advise on schemes of refinancing, reorganization or amalgamation, or to give expert evidence before the courts or before an arbitrator in regard to matters such as those I have mentioned.

To an increasing extent, system investigations are also undertaken with a view to the achievement of greater efficiency. Less frequently, investigations are made where fraud is suspected or has occurred.

When prospectuses and similar documents are issued by a company, the Companies Act requires the inclusion of a report by the auditors of the company on its profits and dividends for at least the past five years (in practice the report normally covers at least ten

years). The report must also deal with the assets and liabilities at the last date to which accounts have been made up. Where a business is to be acquired out of the proceeds of the issue, or shares are to be acquired in a company which would then become a subsidiary, a report by accountants named in the prospectus must be included dealing with the profits of that business or company.

The general practice is for the auditors and accountants to make their reports as short and concise as possible. The reports on profits generally take the form of a tabulation of the profits (as defined in the report) for each of the years covered by the report, followed by any notes of explanation which the accountants consider it necessary to give. These notes generally include a statement that the accountants have made such adjustments as they consider appropriate; if they consider it necessary to specify any of the adjustments made, they do so.

A public accountant is frequently appointed executor under a will, or trustee under a marriage or other settlement, in order to carry out the administration of the estate or settlement. This usually requires the accountant to work in close cooperation with the lawyer responsible for legal matters. Conversely, where lawyers themselves undertake this kind of work, they usually call in accountants to assist them with the accounting aspects.

It is a common practice for an auditor of a small private company to undertake for the company much of its secretarial work, including the statutory returns which have to be made to the Registrar of Companies. Indeed, many proprietors of small private companies look to their auditors for guidance and help on all matters which arise as a result of a business being turned into a company. Some firms of accountants provide, by means of spe-

cial staff, secretarial, and registration services for public companies. The registration work for a public company is usually voluminous in view of the constant changes in ownership of shares in the company through dealings on the Stock Exchange and transfers arising as a result of deaths.

In recent years there has been rapid and widespread development of the practice of appointing practicing chartered accountants as part-time directors of companies. These appointments are not made because the accountant has specialized knowledge of the business of the particular company; they are made because of the knowledge, experience, and judgment which he can contribute on financial and business matters. I must hasten to add that a chartered accountant cannot be auditor of a company of which he is a director; moreover, some chartered accountants, including members of some of the larger firms, make a practice of not accepting directorships.

Where parties to a contract find themselves in dispute, they sometimes prefer to have the dispute settled by an independent person rather than incur the expense, delay, and publicity of a court action. The independent person appointed to act as arbitrator in such circumstances is often a chartered accountant. It is not unusual for deeds of partnership and other agreements to include a specific provision that in the event of dispute between the parties, it is to be settled by an arbitrator to be appointed by the president for the time being of the Institute of Chartered Accountants. For this reason, and also in cases where there is no such specific provision in an agreement, it is seldom that a week passes without the president receiving a communication, from someone he has never previously heard of, requesting him to nominate a member of the Institute to act as arbitrator or in some

similar capacity where competence and absolute impartiality are needed.

#### **Taxation Services**

While auditing and accountancy are by far the most considerable part of the work undertaken by the profession in the United Kingdom, taxation work is of great importance; and indeed much of the profession's development of growth has been due to the ever-increasing complexity and weight of taxation on incomes and profits. The great majority of proprietors of small private businesses would probably never have used the services of public accountants if it had not been for the need to seek advice as to the best way of arranging their affairs from the standpoint of taxation and the necessity to agree their profits with the Inland Revenue authorities. The majority of large businesses also make use of the services of accountants for similar reasons.

I suppose the citizens of every highly industrialized country complain that taxation of incomes and profits is much too heavy and too complex. In Great Britain the standard rate of income tax in 1952 is 47½ per cent which is applicable, subject to certain allowances for individuals, to the incomes of both individuals and companies. In addition there is a steeply rising surtax on the excess of incomes of individuals over £2,000 (\$5,600), the combined income of man and wife being treated as one for this purpose. This brings the combined income tax and surtax to 97½ per cent on the top bracket of incomes in excess of £15,000 (\$42,000).

Companies have, in addition to income tax, to bear a profits tax at the rate of 2½ per cent on their undistributed profits, and a levy of 22½ per cent on those distributed. We are also now faced with an excess profits levy, the regulations in regard to which are

exceedingly complicated, which will take 30 per cent of profits earned in excess of those of a standard which has to be computed in accordance with the regulations. The taxation burden is, therefore, very heavy.

The position is such that almost no decision of business policy can prudently be made without consideration being given to its taxation implications. The person to whom business men normally turn for advice in these matters is their accountant who can speak to them out of his knowledge of their own business and its needs and his knowledge and experience of other cases and the relevant taxation principles and law and can thus advise what they ought to do or avoid doing. Public accountants in the United Kingdom play an important part in giving advice to taxpayers; they also have important duties in connection with the determination of the tax liabilities of their clients.

With the exception of the smallest of private businesses, the Inland Revenue authorities require the production of accounts for the purpose of determining the profits chargeable to income tax. Accounts may be prepared for the purpose by any person whether or not qualified; but in all except the smaller businesses the proprietors in most cases appreciate the advantage to them of using the services of the qualified man.

The agreement of taxable profits consists of two main processes. The first is the preparation of the accounts showing the profit computed in accordance with accounting principles; the second is the adjustment of that profit in order to eliminate deductions which are not permissible for taxation purposes and income which may not be taxable.

With regard to the first process, a company is obliged by the Companies Act to prepare accounts and have them

audited and in these cases the audited accounts are also used as the starting point of the computation for taxation purposes. In the case of a private individual, sole trader, or a partnership, however, there is no statutory obligation to prepare accounts and have them audited. In these cases the extent of the work done by a public accountant in preparing accounts depends entirely on the instruction received from the client and may range from an examination as comprehensive as, or more detailed than, an audit under the Companies Act down to the opposite extreme where the accountant's instructions are to do the minimum of work required to put together a profit and loss account and balance sheet from the information shown on the face of the books. Where the latter is the position, the accountant needs to be extremely careful to make clear the limitations of the work which he has performed, lest he be thought to carry a greater responsibility for the accounts than he himself intends.

With regard to the second process—the adjustment for taxation purposes of the profit shown by the accounts—the procedure varies according to the circumstances. Large companies usually employ a permanent staff of accountants who have made a special study of taxation. This permanent staff undertakes the negotiations with the Inland Revenue authorities, a process which can be extremely complicated. The great majority of companies and owners of businesses, however, entrust their taxation affairs to the public accountants who act as their auditors or accountants.

I will not attempt to detail the method of adjusting the profit shown by the accounts in order to arrive at the profit for taxation purposes; but, speaking broadly, the kind of things which have to be done are:

(a) Expenditure which has been

charged in the accounts but is not allowable for taxation purposes must be added to the profit. Most of these adjustments arise because of artificial and unsatisfactory restrictions in the Income Tax Acts and not because the accounts include items which ought not to have been charged in accordance with accounting principles.

- (b) Depreciation allowances permissible under the Income Tax Acts have to be specially computed in accordance with the statutory rules. The depreciation allowances for taxation purposes may be widely different from those computed on the basis of ordinary accounting principles.
- (c) Some items brought to the credit of the profit and loss account may have already been taxed at source or may not be chargeable to tax. Any such items have to be deducted from the profit shown by the accounts.

It is often by no means easy to determine whether a particular item of expenditure is an allowable deduction or a particular receipt is taxable. Within the framework of the Income Tax Acts there is considerable scope for argument on borderline items and over a long period of years a great deal of case law has accumulated as a result of disputes being settled in the courts. The accountant's knowledge and experience of precedents and practice are most valuable to his clients in dealing with or advising on these matters.

The normal process of settling the figure of profit for taxation purposes consists of sending to the local inspector of taxes (who is a civil servant under the control of the Board of Inland Revenue) the accounts of the business together with the accountant's computation of the adjustments to be made to the profit in order to arrive at the taxable profit. The inspector

examines the accounts and computation and if he disagrees with any of the adjustments made in the computation or has questions to raise on the accounts he will so inform the accountant.

It is no part of the accountant's function to attempt to conceal anything from the Inland Revenue. He does not act for his clients in order to enable them to pay less tax than they should, but he argues as strongly as he can on behalf of his clients on any matters where the interpretation of the statutes may be open to differing views. Frequently the accountant can settle such disputes with the local inspector, but where neither the inspector nor the accountant will give way, with the result that an assessment is raised on the basis of the inspector's interpretation, the question of an appeal then arises.

#### **Taxation Appeals**

A taxpayer who is dissatisfied with the amount of an assessment can appeal against it to tribunals known as the general commissioners and the special commissioners.

Since 1903 the Income Tax Acts have given the taxpayer the specific right to be represented by a lawyer or an accountant at an appeal before these bodies. For this purpose "accountant" is defined as a person who has been admitted as a member of an incorporated body of accountants. The great majority of accountants who today appear before the commissioners on behalf of their clients are members of one of the bodies of public accountants which I named in my introductory remarks. In the simpler cases accountants and not lawyers usually represent their clients before the commissioners, but wherever important amounts are involved or the case turns on points of law, the usual procedure is to bring in the services of a lawyer specializing



in taxation matters. There is no hard and fast rule about this, but the more experienced the accountant the more ready is he to appreciate the point at which the expert lawyer needs to be brought into the case.

When the general or special commissioners have given their decision neither the taxpayer nor the Inland Revenue has any further right of appeal on a question of fact. On a question of law, however, both the taxpayer and the Inland Revenue have the right to appeal to the High Court against the commissioners' decision. Both parties then have a further right of appeal from the High Court to the Court of Appeal, and, with the leave of the Court of Appeal, to the House of Lords which is the supreme authority on the interpretation of United Kingdom legislation.

An accountant has no right to represent the taxpayer in any of the law courts. This is not a specific prohibition in relation to taxation matters. It is part of the general law of the United Kingdom whereby barristers, as I shall explain later in dealing briefly with our relations with the legal profession, are the only persons who can represent a person in the High Court, the Court of Appeal or the House of Lords. When an appeal to the courts by the taxpayer is deemed necessary (or when it is made by the Inland Revenue and has to be defended by the taxpayer) the lawyers acting for the taxpayer will obtain both before and during the proceedings the maximum assistance they can from the taxpayer's accountant; but, however much the accountant may aid matters in an advisory capacity, he cannot represent the taxpayer in court. I am sure that we are fully content with this position.

In cases of illegal tax evasion the Board of Inland Revenue has power to arrange, with the person concerned, for a detailed examination of his af-

fairs over a long period with a view to the acceptance by the Inland Revenue of an agreed monetary settlement, without attendant publicity. The number of cases dealt with in this way is far greater than those in which penalty proceedings are taken in the courts.

A detailed "back duty" examination of a person's affairs is normally undertaken by a public accountant; notwithstanding the powers which the Inland Revenue have to call for production of books and records, it is most unusual for Inland Revenue officials themselves to inspect the taxpayer's books. The accountant's report and computations are normally accepted by the Inland Revenue as a basis on which to negotiate a settlement with the client.

#### Relations with the Legal Profession

In the United Kingdom there are two distinct branches of the legal profession, namely solicitors and barristers.

Barristers are the only persons who are entitled to represent a person in the High Court or one of the superior courts. They do not accept direct instructions from the persons whom they represent; instead a barrister is always briefed and instructed through a solicitor. In addition to their work in court, barristers undertake a considerable amount of work in considering and giving their opinions on the legal aspects of particular facts put before them through a solicitor.

Solicitors and barristers are the only persons entitled to represent a person in the courts below the High Court. In these lower courts it is often a solicitor and not a barrister who acts. In addition to court work, however, solicitors do a great amount of work in the way of preparation of legal documents, such as contracts, conveyances of property, wills and so on. Solicitors and barristers have a monopoly in this respect, though there is nothing to prevent an accountant from expressing to his

client his opinion on the construction of a taxing statute. No person other than a barrister or solicitor is, however, permitted by law to undertake for reward the preparation of legal documents for a third party. Like barristers, solicitors give advice on legal problems and it is usually only when they are in some doubt as to the advice to be given that they recommend their clients to instruct them to obtain the opinion of a barrister specializing in the particular field of law concerned.

There is, in general, little scope for overlapping with the activities of public accountants. There are, however, some respects in which the same kind of work is undertaken by solicitors and public accountants. For example it would be difficult to say whether an accountant or a solicitor is more frequently appointed executor or trustee.

In general the relationship between lawyers and accountants is amicable. I believe, however, that in some of the smaller provincial towns accountants feel from time to time that local solicitors undertake work which the accountants consider ought to be in the hands of accountants. For example, some solicitors undertake taxation matters for their clients, including even the preparation of accounts. It is perhaps due to the very fact that the great bulk of taxation work is in the hands of the accountancy profession that some accountants should feel inclined to grumble about the relatively few cases where the work is done by solicitors. Conversely there is some dissatisfaction amongst provincial solicitors because of the activities of accountants in relation to company formation. When a private business wishes to turn itself into a private limited company, many proprietors normally consult their accountants. If the accountants had to draft the whole of the memorandum and articles of association they would

undoubtedly hand the matter over to a solicitor; but it is possible to obtain from company registration agents standard forms of memorandum and articles which with relatively minor adaptations can be used for the purpose of forming a particular company. With the aid of registration agents, therefore, accountants can do the whole of the work involved in forming a company. The Council of my Institute has issued a statement to members for their guidance on how far they should go in this matter of company formation, but even within the terms of that guidance it is still possible for accountants to do a great deal of the work involved. Not unnaturally provincial solicitors are inclined to feel that this kind of work should be in their hands.

In general, however, it can safely be said that accountants and lawyers in United Kingdom do not tread on one another's toes. The difficulties which, I understand, are encountered in the U.S.A. do not arise in the United Kingdom. As I have already explained, taxation matters are a large and normal part of the practice of public accountants and there is statutory authority for accountants to appear before the commissioners. Moreover, members of our profession are quick to refer clients to lawyers for opinion on difficult and ambiguous points of law. In other words on taxation matters accountants and solicitors tend to assist one another rather than to dispute their respective spheres of activity.

#### Recruitment

In order to become a member of The Institute of Chartered Accountants in England and Wales it is necessary to serve in England or Wales in the office of a member of the Institute who is in practice as a public accountant. The service must be under a special apprenticeship agreement known as

articles. There is no exception to this requirement; it is the foundation of the Institute's system of training.

Before a would-be entrant may commence his service, he has to find a practicing member of the Institute who is willing to take him, and, by passing either the Institute's own preliminary examination or one of a number of other specified examinations the minimum standard of which is approximately that required for entrance to one of the universities of the United Kingdom, has also to satisfy the Council of the Institute that his standard of general education is sufficiently high.

An appreciable number though a relatively small proportion of candidates who enter into articles are graduates of United Kingdom universities. There is no direct evidence within my knowledge to show that university graduates are necessarily better fitted for the profession merely because they are graduates; and indeed many successful accountants have been men who entered into articles direct from school at the age of 17 or 18 years. My personal view is that while character and ability are the factors which count most in a candidate for our profession, the broader his cultural background and the greater the extent to which his general intellectual faculties are developed before he has to devote himself to specialized technical education the more likely is he, other things being equal, to adapt himself without undue strain in later years to the requirements of the widely diversified activities which today fall to be performed by the chartered accountant. So much depends upon the qualities of the individual, however, that I would hesitate to make any dogmatic generalization on this subject.

You may like to hear of a special arrangement which has been in operation in recent years in conjunction with the other recognized bodies of public

accountants and certain of the universities in England and Wales. Under this arrangement the universities provide a special degree course in which, throughout the three years' course, emphasis is placed on accounting, economics, and law. If the candidate succeeds in graduating after taking the special course, he can obtain exemption from the Institute's intermediate examination. The candidate sometimes serves some months in a practicing member's office before commencing the degree course and usually he spends a few weeks in the office during university vacations; but the intention is that the great bulk of the practical experience under articles should be acquired after the degree has been obtained.

There is no necessity for a candidate to take one of the special degree courses if he goes to a university; but if he takes some other degree course he cannot obtain exemption from the intermediate examination. Personally, I am by no means convinced that such exemption is necessarily in the candidate's best interests, nor that the emphasis on particular subjects is desirable. The special arrangement with the universities must still be regarded as being in the experimental stage. It did not commence until 1945 and there has not been time for more than a negligible number of candidates to take the degree, complete their practical experience, and sit for the final examination of the Institute.

Some members require a candidate, before entering into articles, to serve for a probationary period of up to three months, during which time the principal can form his opinion of the aptitude and suitability of the candidate; whilst the candidate can gain some idea of whether the profession is likely to be the kind of career he would like to make. Such a probationary peri-

od is recommended by the Council of the Institute.

The total number of persons entering into articles in the last few years has been: 1949, 1305; 1950, 1450; 1951, 1380.

### **Practical Experience**

The period for which a candidate is required to serve under articles is five years, or three years for a graduate of a university of the United Kingdom. Articles cannot be entered into before the age of 16 and those who enter into five-year articles normally do so between the ages of 16 and 18. Five years may seem a long period on which to insist but our experience of concessions granted to ex-service candidates after the last war shows clearly that for the average candidate it is not too long. The shorter period of three years allowed for a graduate is in recognition of his further education and mature years.

We describe the candidate serving under articles as the "articled clerk" and the member in whose office he is serving as the "principal." Until fairly recent times it was the almost universal practice for the articled clerk (or rather his parent) to pay a substantial premium to the principal. In some cases premiums as high as 500 guineas (£525 or just under \$1,500 at the current exchange rate) were charged.

Moreover, it was unusual for the articled clerk to receive any remuneration during his period of service, although in some cases a small amount of "pocket money" was paid. The whole or part of the premium was sometimes returned during the period of service.

Since the war, however, there has been a great change in economic conditions and in the general outlook on these matters and the majority of articles are entered into today without premium. In most cases where a pre-

mium is charged, it is returned wholly or in part during the period of service. Moreover, a salary is provided for in about one-half of the articles which are entered into. In those cases where no salary is specifically provided in the articles it is, nevertheless, not unusual for small salaries to be paid. These make it practicable for persons to enter into articles who would not be able to do so if no such payment were made.

With certain limited exceptions the whole period of service under articles must be in England or Wales on the principal's business of public accountant. To a considerable extent the duties undertaken by an articled clerk are similar to those of other employees of the principal. The reason why the Institute insists on the service being under articles is that the relationship which exists under articles is essentially that of principal and pupil rather than master and servant. Entry into articles makes clear at the outset that the articled clerk's intention is to become a chartered accountant, so that throughout the term of service his work and experience can be arranged with that object in view. It is, therefore, essential that an articled clerk's duties should be properly planned in order to afford him the requisite opportunity to obtain experience. So far as is practicable he is engaged on all the types of work passing through the office, in such a manner as will enable him to obtain the maximum benefit having regard to the stage reached in his training.

It is also important to ensure that an articled clerk devotes substantially all his energies to obtaining his qualification. He is, therefore, not permitted to engage in any other business or occupation during his period of service, except with the express permission of his principal and the Council. Permission is given by the Council only for

relatively minor activities which are not inconsistent with his training. It is, moreover, essential that an articled clerk should understand the importance of observing accepted principles of professional conduct and etiquette. If a complaint is made against him and the Disciplinary Committee of the Council holds that he has been guilty of an act or default of such a nature as to render him unfit to become a member, his articles must be cancelled. An articled clerk who misbehaves himself in a serious manner may thus find that his career in the profession has finished.

Auditing and accountancy are the main duties on which the articled clerk is engaged and at first his work is mainly of a routine nature. During the early part of his service he must obtain an understanding of the primary bookkeeping records and principles which are the basis of all accounting systems; and he must develop a sense of pride in his work and acquire a thorough understanding of the importance of speed and accuracy. When he has proved his progress by passing the intermediate examination, which is taken half way through the articles, he can then be engaged on work of a more advanced nature. During these later stages he will be working under the direct supervision of his principal or senior members of the principal's staff on auditing and accountancy work, taxation matters, various kinds of company work, investigations, executorship and trusteeship accounts, and other matters which I have mentioned as being frequently undertaken by practicing members.

A member may not have more than two articled clerks in his service at the same time. This limitation is imposed on the ground that one member cannot provide the required training and supervision for more than two clerks simultaneously.

### Examinations

An articled clerk is required to take two professional examinations conducted by the Institute, namely the intermediate and the final. The former is taken half way through the articles. The examination consists of six papers each of three hours' duration, namely: Bookkeeping and Accounts (three papers); Auditing; General Commercial Knowledge (including the Elements of English Law); Taxation and Cost Accounting.

The whole intermediate examination must be taken at one sitting and if the candidate fails he must sit the whole examination again on a subsequent occasion. Experience shows that the great majority of the candidates who make a really poor showing at this examination are unlikely ever to qualify. Steps have, therefore, been taken to ascertain after each examination the candidates who failed to reach a certain number of marks and to inform those candidates that they were "bad failures." The notice sent to them shows the aggregate marks obtained and gives a warning that a "bad failure" has little chance of passing the examination at a subsequent attempt unless the bad failure can be attributed to exceptional circumstances such as illness, totally inadequate preparation, or complete lack of effort. Since these "bad failure" notices were introduced the number of such candidates who have ventured into the examination room again has been greatly reduced.

A candidate who passes the intermediate examination can proceed to the final examination at the expiration of his service under articles, but he is normally not allowed to sit within two years of passing the intermediate. The final examination consists of seven papers, each of three hours, namely: Advanced Accounting (two papers); Auditing (including Investigations); Taxation; General Financial Knowl-

edge and Cost Accounting; English Law (two papers).

As in the case of the intermediate, the candidate must take the whole examination at one sitting; if he is not successful he must sit the whole examination again on a subsequent occasion. There is no limit to the number of times a candidate can sit the examination, but the Examination Committee has discretionary power to refuse a further entry.

With the exception of one of the legal papers in the final examination (for which a lawyer acts as examiner) the examiners have hitherto been experienced members of the Institute, actively carrying on their profession.

The large numbers of candidates submitting themselves for the examinations in recent years have, therefore, imposed a very great burden upon examiners. Suggestions have been made that to relieve them the Institute should have recourse to professional examiners. The adoption of this procedure would involve the appointment of examiners who have not up-to-date experience of problems as they are met in practice and might detract from the practical nature of the papers, a very undesirable result in a profession which places such emphasis upon the combination of practical and theoretical training for its students. The work of the examiners is certainly very onerous and we are continually seeking means affording the relief which they need.

The candidates' answers to the examination papers are marked by the examiners who set the papers; but these do not know the names of the candidates, each of whom is known throughout by a number. Moreover, the examiners do not know the standard which determines whether a candidate passes or fails. This information is known only to the moderators and the officials of the Institute and I,

therefore, cannot tell you what it is. I can, however, say that the standard is not too high for a reasonably competent candidate to attain; there is certainly no policy or practice of varying the requirements for a pass so as to regulate the number of admissions to membership of the Institute.

In recent years the over-all percentage of successful candidates in the final examinations has been between 40 and 45 per cent of the total number of candidates sitting, but the failures which these figures imply include candidates who have been unsuccessful on more than one occasion. The percentage of successes for candidates sitting for the first time is much higher; for example, in the November 1950 examination, when the over-all pass percentage was 42 per cent, the percentage for first candidates was 53 per cent and even that figure was affected adversely by circumstances which are believed to be nonrecurrent.

Practically every articled clerk studies for his examinations by means of a correspondence course. There is a small number of tutorial concerns which specialize in this form of tuition for the Institute's examinations; two of these concerns are between them responsible for the tuition of the great majority of articled clerks. The correspondence tutors who specialize in this work plan a program of studies designed to cover the ground in the time available to each student. They recommend textbooks and provide study notes to assist the student in his reading. They test the student's progress by marking and returning written test papers submitted regularly by him in accordance with his program. Each student carries on his studies, at his own pace, largely in his own time. His program can be accelerated or retarded, by arrangement with his tutor, to suit his ability and the time he can devote to study. Some articled clerks ob-

tain oral tuition from private tutors or by attending lectures at colleges of commerce; but the information available to the Institute indicates that nearly all these students also undertake a correspondence course.

### Students' Societies

Chartered accountant students' societies are established in 25 towns throughout England and Wales. In addition, branches and groups have been formed in the areas of some of these students' societies, particularly in those areas where the main towns are some distance apart. Active membership of a students' society is regarded as an important part of an articled clerk's education and every articled clerk is, therefore, obliged to join such a society.

The main purpose of the students' societies is to act as educational associations in the widest sense. Accordingly, they arrange lectures, discussions, mock meetings, and debates, particularly on subjects of importance in the profession and related to the wider education of the future members, but not necessarily selected with a view to preparing students specifically for the examinations of the Institute. Some of them arrange residential courses lasting about a week once or twice a year. There are also social functions of various kinds, such as annual dinners and luncheons. All these arrangements have great value in making students conversant with the procedure at meetings, in introducing them to leading members of the profession (who take an active interest in students' societies' affairs by presiding, acting as speakers, and lecturers and in other ways), in providing opportunities for students to discuss their experience and problems with each other, and in cultivating that sense of corporate responsibility without which a stu-

dent cannot later take his proper place in the profession.

Students' societies also maintain libraries and arrange visits to demonstrations of accounting machine and office equipment, visits to the offices and works of companies, and visits to organizations such as the stock exchange, the banks, and various commodity exchanges. Sports arrangements are another valuable feature of these societies and some of them have regular annual schedules with other student bodies.

Members of the committees of the students' societies and the various officers of the societies consist largely of articled clerks. They include a sprinkling of young chartered accountants and the president of the students' society is usually one of the leading local practitioners; but by and large the societies consist of students and are run by students for the benefit of students. Invaluable experience is gained by those students who are prepared to give the time required in order to act as officers or members of the committee of a students' society.

### National Service

In the United Kingdom all young men who are medically fit are required to undergo a compulsory period of two years' national service in one of the armed forces. Normally this period of service commences soon after reaching the age of 18. It has, however, been recognized that the progress of any serious student can be severely prejudiced if on reaching the age of 18 he has to break off his studies for a period of two years. Arrangements are, therefore, in force whereby persons who are pursuing a serious course of study can postpone their periods of national service until their studies have been completed.

Under these arrangements regulations have been agreed between the

Institute and the ministry concerned whereby articulated clerks can obtain deferment for the entire period of their service under articles and for the further period required in order to sit for the final examination after the articles have expired. There are various conditions which I need not detail; for example, there is a periodic review of progress and there is an upper age limit of 26 beyond which deferment will not be continued. In general, however, the effect of the deferment arrangements is that an articulated clerk can safely pursue his studies and serve in his principal's office throughout the full period of five years and he can then sit for the final examination before he has to commence his compulsory national service. In practice it is found that nearly all articulated clerks apply for and obtain the benefit of these arrangements.

#### **Admission to Institute**

After completing his service under articles and passing the final examination, the candidate may apply for admission to membership of the Institute. Before being admitted he is required to submit a certificate from the member to whom he was articulated, certifying the period for which he served and specifying the nature of the duties on which he was engaged.

For the past two years, each newly admitted member has been provided with a handbook which gives him considerable information about the Institute, its work and activities, and, in addition, clearly indicates to him the standard of conduct which he is required to observe if he does not wish to receive the unwelcome attention of the Disciplinary Committee. The number of members admitted to membership of the Institute in the last three years has been: 1949, 659; 1950, 799; 1951, 988.

#### **Other Accountancy Bodies**

What I have said above on training and examinations relates only to the method of qualifying for membership of my own body, The Institute of Chartered Accountants in England and Wales, which received its Royal Charter in 1880. It does not deal with the four other United Kingdom bodies of public accountants mentioned in my introductory remarks: each of these, like my own Institute, is an autonomous association, having its own regulations for admission to membership, holding its own examinations and having its own machinery for controlling and exercising discipline over its members.

The charter of the Scottish Institute dates from 1854, and that of the Irish Institute from 1888. Members of my own and these two other institutes are known as chartered accountants. The regulations of the Scottish and Irish Institutes are similar to those of the Institute in England and Wales in that the basis of qualification in each case is 'service under articles and examination. There are, however, a number of differences in detail between the regulations of the Scottish and Irish bodies and those of the English Institute.

Besides the three chartered institutes, there are two other recognized United Kingdom bodies. The Society of Incorporated Accountants and Auditors (whose members are known as "incorporated accountants") came into existence within a few years of the incorporation of the English Institute. With certain limited exceptions into which I need not go in detail, admission to membership of the Society is by examination and practical experience. The Society does not, however, insist on the practical experience being gained under articles; it will accept a slightly longer period of approved service not under articles. The Society is predominantly a body of persons



whose practical experience has been gained in the offices of public accountants; but certain kinds of specialized experience, such as that obtained by officers of municipal authorities, is also accepted.

The Association of Certified and Corporate Accountants (whose members are known as "certified accountants") came into existence in its present form in 1938 as a result of the amalgamation of a number of smaller bodies which had been in existence for many years previously. The Association is different from the other bodies I have named in that it includes many members who have gained their practical experience in industrial, commercial, and similar organizations and not in the offices of public accountants. Employees in such organizations can register as students of the Association and take its examinations. Its members include a substantial number of accountants in public practice and students can enter into articles with such members or serve with them without entering into articles; but, in addition, the Association caters for many students in the field of industry and commerce.

It may be of interest to give approximate figures for the membership of the accountancy bodies I have mentioned. The numbers are shown below.

While precise statistics are not available, approximate estimates made by officers of the bodies indicate that between 6,000 and 7,000 of the members included above as not in practice are in the employ of members in practice. This would indicate that about 20,000 of the members of the bodies are working in public accountancy in the United Kingdom.

I should, perhaps, mention that whilst the bodies for which I have given the above figures are recognized by the government for the purposes of the Companies Act their members have no monopoly of the right to practice as a public accountant. Anyone, whether qualified or not, may practice as such; the only general restriction in favor of members of the recognized bodies is that other persons are usually not eligible for appointment as auditors of companies other than privately owned or family concerns, and even in that respect there is a specific statutory exception in favor of the properly qualified foreign accountant.

#### Retention of Qualified Staff

Since the war nearly all public accountants have experienced difficulty in maintaining adequate staffs of qualified accountants. This difficulty has been due to two main causes.

In the first place, six years of war

Institute in	Total Membership	Number in Practice in U.K.	Number in U.K. Not in Practice	Number Outside U.K. in Practice or Otherwise Engaged
England and Wales	16,900	6,500	8,800	1,600
Scottish Institute	5,130	1,110	3,120	900
Irish Institute	840	120	240	480
Society	9,540	3,000	5,290	1,250
Association	8,070	2,250	5,160	660
Total	40,480	12,980	22,610	4,890

resulted in a great dearth of newly qualified accountants. Even though record numbers have been admitted to membership during the past few years, the demand is still much greater than the supply.

In the second place, there has been a great expansion in recent years in the volume of work undertaken by the profession and in the opportunities which are offered by industrial and commercial concerns for qualified accountants to join their staffs. These concerns can offer salary and pension inducements which appear attractive to the newly qualified man and there is no doubt that the expansion in their need for qualified accountants has added to the difficulties of the public accountant in obtaining and retaining staff.

My own impression is that while there is still a serious shortage, the point is being reached where retention and recruitment for service within the profession in the United Kingdom are no longer matters of such desperate difficulty as was the general experience

a few years ago when the dearth due to the late war was at its worst. There appears, however, to be little amelioration as yet in the difficulties which face firms recruiting for offices outside the United Kingdom.

I must now bring these remarks to a close. They may serve to draw attention to some of the differences, but I hope they will also have served to emphasize the basic similarity between—nay the identity of—the work and purpose of your great Institute and the profession in the United Kingdom.

We are all seeking to procure that accounts shall bring out fairly and truly the record of the position and profits of businesses, to assist the public with all the integrity, honesty, and skill that lie within us, to develop our own capacities and the capacities and opportunities of our successors in every proper and possible way. With these objects before us and the determination that lies within us, our profession on both sides of the Atlantic will go forward from strength to strength.

Professional  
Accounting  
Training

## How Much Cultural Training Is Desirable?

by **Raymond E. Glos**

Immediate Past President of the American Association of Collegiate Schools of Business; Dean, School of Business Administration, Miami University, Oxford, O.; Member, AIA

**T**HE TOPIC ASSIGNED me is delightfully vague. The terms "cultural training" and "desirable" connote different meanings to different people. Rather than to deal in generalities my choice is to be very specific in attempting to answer the question of how much cultural training is desirable. This cannot be done unless and until certain assumptions are made.

Realizing full well that professional accounting training may encompass a wide variety of backgrounds, I am, nevertheless, going to confine my remarks to undergraduate collegiate training. Without much doubt a majority of young men entering the public accounting profession today present exactly this type of an educational background.

The assumptions I should like to make are as follows:

1. The trainee is taking a four-year college degree program of approximately 120 semester hours or 180 quarter hours. Although the exact number of hours may vary depending upon the school, and upon practices regarding credit for basic R. O. T. C. courses, physical education, and the like, the

totals mentioned are generally acceptable. Necessary credits may be earned in day or evening work, or a combination of the two.

2. The student is majoring in accounting or at least studying this subject to the extent that courses are available. Unless the student is studying accounting he is not training for the profession at the undergraduate collegiate level. Perhaps some may say that an entire undergraduate program should be cultural, to be followed by graduate study in accounting. As yet, I am not willing to believe that both objectives cannot be satisfactorily attained in a four-year course.

3. Courses in accounting and other business subjects, including economics, are not classified as cultural. This is an arbitrary assumption but finds its validity in the fact that most business and economics courses are vocational for an accounting major. Of course, many business courses are cultural or at least have cultural values. This is particularly true for many courses in economics that must certainly be classified on a par with history, political science, and

sociology as far as cultural values are concerned. However, since they relate to a well-rounded professional training for an accounting major, they have been excluded from the cultural classification.

4. Cultural training is here defined as nonvocational, or perhaps a better term is nonprofessional. Some courses, such as English composition, are vocationally desirable, but would qualify as nonprofessional.

5. Courses offered by the liberal arts college of a university will, in general, qualify as cultural for an accounting major. Who is brave enough to define a cultural course? Without doubt some courses offered by a liberal arts college are not cultural in that they do not widen horizons, train the mind, or improve aesthetic tastes. This is just another reason why the term nonprofessional is an improvement over the term cultural for this discussion.

6. General or nonvocational courses offered by colleges or schools of agriculture, education, engineering, music, art, architecture, and the like also qualify as cultural courses. I refuse to believe that colleges of liberal arts have a monopoly on cultural courses. For an accountant a course in music appreciation that may be given by a school of music is, at the least, as cultural as a course in general chemistry.

Now, granting the assumptions stated, we can approach the question of how much cultural training is desirable. The word desirable complicates matters considerably because more training in all areas would be helpful and we might end up with a program that no one could complete until he reached his thirties. I would prefer to think in terms of a necessary minimum of cultural training rather than a quantity that might be desirable.

The American Association of Collegiate Schools of Business enrolls in its membership 70 outstanding schools

of business in this country. It specifies as one of the requirements for membership that 40 per cent of the work accredited to a degree must be taken in business subjects, 40 per cent in subjects other than business and economics, and the remaining 20 per cent is left to the school's discretion.

I have no quarrel with the Association's standards and I believe in compromise. Consequently, I am suggesting that the optional 20 per cent be divided evenly between professional and nonprofessional courses. This would mean that 50 per cent of an undergraduate program should be taken in nonprofessional work. In hour totals it measures 60 semester hours or 90 quarter hours.

However, this arbitrary minimum and maximum will not prove to be the desirable amount unless certain safeguards are installed as to when the courses are taken, and, within limits, the fields of study. It is my opinion that the student should take some nonprofessional work each year. This might well be a heavy load in his freshman year, lighter in his sophomore year, and so on, until in his senior year he is taking almost all professional work.

Assuming that the university operates on a semester basis, the following distribution is suggested:

Hours of	College Year			
	Fresh.	Soph.	Junior	Senior
Nonprofessional courses	24	18	12	6
Professional courses	6	12	18	24
Totals	30	30	30	30

I hold no brief for this particular schedule of semester credit hours except to the extent that it shows that professional work will be heavier in the years immediately preceding graduation and that nonprofessional work is scattered throughout the four years. I recognize that the student needs a heavy dosage of professional work immedi-

ately preceding employment, but I do not want him to forget that he should also be aware of the value of cultural training throughout his college course.

The next problem is that of the fields of study. If cultural courses are concentrated in one area or another, they tend to become a secondary profession. Thus, if a man concentrated his non-professional work in the field of music,

he might have an avocation as well as a vocation, but his cultural background would be limited. Again referring to the standards for membership of the American Association of Collegiate Schools of Business, the wording used to describe desirable subjects other than business and economics courses is that "breadth not specialization is the objective."

**DISTRIBUTION OF CULTURAL COURSES**

By percentages

Freshman Year	Sophomore Year	Junior Year	Senior Year
Cultural or Non-professional	80	20	20
		40	80
20	40	60	Professional

To avoid excessive specialization, even in the cultural field, it seems reasonable to specify that work must be taken in certain areas. This procedure also has the advantage of making maximum use of the 60 semester hours that have been recommended for the cultural area. Without diversification, the objectives of these hours might fall short of accomplishing the greatest value.

Shown below is a suggested four-year program that incorporates this principle of diversification in a college program operated on the semester basis.

Bear in mind that this is merely a suggested program. No two educators would agree on the content of the non-professional work. My chief concern, at this point, is that it be diversified

enough that the accounting trainee have a well-rounded education despite his interest in a profession.

Finally, no program of training, college or otherwise, is going to guarantee that the individual will either be a cultured gentleman or a well-trained accountant. It is up to the individual, and many persons self-educate themselves far beyond the reaches attained by many college graduates. However, on my assumption that a college education is going to be the basis of training for the accounting profession, let us be sure that the trainee has an adequate opportunity for an acquaintanceship with cultural subjects at this point. He will never have another opportunity quite as satisfactory for accomplishing this important purpose.

First Semester	Freshman Year		Semester Hours
	Semester Hours	Second Semester	
English composition	3	English composition	3
Mathematics	3	Mathematics	3
Natural science	4	Natural science	4
Other nonprofessional courses	2	Other nonprofessional courses	2
Professional courses	3	Professional courses	3
	—		—
	15		15
	Sophomore Year		
English or speech	3	English or speech	3
Psychology	3	Philosophy	3
Social science	3	Social science	3
Professional courses	6	Professional courses	6
	—		—
	15		15
	Junior Year		
English	3	English	3
Nonprofessional course	3	Nonprofessional course	3
Professional courses	9	Professional courses	9
	—		—
	15		15
	Senior Year		
Nonprofessional course	3	Nonprofessional course	3
Professional courses	12	Professional courses	12
	—		—
	15		15

# How Much and What Type of Technical Training Is Desirable?

by **Samuel J. Duboff**

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**A**S A PRACTICING accountant who spends a considerable portion of his working time on matters relating to selection of personnel, staff training, and other personnel matters, I am keenly interested in this subject of technical training. Throughout the year I, and my opposite numbers at other firms, tour the colleges (large and small) looking for talent. We interview the seniors who are interested in our firms and make offers of employment to those we consider suitable candidates. This activity enables us to see a representative sample of each year's accounting school graduates.

In recent years, for a variety of reasons, pickings have been relatively slim. Industry and governmental agencies are strong competitors for accounting graduates and their representatives visit the colleges in increasing numbers. The low birth rate of the early 1930's probably accounts for the smaller graduating classes. The number is further reduced by those men who enter the armed forces immediately upon graduation. Furthermore, the over-all quality of the recent accounting graduate seems to be below that of prior years.

In our discussion of technical training, we must not overlook two important related factors: (1) the caliber of the men who enroll for this training, and (2) the standards of instruction. A sound curriculum in itself will not insure that well-qualified men will emerge.

## Qualifications of the Student

The accounting profession renders services through technically trained men with wide experience and good judgment. Because of the profession's rapid and dynamic growth there are many opportunities available in senior and more responsible positions. In addition, some of the experienced public accounting personnel have accepted managerial positions with private industry, which has learned to appreciate the value of the broad training acquired by the public accountant. Senior personnel are developed through rigorous training.

Out of the group of today's college graduates we will find the senior and leader of the future. There are no other worth-while sources of supply. We are therefore deeply concerned about the qualifications of the men who are at-

tracted to our field. The profession needs a steady influx of beginners with the personal qualifications for rendering satisfactory services and for rapid progress. Surveys<sup>1</sup> conducted among reliable cross-sections of practitioners in Illinois, New York, and Texas reveal reported shortcomings of beginners in the following qualifications: grammar, handwriting, spelling, oral and written English, initiative, imagination, responsibility, ambition, general interest, and human relations.

Too many students specialize in accounting because they are "good at figures." As the American Institute publication *A Career In Public Accounting* points out, "He may be a 'wiz at figures,' but this, though useful, is only a small part of his professional equipment. Creative imagination for one thing is more important." Other qualifications, of course, are the ability to write clear and lucid prose, the ability to talk effectively, the ability to get along with others, self-reliance, appearance, personality, adaptability, sound judgment, inquiring and analytical mind, general intelligence, integrity of character, cooperation, educational background, etc. Many of the foregoing have to do with personality, a topic which Dr. Robert N. McMurry<sup>2</sup> admirably covers in his paper entitled "A Study of Personality Traits May Be the Key to Choosing the Valuable Accounting Junior."

The American Institute in recent years through its testing programs administered by the Committee on Selection of Personnel and through its public relations activities has grappled with

the problems involved in attracting outstanding men into the profession. It is gratifying to hear that a more intensive effort has been started through the creation of a new Committee on Accounting Personnel which generally will conduct a program of activity embracing (a) a study of personnel problems of the profession, (b) a campaign to attract promising recruits into the profession, (c) administration of the selection of personnel testing program, and (d) consideration of various possible activities in the field of placement, staff training, personnel practices of accounting firms, relations with educators, etc.

### Faculty

The curriculum is only the form of a training program. The instructors and students give it substance. The interest and attitudes of the student are closely related to the qualifications of his instructors. Many students have decided on a career in accounting after one elementary course in accounting because of the excellence and the enthusiasm of their instructors. Reputations of accounting schools generally are based on the excellence of the instructors rather than on curriculum.

It is interesting to note that practicing doctors usually teach at medical schools, practicing lawyers at law schools and practicing dentists at dental schools. Perhaps it logically follows that men with accounting training should teach technical accounting subjects. Some schools do require their accounting instructors to be certified public accountants. But this is by no means a prevailing practice. Dr. Saxe<sup>3</sup> makes the valuable suggestion that colleges provide sabbatical leaves for their instructors for professional experience opportunities. On the other hand, it might be suggested that our successful

<sup>1</sup> *Background for Public Accounting*, Committee on Education of New York State Society of CPA's, 1951; Sakol, Samuel A., "Report on Survey by Committee on Education," *The Illinois Certified Public Accountant*, June 1948; Smith, C. Aubrey, and Davis, Keith, "Texas Survey Shows Wide Variation in Personnel Practices," *The Journal of Accountancy*, May 1952.

<sup>2</sup> *The Journal of Accountancy*, April 1951.

<sup>3</sup> Saxe, Emanuel, "Current Problems in Accounting Education," *The New York Certified Public Accountant*, January 1952.



practitioners devote as much time as is practicable to teaching assignments. Both the schools and the profession might learn to better understand each other's problems through such a temporary exchange.

The profession, I believe, should cooperate with the schools to attract outstanding qualified instructors to teach technical accounting courses. This is not a simple problem, in view of shortages of personnel, remuneration scales and the competition of public accounting firms and industry.

### How Much Technical Training?

Although all states and territories and the District of Columbia have adopted uniform examinations as a test of qualifications for the certified public accounting certificate, there is great disparity in their educational and experience requirements to sit for these examinations. Only a few states require more than a secondary school education. The question of education for the accounting profession has indeed become a matter of great controversy during recent years. Educators, practitioners, and students have expressed many different viewpoints on the desirable types of schools, curricula, content of courses, objective, etc. As *The Journal of Accountancy* points out in an editorial in the June 1952 issue (page 676), "Almost every accountant has his own prejudices, and it will require much patience, much information, and much goodwill to reach conclusions that will be acceptable even to a majority of the profession."

Finally, a definitive step has been taken to explore thoroughly the entire problem of what are desirable educational and experience qualifications for the CPA certificate. Certain individual members of the American Institute of Accountants, the Association of CPA Examiners, the American Accounting Association, and the American Asso-

ciation of Collegiate Schools of Business have organized a Commission on Standards of Education and Experience for CPA's.<sup>4</sup> There are 24 distinguished members on the Commission representing every point of view—teachers, deans, practitioners, examiners. Its principal task will be to recommend a goal towards which the profession should strive, no matter how long that may take to achieve. Perhaps it will also consider interim steps toward achieving its ultimate aims. Certainly an objective study of the whole problem is long overdue. The results of the activities of the Commission will be awaited with great interest by everyone concerned with this problem.

Undoubtedly the Commission will consider at length the desirability of a professional school for public accounting with a professional degree comparable to that offered by other professions.

Let us turn our inquiry to some of the shorter range aspects of technical training.

Much thought has been devoted to the possibility of at least establishing minimum standards of accounting education. The Committee on Education of the Institute in 1937 suggested a four-year college course of which approximately half should be devoted to general studies and half to business courses with emphasis on accounting subjects. In 1945 this committee considered it impracticable to attempt to prescribe a uniform curriculum for all colleges, but believed a minimum program to be both desirable and feasible. Many other opinions have been expressed on this matter. Basic agreement seems to be on some form of a minimum program, whether this be attained through (a) a full college course in liberal arts plus graduate work in the accounting field, (b) a five-year college

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<sup>4</sup> Editorial, "Next—Uniform Education and Experience Requirements for CPA's?" *The Journal of Accountancy*, June 1952.

course offering a Master's Degree in accounting or (c) a four-year college course with an accounting major.

In attempting to establish minimum technical training programs, consideration should be given to the needs of the student and the profession. Education is a continuing and unending pursuit. The accounting graduate is only embarking on a period of further study of accounting, auditing, and business problems. He must search for what Mr. Peloubet<sup>5</sup> calls the "material" part of his background. The man who aspires to success and leadership in the profession will continue his educational efforts after graduation through self study or extension or graduate courses.

Accordingly, as a minimum objective, I believe that for the average beginner in the field of public accounting, a four-year course, in which about one-half the time is devoted to business subjects with emphasis on accounting, should be adequate. The beginner's progress and development will depend mainly on his personal qualifications and the type of training and experience he acquires in the field, rather than on college training greatly in excess of this minimum. Graduates who do not succeed in the public accounting profession fail generally because of their personal rather than their technical qualifications. They are usually men who should have been weeded out on the high school or early college level through a competent system of vocational guidance.

### What Type of Technical Training?

The type of desirable technical training depends on the training objective. As in other education problems in our profession, it is no surprise to find that there is much controversy on this point.

Some authorities believe that the professional accounting field has become so wide and complicated that it is no longer possible for the colleges to cover both theory and details of practice. They suggest that the colleges handle the theoretical aspects. Opposed to this concept are those who desire greater training emphasis on techniques to prepare students more adequately for the assignments they will undertake in the field.

Again, I believe, the needs of the graduate and the profession must be considered. If the graduate is employed by a large firm which has an adequate training program, close supervision in the field, and a wide diversification of experience to offer, the theoretical training concept might be satisfactory. If the graduate, however, joins a firm which cannot offer these advantages—and many cannot—he may be thankful for any techniques which he learned about at college. Furthermore, the large firm conducts a long, formal training program which emphasizes auditing techniques because the beginner's technical training in this area is inadequate. A formal training program is an expensive procedure and would normally be limited to orienting the newcomer to the background and policies of the firm.

The basis for success in the profession today, I consider, is no different from what it was in the past—the maturity, capacity, interest, ambition, and will power of the man. Those among our successful practitioners who had little formal education illustrate this. Observe the progress of a group of men from one college with similar technical backgrounds who start together in the same firm. After a few years, several stand out as superior. This superiority does not stem in major part from their technical collegiate training. It is primarily the result of their personal qualifications, including the capacity for growth and the efforts made by them

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<sup>5</sup> Peloubet, Maurice E., "How Much Education Can An Accountant Use?" *The New York Certified Public Accountant*, January 1952.

to achieve this capacity to the fullest measure.

I believe that the students (and a great many practitioners) desire that technical training at college should adequately prepare a man to enter and succeed in the public accounting profession. To help further this objective let us examine together those areas of technical training which may need more emphasis, research, and study.

1. *Vocational Guidance and Counseling.* The student should learn about the qualifications needed for success in the profession and through (a) interviews by competent personnel and (b) achievement and psychological tests he should be guided on the wisdom of his choice of a career.

2. *Human Relations.* The ability to get along with people is a desirable trait in every field of endeavor. In public accounting it is a necessary qualification for success. The beginner's relationships with his seniors, other assistants, partners, supervisors, clients' personnel, etc. will be influenced to a great extent by his ability to get along with people. The beginner must know how to be a follower at the start of his career—but must be ready to assume leadership at a later date. He must know how to function as part of a team on one engagement and, perhaps, as part of a new team on his next assignment. He must be able to adapt himself easily to new conditions. That the accountant must know how to handle people as well as figures comes as a surprise to many graduates. A course that will stimulate him towards trying to understand himself and others seems desirable for everyone, especially for the man who aspires to success in a field in which the personal qualifications are valued so highly.

Harvard University started a course on Human Relations several years ago.<sup>6</sup>

Enrollment in the course jumped from 35 to 175 with a long waiting list. In 1950 Harvard seniors voted it the most stimulating course. Similar courses have been started at other colleges.

3. *Oral and Written English.* Practitioners do agree that the beginner lacks the ability of effective oral and written communication. The surveys in New York and Illinois bear this out. However, it is probably a deficiency which exists among all of our college graduates and perhaps is attributable in part to education below the college level.

Courses in report writing, business English and public speaking should be required. Cooperation among all instructors at the college is essential. The students should be made aware of their deficiencies and should be stimulated to take steps to overcome them. With this in mind, students have organized public speaking clubs at some colleges. The 1951 Committee on Education of the Institute recommended that further study be given to the extent to which the curricula of colleges are giving the training that students need in the art of expressing themselves effectively both orally and in writing.

4. *Arithmetic.* It is sad, but true, that a majority of our beginners are deficient in arithmetical processes. Give them more than two figures to add and they proceed to the nearest adding machine. Some of these "whiz" kids have become stale, because at college they could always use machines. Others, unfortunately, never learned arithmetic. 57 of the 63 practitioners who participated in the New York survey indicated that arithmetic was an essential course on the college level! Many beginners are shocked to learn (a) that they are deficient in this respect and (b) that expertness in the arithmetic processes is a necessary technical requirement.

5. *Fundamental Principles of Ac-*

<sup>6</sup> Lageman, J. K. "Why Do People Act Like That," *Nation's Business*, May 1951.

counting. (a) The student should acquire an understanding of the fundamental principles of accounting through courses in elementary, intermediate and advanced accounting and cost accounting. (b) Advanced accounting should include (1) problems drawn from actual business situations designed to develop independent thinking and judgment and (2) the study of contemporary literature and current decisions. One deficiency among beginners is their lack of familiarity with Statements on Auditing Procedure, Accounting Research Bulletins and other important releases of the American Institute.

6. *Auditing.* All of our beginners devote a major portion of their first years in the profession to this phase of accounting. Auditing procedures and practices carried out by inexperienced and poorly trained accountants may seriously harm the reputation of a firm. By offering the student at college a thorough background in auditing objectives and techniques, we are teaching him what we know he is going to need upon graduation.

That there is urgent need for improvement in the handling of this subject on the college level seems to have become established. The 1951 Committee on Education of the Institute in its report stated that further study and analysis should be given to the question of the extent to which the curricula of collegiate schools of business are giving the training that students need in auditing. Lack of knowledge of practical auditing procedures was high on the list of reported deficiencies of beginners in the Illinois and New York surveys among practitioners. The Committee on Auditing Education of the American Accounting Association is presently conducting a survey, one objective of which is to solicit suggestions from practitioners for the improvement of college training as it relates to auditing.

The auditing course should go be-

yond the teaching of theory and objectives. The student should have experience in handling and examining the types of evidence he will encounter in the field. He should experience almost a complete audit under conditions approximating as closely as possible those found in the field. Construction of such an audit set requires much effort and expense. However, a number of firms have made this effort and have demonstrated that it can be done and that it is extremely valuable for achieving training objectives.

The student should not only learn about *what* he is doing, and *how* he is to do it, but he must realize *why* he should perform the necessary audit steps. He must learn to understand that everything he does on an audit is important and that there is not always one correct answer to every problem. He must recognize the necessity for neatness, following instructions, accuracy, thoroughness, and attention to details. He must learn the importance of cooperation and teamwork in the conduct of an audit. Above all, the student must learn the value of good judgment, without which no one can succeed in the profession.

Perhaps, as some people believe, judgment, like virtue, cannot be taught. However, every beginner must recognize the need for disciplining his judgment until it has matured under the nurture of field experience. Realistic audit sets directed by qualified instructors can help accomplish these objectives.

The internship programs developed by a number of colleges are an excellent supplementary feature of basic auditing training. This subject will be discussed by another speaker during this session.

It is interesting to note that in answer to the question, "What would you add or delete from the course of study which you had," 72 per cent of the

staff men in the Illinois survey replied, "Add more auditing courses using actual case studies and emphasizing working paper preparation and practical procedures."

7. *Internal Control.* The extent of the beginner's shortcomings in this subject may be illustrated by the comments of Alden C. Smith, a member of the Board of CPA Examiners of New York State, "I want to refer again to the auditing examination. Some of the questions contemplated a knowledge of internal controls and I am told that many of the papers showed an amazing lack of understanding of this subject. Fundamental to auditing is internal control; audit programs are predicated on the accounting controls, and a knowledge of the essentials of proper control procedures is a prerequisite of a good auditor. The time and effort spent in studying this subject will pay you well, not only in preparing for the examination but also in fulfilling your responsibilities as an auditor."<sup>7</sup> Mr. Smith was discussing the answers of men who had had three years of field experience!

In view of our increased responsibilities in connection with this subject, I believe that it is desirable and essential that a separate course be offered in internal control. Subject matter should emphasize:

- (a) Principles involved in setting up a system of internal control for all phases of a company's operations.
- (b) The accountant's responsibility for checking the system and his reliance on the system in planning his audit.
- (c) Various tests made by the accountant to determine the adequacy of the system.
- (d) Internal control questionnaires.

(e) The accountant's report on internal control.

8. *Public Accounting Practice.* Graduates, as a group, seem to be uninformed about many general aspects of our profession. Impressions on matters such as desirable type or size of firm with which to seek employment, ethics, organization of an accountant's office, history, etc. come from sources which are not always the best informed. I suggest, as a separate course, a series of lectures by practitioners representing large, medium, and small firms covering such topics, as:

- (a) Organization of the accountant's office.
- (b) Selecting and training the staff.
- (c) Duties of partners, supervisors, seniors, and assistants.
- (d) Organizing an audit.
- (e) Relations with clients.
- (f) Professional ethics.
- (g) Legal liability of the accountant.
- (h) CPA requirements.
- (i) Historical background of the profession.
- (j) Professional societies.
- (k) Personal qualifications of the accountant.

I understand that at least two colleges have recently started a course somewhat along these lines.

9. *Other Business Subjects.* At an early point in every audit engagement the public accountant has to study the manufacturing processes and flow of the materials, get some idea of the plant layout and equipment that is being used and become generally familiar with the terminology of the business. This phase of the accountant's training, part of Mr. Peloubet's "material" concept ("what he must know about"), does not always receive adequate attention. Two courses are suggested: (a) *A Survey of Industrial Organizations* designed to develop industrial back-

<sup>7</sup> Smith, C. Alden, "Taking the CPA Examination," *The New York Certified Public Accountant*, September 1952.

ground through a study of the functions and operating procedures of the various echelons in certain industries and (b) *Factory Organization and Management*, an examination of the general staff functions of production control and its relations with the line organization of the manufacturing division. These courses could include field trips, motion pictures, and lectures by industry representatives.

### **Need for Continued Study**

The time is past when an aspiring accountant, with little or no technical background, can enter the accounting field and undergo a long and arduous apprenticeship doing routine tasks for many years. Modern accounting requires qualified personnel for every phase of its activity. The work of even the most inexperienced beginner is important and can affect the reputation of a firm. The technical aspect of the ac-

countant's professional training at college should, therefore, prepare (as realistically as is practicable) the student to undertake his responsibilities in the field. This is an objective which cannot be delegated entirely to the practitioner.

The interest, motivation and drive of each man will determine the scope of his education. However, the complexities of the modern accounting field should require a minimum standard of technical training.

To maintain high standards of professional service and to strive to improve these standards are worthy objectives of our profession. Continued studies of all phases of professional education (including the curriculum, the quality of instruction, and the qualifications of our students) should insure that we will always have a supply of qualified beginners to further these objectives.

# Value of Internship Programs in Preparing Accountants for a Professional Career

by **John C. Martin**

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**T**HE TERM "INTERNSHIP Programs" as used in connection with preparing accountants for a professional career applies to the educational method used by the accounting departments of the leading schools in this country to give their students some practical experience before they leave their academic environment. Obviously, such an educational method can be made possible only by the cooperative efforts and planning of the school administrators and representatives of either professional public accounting firms or commercial and industrial businesses. In most schools the public accounting internship programs have generally been the most successful, although programs in industrial firms have become more numerous during the last few years.

## How They Operate

Some few schools operate a so-called cooperative program in which students alternate between work periods and periods of academic instruction. Most schools, however, follow a program in which the intern works for a period of from four weeks to six months as a regular employee of the cooperating employer.

Two factors primarily determine when the students can participate in the internship program with the best educational results. First, the students must have a sufficient academic background to properly perform assigned work and they must be sufficiently advanced to be able to apply their knowledge of accounting theory to practical accounting techniques. Secondly, the students should have enough classroom work left after their internships to have an opportunity to evaluate their practical experience in relation to their academic needs. Because of these two factors, it is generally found that students go on internship programs during the summer between their junior and senior years or during the winter of their senior year. In a few schools where substantial accounting work is completed in the sophomore and junior years, the internship programs may be instituted somewhat earlier. Many schools permit graduate students to take part in the internship programs and in a few schools, only graduate students are permitted to participate.

In placing students with internship program employers, some schools follow the practice of selecting those stu-

dents who will be permitted to participate in the program. This step is then followed by actual assignment of such eligible students to specific employers by the faculty itself. Other schools allow the internship program employers to select their respective interns from either the entire student body or from a particular group designated as being eligible for the program.

Schools following the former practice generally restrict participation in the internship program to students in the upper scholastic strata thus being reasonably assured of good performance on the part of the student. Schools following the practice of allowing employers to select their respective interns do not generally restrict the internship to the top students. They feel that all students will benefit from the experience and especially the poor students who may need the experience to give them an added stimulus in their academic work or who may, as a result of the actual experience, be persuaded to leave the field of accounting.

The length of time that the intern works in the accounting firm is dependent on the length of the peak season of the employer and the length of the period that the intern can be away from school. The busy season of the public accounting firm and the summer vacation periods of industrial concerns are both about three months long and thus dovetail nicely with the academic schedules of those schools operating on the quarterly system. Different arrangements must be made in the case of those schools operating on the semester basis, with the length of the internship varying from four weeks to a full semester. Periods of less than two or three months are of doubtful value to either the student or employer, since the student does not have the opportunity of obtaining a diversity of experience and the employer must devote a large por-

tion of the time to orienting the student to his new environment.

The students' compensation during the period of internship will usually closely approximate the salaries paid to new employees in similar work. It would be theoretically desirable to standardize the salary as much as possible so that companies will not be competing for interns on the basis of higher compensation. However, from the practical standpoint, each firm or company has internal limitations, such as salary schedules, union contracts, and beginning salary rates which do not make a fixed salary to all interns feasible in most cases.

Probably the most neglected feature of the internship program is the type of work which is performed by the student during the period of internship. In many public accounting firms the pressure of the busy season prevents the top men of the organization from observing the training of the interns and the training has a tendency to become incidental to getting the work done. In such a situation the value of the internship period to the student depends completely on his luck in getting good assignments and in working with a senior who has both the capacity and will to teach him. A well-planned training program, on the other hand, should not leave the quality of training to chance but should be planned cooperatively by the school administrator and the representative of the employer firm or company.

Most schools require the student to submit a report at the conclusion of his internship, while only about one-half of the schools grant academic credits for the internship period. The student reports, even where no credit is granted for the internship period, are generally considered desirable in that they provide a basis for evaluating the internship program, checking on the training given by the particular company, and



forcing the student to think about the work he is doing in order to present it in a satisfactory report.

### **Purposes**

The primary and somewhat indirect purpose of internship programs in accounting is to raise the general level of professional competency in the accounting field. This purpose is accomplished by improving the educational processes which are applied to those individuals who emerge from our colleges and universities each year to enter the field of accounting either in a professional or an industrial capacity.

The direct purpose of an internship program in relation to the student is to give him a more effective education by permitting him to acquire some practical experience in the field of accounting before he completes his academic courses. Such a procedure enables the student to apply this practical experience in his advanced course work and better equips him for choosing the particular field of accounting which he wishes to enter upon graduation.

An indirect purpose of an internship program, which in its relation to the employer is quite apt to be viewed by him as a direct purpose, is the furnishing of an opportunity to the employer of not only obtaining temporary help of a high caliber during the busy season but also at the same time giving the employer an opportunity for the selection of permanent employees while such employees are engaged by him on a trial basis.

### **Responsibility of Employer**

If internship programs are to accomplish their primary purpose, it is the responsibility of the employer, whether he be a practicing professional accountant or an executive of a commercial or industrial concern, to recognize that such programs are primarily an educational method, the value of which

must be judged from an appraisal of the benefits which the student receives. The emphasis in the employers' thinking must be on the benefits received by the student if such programs are to contribute in all their capacity to the long-range advancement of the accounting profession. If the employer uses the intern to his own advantage with no thought or consideration given to the students' training, the program is doomed to failure since the students' time would be more profitably spent in classroom pursuits.

In considering the internship program as primarily an educational method with long-range benefits for both the employer and student, the employer becomes responsible for a properly planned and properly administered training period. A well-planned training program necessitates cooperation between the administrator of the program in the school and the representative of the company. The company representative should have the program planned in advanced of the arrival of the intern and such plan in many cases can feasibly be discussed personally with the school administrator for his suggestions or criticism. Certainly, if the employer is interested in obtaining such temporary employees in the years to come, he should be zealous in his effort to see that the training program he institutes is one that measures up to the standards set by the school. This type of program will also have a far more favorable effect on the student and will operate to make him a potential permanent employee upon his graduation.

In planning an internship program, the employer should be responsible for obtaining the highest diversity of experience for the intern that is practical during the relatively short period of his employment. In a public accounting office, the intern should spend some time in the report department, and he

should be assigned to a diversified group of audits involving various types of operations including manufacturing, retail, wholesale, nonprofit organizations, and farms; such audits should include large, small, and medium sized engagements.

He should be working under as many of the employer's personnel as possible, ranging from the principals down to the junior with only a few months more experience than has the intern himself. All of these employees should be instructed to help the intern learn more than the job requires, not at the client's expense, but on the off hours and in the "bull sessions" of the hotel room. The intern should be assigned in-town as well as out-of-town where he will be exposed to the wailing of the family man who has had only two meals with his family in the last three and a half weeks. Work on tax returns under supervision or at least observation of the operations of a large office tax department should be made available to the intern.

Every employee under whom the intern has worked during the period should submit a brief written performance report at the conclusion of the work. These reports should come to the attention of a principal for action if necessary during the progress of the program. At the conclusion of the period, the performance reports in the aggregate should be analyzed and reviewed by a principal and the intern in a final conference. A frank evaluation of the intern's potentialities and weaknesses by the principal can be the most valuable experience of the entire program period.

Should the intern be assigned to a company in the industrial field, it is the responsibility of the company representative to assign the intern to as many accounting sections as possible, all the way from stock records through accounts receivable and accounts pay-

able to the factory ledger and general ledger. He should be given the opportunity to observe the reports section and the controller's office and to see the working relationships between budgets and accounting and between accounting reports and factory, sales, and administrative executives. If it is impractical to use the intern on a departmental rotating basis, such as might exist during a vacation period, an opportunity and a definite period should be scheduled for his observation of the various departments other than the one in which he is employed.

The employer, whether he be in the public or industrial field, has the responsibility of making it possible for the intern to get the feel of the business world and to obtain a perspective view of the particular field of accounting in which he is employed. The intern may find that he does not like or is not adapted to accounting or a particular field of accounting at all and may change to some other field better suited to his abilities and interests.

### **Advantages to the Student**

There are many advantages which a student may receive from a period spent as an intern in accounting work. These advantages will vary with the student, the internship program followed by the employer, and the administrative problems of the school.

The internship programs permit the student to gain a type of education which cannot usually be obtained in the college environment. During his internship he will be confronted with numerous situations which call for compromises or special techniques which are very difficult to portray to the student in the classroom. The element of judgment in the professional accountant's make-up as related in his classroom texts suddenly becomes a real factor in his thinking. He has a chance to become acquainted with the

actual records used in accounting, and machine methods, forms, and charts of account will be familiar to him and will have an entirely new meaning when he subsequently confronts them in his academic courses. He will be working with people for perhaps the first time in his life, as an employee and as part of an organization. He will have received valuable training in taking orders, following directions, and in various other aspects of personnel relations in the business world.

The internship program helps to bring to a maximum the value of the student's accounting education. The practical experience and background which he has gained enable him to evaluate properly the academic material presented. When he returns to school, he should be able to make a better selection of the subjects which are needed to complete his accounting education and to fill in the gaps in his background which his experience or his conference with his temporary employer may have exposed. After a period of employment, it is usually evident to a student that he needs more training in such things as report writing, speech, salesmanship, and other subjects which otherwise he may not have included in his curriculum.

After a period spent in public accounting or industrial accounting, or ideally both, a student should have a better idea of what he wants to do when he graduates. The experience of the intern with a particular concern provides him with an opportunity to make a job contact which in many cases will develop into a permanent position after graduation. He will compare his experience with that of friends on internships with other firms. Such a comparison provides each student with the chance to evaluate the various firms and their desirability as permanent employers.

The employer who takes students

for an internship period has a source of good temporary help to relieve peak periods or to take care of vacation replacements. The work provides good training for the intern who may later become a permanent employee of the firm or company. The employer has the opportunity to observe the intern at work and can make permanent offers to those trainees who have demonstrated their worth and indicated their potentialities. Since the trainees are also familiar with the firm, the possibility of poor choices or mistakes on either side are materially lessened. An additional advantage to the employer who has properly administered a well-planned program is that the student returning to school with a very favorable impression of the company will most likely encourage other students to accept offers from the company.

Many employers also discover that by placing some of the responsibility for the training and supervision of interns on their senior accountants and supervisory employees, these people are forced to review their own duties and organize their work in order to adequately instruct the interns. Often such a review leads to improvements in procedures and systems and serves as a refresher course for the supervisors themselves.

### **Advantages to the School**

The primary advantage of an internship program to the schools is the contribution the program makes to the education of the students. The previously mentioned advantages to the students may also be said to be advantages to the schools. However, there are some additional advantages to the schools which provide only indirect benefits to the students. The courses offered by the schools are tested by the students against the practices of the business world. Returning students will be highly critical

of outmoded or impractical materials which are being taught with the result that the faculty will be encouraged to do a better job and will be required to keep up-to-date on current practices in the field. The internship period also has a stimulating effect on the students so that they, as a general rule, do better class work when they return.

From the schools' standpoint, an internship program also increases the degree of college-industry cooperation. This increased cooperation assists the school in the placement of its graduates, thus attracting good students.

Some disadvantages of internship programs exist primarily in relation to the school and the students, such as the upsetting of normal routines, the creation of many administrative problems, and the interruption of the students' part-time employment, campus activities, and other continuing functions. However, in my opinion, such disadvantages are far outweighed in the case of all participants in the programs after a careful review is made and consideration is given to the many advantages previously mentioned.

## Training Juniors

by *Ira N. Frisbee*

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**A** COMPLETE PROGRAM FOR training the new junior will include three types of staff training. These are: (1) on-the-job training, (2) organized classes or group discussions, and (3) individual study. Only the first two of these types will be considered in this paper, and much of the discussion will relate chiefly to the problems of the small and medium-sized public accounting offices.

### 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. We may visualize this as a class with one student, or an illustration of the tutorial system of instruction.

Actually, this ideal seldom is even approached. 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, so that practically no attention is given to staff training of juniors on the job. In fact, it is difficult for an overworked 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 have little ability or aptitude for teaching, even as a tutor rather than as a lecturer, and it is not reasonable to expect such persons 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 also it affords them an opportunity to anticipate problems peculiar to the audit.

To expedite this review, it is well

for each assistant to have 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 cooperation and skill of the in-charge accountant and upon his ability to give his assistants a worthwhile participation in the job. If skillfully handled, such an interview in advance of the actual work in the client's office will instill interest and enthusiasm in the staff men. Actually, the time spent should be more than offset by time saved later in the engagement. Also, without this required program of review, the senior 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 a job 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 each and every step to be taken. The best teaching is done by giving students problems which are almost beyond their grasp and at the same time instilling them with the interest needed to work them through to a successful solution.

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 assistant or assistants, particularly at lunch or while they are 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 when the senior makes 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 being done is to invite stupidity 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 useful.

To summarize briefly, we may say that effective but practical on-the-job training can be obtained in all accounting offices if the man 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 will not only give valuable training but will accomplish 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 if the practitioner will only use it.

#### Formal Staff Training Programs

Regular staff training classes will not be necessary if on-the-job training is completely effective and not too costly. But, for medium-sized and large firms particularly, it is likely to be more efficient to train several people in a group, especially 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 rather 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.

Also, there can be no doubt that a formal training program puts an emphasis on training which affects the entire organization. Many of the seniors will have attended the training classes while they were juniors, and some will be assisting with the current classes. Therefore, they will be more cognizant of their responsibility to the beginners because they have been, or still are, a part of the program.

### What Should Be Included in Class Training?

In deciding what to include we may begin by deciding 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.

Such a class 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 courses, rather than to retard the speed of class instruction to the level of the lowest beginner.

### A Suggested Class Program

As to the subjects to be included in a program for staff beginners, the four general classes of topics discussed below are submitted.

1. *Staff manual and similar material, whether prepared in staff manual, staff bulletin, or instruction list form.* 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, etc. 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" in the January 1944 issue of *The Accounting Review* in which he said, in summary, "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." Also, mention

can be made of the attributes which the firm considers to be the most 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.

One class meeting may be adequate for the subjects included in this part of the program.

2. *The preparation of audit working papers.* In this part of the course the general plan of preparing working papers, indexing them, organizing certain papers for the permanent file, controlling the 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 is to be given to the indexing system used by the firm and to listing on the 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, say, 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. Also, each firm should develop its own method 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.

3. *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. 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 they should 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. Always there should be reference books available. Comparisons should be made particularly with the *Case Studies in Auditing Procedure* and the *Codification of the Statements on Auditing Procedure* of the American Institute of Accountants and with material in recent text-books, such as the seventh edition of Montgomery's *Auditing*.

It may be that an entire meeting, or more, will need to be spent on 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*, pages 114 to 116.

It may be well to emphasize that the most important part of the training in audit procedures is in developing the reasons for the procedures. Many

people 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 overall procedure will the auditor 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 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, etc., 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 "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 basic point of beginning. 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.

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 parts of the audit.

The auditing procedure portion of the staff training course can easily be expanded 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 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, and the trust indenture covering a bond issue, capital stock certificate books, and the 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).

4. *Report writing and the preparing of financial statements.* Although the beginner will not be immediately faced 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. The matters to be covered preferably should be formalized in a Standard Statement-Presentation Manual. 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 the interest and thinking of the members of the class.

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, etc.), extent of the description of the capital stock accounts, use of "retained earnings" instead of surplus and details thereof ordinarily included in the statements, use of footnotes to the balance sheet and 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 well be given to the long-form report, particularly 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 staff 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 set-up 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 set-ups 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 1,100 companies.

The program for training beginners which has been outlined above 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 students 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.

### Teaching Methods

No doubt many other important subjects have been omitted from the program given above, but it is believed that the most important subjects for the beginning juniors have been included. An incomplete program covering the most essential material in an effective manner is much better than a more inclusive program which is poorly presented. A few suggestions as to the teaching methods for effective presentation may be helpful for carrying out the suggested program.

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" 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.

This writer believes that the discussion method should be used in preference to the exposition method whenever possible. But care must be taken to avoid lengthy and inappropriate discussions. The leader of the discussion must be a real leader. This means that he must direct the discussion by inserting questions and observations 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, and probably it is desirable that the class be limited to a maximum of twenty.

Ideally, the discussion method should be supplemented by illustrative material and by the use of practice problems. Usually this is 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.

Usually it is deemed necessary to plan for a written examination 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. An advantage usually is that the students 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. And, of course, the real success of the entire program will be evidenced in the work that the trainees perform and in their progress after the course is completed.

Supervision  
of Audit  
Engagements

## Planning of the Work and the Supervisor's Place in It

by **Weldon Powell**

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**T**O MANY OF US THESE days the word "planning" may mean something we do not like. But whether we think planning is good or bad for the economy of our country, there can be no doubt about its beneficial effect on an audit engagement.

The person primarily concerned with this necessary part of the work is the supervisor. In using the term "supervisor" I mean the individual directly responsible for seeing that the examination is made in accordance with generally accepted auditing standards. He may be an accountant conducting his own practice, a partner in a firm, a manager or principal, or other senior member of the staff who is qualified by experience to direct the work of others.

The Institute's Committee on Auditing Procedure has recognized the importance of planning. Two of the nine standards listed and discussed in the Committee's Statement of Auditing Standards issued in 1947 relate directly to it. One of these, which is the first standard of field work listed in the statement, reads, "The work is to be

adequately planned and assistants, if any, are to be properly supervised." The other, which is the second standard of field work, says, "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."

All of us should be well acquainted with the Statement of Auditing Standards. Its importance is indicated by the fact that at the annual meeting of the Institute in 1948 the membership approved and adopted the summary set forth in it and resolved that the expression "generally accepted auditing standards," which all of us use in our opinions or certificates, should be deemed to refer to the standards or principles set forth in that summary. It is a good thing to reread the statement occasionally.

### Staff Assignment and Instruction

As a preliminary to the planning of an examination there is the selection of the accountants to execute the work

—the supervisor, the senior, and the juniors.

Each engagement should have the general oversight of a partner. In many engagements the partner may delegate to a supervisory member of the staff the planning of the examination, direct supervision of the field work, and review of the working papers and report. In some engagements he may undertake a part or all of this himself. In any case, the final responsibility must be his and he must arrange to devote enough time to the work to meet this responsibility.

Among the points to be considered in assigning staff there may be mentioned the following: the technical and temperamental qualifications of the available accountants (it being desirable to have on every engagement a group of accountants who have had both a good accounting education and a thorough training in the technique of the firm, who have had both wide general auditing experience and some contact with the kind of business in which the particular client is engaged, and who are temperamentally suited to the requirements of the work); the rotation, at suitable intervals, of the accountants assigned to each client's affairs; and the use of field work for the training of staff accountants, not only to make seniors out of green juniors but also to make supervisors out of in-charge accountants, and in either case to give each member of the staff a diversified experience.

The ideal, of course, is seldom obtained in practice, and this has a bearing on the planning of the audit. With seasoned seniors and juniors, the supervisor's part may be more general in character; he may outline the broad course of the work and leave to his subordinates the filling in of the details. With a less mature group, the supervisor may have to go into many of the details himself and instruct his

subordinates specifically as to what they are to do and how they are to do it; he also may have to arrange to spend a greater proportion of his own time in direct supervision of his assistants during the execution of the engagement, and to review their work more thoroughly at its conclusion.

When the field accountants have been assigned to an engagement, the supervisor should see that they have a clear understanding of the work expected of them, before they start. This should cover not only what they are to do and how they are to do it, but also the objective they are to work towards. An auditor has to be always on the alert to avoid becoming so deeply involved in detail that he misses the significance of what he is doing. It seems to me that an important part of the work of the supervisor in planning is to arrange for briefing the field staff.

This usually involves written instructions of some kind, supplemented by oral discussion. In large engagements it frequently is desirable to hold group meetings to discuss the work. I have always felt that very real, although intangible, benefits result from taking assistants into one's confidence to the greatest extent practicable at the outset of an assignment.

In a small concern where most of the bookkeeping is done by one person, there being practically no internal control, and where the audit work can be carried out by one accountant in a fairly short time, the use of work programs, time budgets, and similar material would seem to be inappropriate. In such a case the supervisor may instruct the field accountant orally as to how he is to proceed, and the latter may indicate the scope of his work in the working papers as he performs it; a brief handwritten memorandum may suffice to set forth the essential information as to examinee's records and the lack of effective internal control.

On the other hand, in a large engagement where the client's operations are complex and possibly far-flung, and where the services of numerous different accountants are required, some program material usually is a necessity.

Between these two extremes are the medium-size engagements, which doubtless constitute the bulk of the average practitioner's audits. As to these there may be a difference of opinion. I shall outline briefly my own preferences.

### **Work Programs**

I do not like rigid standard questionnaires, work programs, or check lists which purport to be all-inclusive and to be suitable for universal use. I think any one using them runs the risk of doing too much work, or too little work, or the wrong kind of work.

On the other hand, I do favor flexible standard forms which are designed to suggest rather than to prescribe procedures, and to provoke rather than to stifle thought. With these as a foundation, a work program can be developed to suit the peculiar requirements of each engagement. I believe such a work program is highly desirable in most engagements, if for no other reason than that its preparation requires some concentrated thinking about the work in advance. Beyond this, of course, a well prepared work program serves to keep the course of the field work within due bounds.

A work program should be both specific and general. It should detail the operations to be performed and the procedures to be followed in respect of routine matters. At the same time it should cover those aspects of the work which transcend routine, and as to them it should be expressed in broad terms.

For example, the work program relating to inventories should include such specific instructions as are ap-

propriate in the circumstances as to review of the arrangements for taking physical inventories, observation of the counts, and test of the quantities; test of the prices and computations, and, in this connection, consideration of current market prices; investigation of cut-off; inquiry into material at outside points; and similar work. But it should provide also for a broad study of the inventories, including computation and comparison of turnover rates and other significant ratios; investigation of internal control; review of the entries in control accounts; consideration of the implications of any difference between book and physical inventories; and so on. In a manufacturing concern, the inventory work usually should be integrated with a review of the cost system.

In a repeat engagement the work program may be based upon the one for the previous examination, but only after consideration anew of the former procedures in the light of conditions as they now exist. One of the worst sins an auditor can commit is to copy blindly the preceding year's working papers. If the work program is to be used at branch locations by other offices of the firm or by correspondent firms, special care in its preparation is desirable. In a new engagement the work program may have to be developed a few steps at a time, although in most cases the supervisor should be able at the outset to sketch out the major operations even if he leaves some of the details to be filled in later.

Some other points to be borne in mind in developing the work program are the rotation, in some situations, of the audit coverage from period to period, emphasizing now one detail of the examinee's accounting and later another, so that in the course of several years all have been given close attention; and the form of the working papers, it being feasible in some in-

stances to prepare *pro forma* analyses in advance, especially on branch examinations.

I should like to emphasize that any formal work program should be regarded as a guide. Although it should be expected that the field accountants would carefully observe specific requirements in respect of those items where uniformity is essential (as in the case of information required of branch locations for consolidation and report purposes at headquarters), it should never be expected that they should be in any way restricted by the instructions in the intelligent application of sound auditing procedures, and this should be made clear to them. If conditions are encountered during the examination which indicate the necessity for revising the work program, appropriate changes should of course be made.

#### Time Budgets

In developing a work program, the supervisor may want also to prepare a time budget for the use of the staff. I say he *may* want to do this, because I know some accountants who think it undesirable to schedule the time estimates for the work in advance. These accountants think that working against a time budget tends to make the operations too mechanical.

I do not share their view. Time budgets usually assist the field accountants in planning their day-to-day operations. If the estimates have been soundly made they give some indication to the men of the relative importance attaching to the various segments of the work. They offer a convenient means of measuring progress. They tend to bring unforeseen conditions to light promptly.

Time estimates should be made in the light of prior years' experience if the engagement is a repeat engagement. Of course, the possibility cannot

be overlooked that there may have been changes during the current year in the accounting arrangements, the volume of business, the degree of internal control, the personnel in the client's office, or in other conditions affecting the examination, and for that reason it is important that inquiries be made concerning these matters before establishing the time budget.

The degree of detail in which the time is estimated usually depends upon the particular engagement. On the one hand, a time budget which is confined to a few large segments of the work ordinarily is not very useful. On the other hand, one which deals with every small operation usually is not practicable. A happy medium should be the aim.

As in the case of any other budgetary operation, it is essential to the successful use of time estimates that reasonably frequent comparisons be made between the time estimated and that actually consumed, and that the estimates be revised as occasion requires.

#### Basic Approach

Frequently — perhaps usually — the first operation scheduled, after any necessary cash and security counts have been completed, is the taking of a trial balance of the general ledger, and then the bulk of the audit work is arranged according to the accounts as they appear in that trial balance, supplemented by systematic tests of the transactions entered in original records, review of the minutes, and similar operations of a general nature. In a way this is both logical and convenient: inasmuch as the aim of the examination is simply to do the work necessary to enable the accountant to express an opinion upon the examinee's financial statements, and the statements are assembled from the general ledger, the accounts on the



trial balance provide a focus for the auditor's work.

In many cases, however, an alternative approach is more effective, which is to plan the audit work so as to gear it to the flow of the accounting work in the concern under examination, which generally parallels the functional organization of the business. If the audit work were arranged in this way, it would comprehend as to each of the major departments, investigation of the accounting system and the internal control, tests of the routine transactions, and analysis, inspection, observation, and confirmation of, and other inquiry into, the pertinent accounts and items. The various steps in the examination would thus be integrated. The review of the internal control would be correlated with the testing and other work on the pertinent records and accounts. The maintenance of an over-all view of each segment of the audit work would be facilitated.

Under such an arrangement there would, of course, have to be some introductory work and some supplemental work of a general nature. The latter would include an analytic review, that is, a study rather than a detailed analysis or checking, of the operating and income accounts of the enterprise as a whole.

#### **Time of Starting Work**

There are several things to think about in planning the commencement of an audit. One is the necessity for effecting surprise. Another is the necessity for taking up the work on several different items simultaneously. In some cases the date of the physical inventory or some similar consideration determines the starting date. And of course there are practical office matters such as the availability of staff.

In many engagements, including practically all large ones, preliminary work is done prior to the end of the

examinee's fiscal year, and this has to be carefully planned. The desired end is to arrange for as much work during the summer months as may profitably and safely be done at that time, so as to relieve the pressure during the period immediately following December 31.

Operations which usually may be planned for performance prior to the end of the year include investigation of the accounting procedures and the internal control and related audit work, test of detail transactions for the first part of the year, analytic review of operating accounts for the same period, and preparatory work by way of lining up papers for the end of the year. Of course, where operations such as this are undertaken during the preliminary work, the work program must call for investigation at the year-end of material changes during the interim, and for bringing some of the operations down to date.

#### **Survey of Internal Control**

Because review of the internal control is one of the most important steps in the proper planning of an audit, I should like to discuss it briefly.

I have used the questionnaire approach in evaluating the system of internal control for a good many years. A questionnaire of the kind I have found satisfactory covers several pages. Each page is devoted to one of the usual major accounting and custodial activities of a business enterprise and contains space for the names of the pertinent officers and employees, or departments, and questions, together with certain explanatory material, relating to the more important functions within each activity.

The questions are designed to focus attention on particular points at which internal control may be weak, so as to facilitate concentration of testing on the specified records affected and to

eliminate unnecessary auditing of records which are adequately controlled. All questions are stated so that an affirmative answer indicates a satisfactory situation as to control and a negative answer indicates a bad or weak situation. Some of the questions relate to simple facts, such as whether the employees who process suppliers' invoices have access to cash or to inventories. Most of the questions, however, relate to the auditor's opinion as to the examinee's accounting in certain respects and are designed to make him think about the possibilities before expressing himself.

For example, one question is as to whether the preparation of sales invoices is controlled to prevent errors and irregularities. The explanatory material referred to above sets forth some of the more usual means of obtaining effective control over various functions and records and is intended to aid the auditor in formulating answers to questions of this kind. The form has a liberal supply of blank space, for explanations, suggestions, and other uses.

Space is provided for the auditor to express his over-all conclusions concerning the internal control as to each activity of the business, based upon his findings as developed through answering the questions. In those cases where there is some weakness or lack in the internal control he is expected to state the respects in which this is the case, identifying the specific procedures followed by the examinee which are not good, or the points in the examinee's routine where the control is weak or lacking, and identifying also the accounting records involved, upon which attention may need to be focused in selecting the audit procedures and determining the extent of tests.

Where the use of the questionnaire is feasible in smaller organizations it usually is filled out as far as practicable at the outset of the engagement.

In larger organizations it may be filled out part by part, in each case just prior to and in conjunction with taking up the related audit work in respect of a given activity of the business.

In any case, the auditor must satisfy himself, not only by careful inquiry, but also by inspection of the records, and as far as practicable by actual observation of the procedure, as to the routine actually employed. Knowledge acquired by questioning the examinee's employees at the outset of the work should be considered subject to substantiation by other means as the examination progresses.

The auditor also must consider the probability of changes in routine and personnel during the period under examination, including temporary changes due to vacations and other absences of individuals.

In evaluating the effectiveness of internal control for the purpose of deciding upon the extent to which various audit procedures should be applied, the auditor should be concerned not only with possible combinations of duties which would permit concealment of irregularities singlehanded, but also with the possibilities of collusive action. He should consider also the possibility that important errors might exist in the records, which, although not due to fraud, might result in inaccurate or misleading financial statements.

Another important consideration is as to whether the prescribed procedures are effectively carried out; that is, whether the records are adequate, whether the employees (including supervisory personnel) are competent, and whether errors, discrepancies, and other irregularities developed during the work are properly followed up.

In order that the form be used most effectively, the contents, or the pertinent portions thereof, should be made known to the assistants performing the

audit work on the related activities. The accountant-in-charge should be sure that his assistants are thoroughly familiar with the situation and the implications therein, and with the audit procedures necessary to uncover fraud which may be perpetrated or errors which may be made because of system deficiencies.

In connection with internal control I should like to refer to the material on internal control issued by the Committee on Auditing Procedure of the American Institute of Accountants. The special report published by the Committee in 1949 and the case studies issued since that date should be familiar to all practicing accountants.

#### Planning for Inventories

I should like to emphasize the importance of planning in connection with the work on inventories.

Usually it should be the responsibility of a supervisor to ascertain the procedures to be followed by the examinee, consider their adequacy, and decide how much physical testing should be done by his crew. A brief memorandum should be maintained in the working papers covering the survey of conditions existing at the plant and conclusions as to control methods. In setting the time to be spent on inventory observation and tests, there should be taken into account the adequacy of the examinee's safeguards over inventories and the relative importance of the amounts involved. In most cases observation need not be extended to include minor parts and supplies and salvage items. In a well organized concern, all examination purposes may be served by assigning relatively few accountants to observe the work of the employees in taking physical inventories, such accountants to list only items of largest monetary importance, for identification and test to final inventory sheets. Generally, it

is more important that the auditor carefully review and satisfy himself as to the adequacy of the examinee's inventory procedures than that he list many items. His approach should be to satisfy himself that the plans for taking inventories are satisfactory, so that a good result will be obtained if the instructions are followed, and then to determine by observation that the instructions are being followed.

#### Planning vs. Execution of Work

In the planning and the execution of an audit there is a fuzzy area where the two overlap to a considerable extent. On many occasions a process similar to that of trial and error is followed. A preliminary survey is made, a partial or tentative program of work is laid out, and some operations are undertaken. In the light of the results obtained, the program is completed or revised, and the examination proceeds. This is especially likely to be the case in a new engagement where there is not experience to serve as a guide in considering the examinee's accounting arrangements and evaluating his internal control.

In some examinations the supervisor himself calls at the examinee's office or plant to survey the situation and acquire first hand knowledge of the problems to be dealt with, so that he can better instruct his subordinates. In others he relies on information given him by his assistants, tempered possibly by his knowledge of conditions gained through previous experience with the particular examinee's affairs.

In any case the greatest emphasis should be placed upon over-all study and consideration in approaching the work. A better piece of work will result if at the outset attention is given to such matters as a critical review of the company's financial statements and computation of pertinent ratios for the current period to date and comparison

with the corresponding period in the preceding year, supplemented by discussion with the comptroller or other appropriate official, for the purpose of arriving at a general understanding of the nature, volume, and trend of the business, the financial condition, and the main accounting problems to be dealt with this year. Attention should be given to brief general inspection of the principal manufacturing departments, assembly lines, store rooms, etc., and in this connection a firsthand observation of the routine of and control over the paper work in the

plant; study of the most recent organization chart and consideration of significant changes in the organization during the period; review of any changes during the period in the company's accounting manuals and similar written instructions and in its basic accounting practices; and review of the work of the internal audit staff during the period and consideration of its effectiveness.

In short, approach the planning of an audit from a businessman's point of view and keep the detail work, important as it is, in its proper place.

## What the Supervisor Actually Does as the Engagement Progresses

by **T. Dwight Williams**

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**M**Y SOLE PURPOSE IN being here is to take part in a discussion of the problem of planning and supervising audit engagements, not to read a paper outlining an exact and exclusive method of doing the job. It is my hope, by discussing the supervisory work actually done on a small engagement, to raise one or two questions of sufficient interest to warrant further discussion.

Our practice is composed of relatively small business organizations. Most of you are acquainted with the type of practice. It is not highly specialized but has the usual quota of wholesale and retail organizations, contractors, oil producers, and a smattering of manufacturing and transportation companies. The organizations examined vary in size. Most will require the use of only one or two staff members; a few as many as five or six; and occasionally one will require the use of several more for only a short period of time—for example, when inventories are widely scattered or it is important to obtain control of cash, securities, and accounts that are very active.

While the problems of supervision

are, I suppose, basically the same on all engagements, the mechanics of solving them must necessarily vary with the size of the engagement.

The examination of the accounts of a small concern having only one or two people in the accounting department and little, if any, effective internal control, will be much more detailed than in a larger one having a good system of internal control. An audit program for the first will be designed to insure that substantially all transactions are examined, while one for the second will be designed to insure that no unnecessary work is done but that adequate tests and samples are made to establish the accuracy of the accounts.

Our supervisory work is usually done by one of the partners, generally the one responsible for the engagement. The detailed supervision of some of the smaller engagements is quite often delegated to one of our better staff men, but he is, of course, responsible to a partner. The other partners are used, as needed, throughout the engagement for consultation on special accounting or tax problems which may arise, and in an emergency, in

the supervision of the engagement. Because our office is small, each partner knows generally, at least, about all the engagements in the office.

After the engagement is accepted, the work of the supervisor may be grouped under the following headings, but not necessarily in the following order:

1. Obtaining information as to the history of the organization, the purpose and nature of the engagement, and the type of report desired.
2. Selection of staff personnel.
3. Preparation of audit program.
4. Reviewing work as it progresses to see that the original program is adequate and being properly carried out.
5. Reviewing completed report and supporting data to extent necessary to determine that the examination is adequate to support an opinion and that full disclosure is made in the report.

A general outline of the history and organization of the business is obtained in the original talk with the client. The nature of the engagement is, of course, discussed at that time. The engagement may require preparation of a special report. By that, I mean special in the point of time and not a regular annual report. The time within which the report is needed will be important to the supervisor. It is our experience that the client is always in a hurry for a special report. Care should be taken to see that, in spite of the hurry, a proper examination is carried out, but the need for the report will have a bearing on the methods used; an example might be obtaining confirmations by telegraph. Annual or regular reports can be planned for and interim work done which will reduce the peak load.

#### **Preliminary Plan**

On initial examinations, a short history of the organization will be ob-

tained from a talk with the client. Arrangements are made at that time to obtain reports of previous examinations by other accountants, company statements, organization data; that is, articles of incorporation, by-laws, minute books, income tax return, and revenue agents' reports. The analysis of these records is usually made either by the supervisor or under his very close supervision. A memorandum is drawn up to summarize the results of the preliminary investigation. In this way, the supervisor obtains the information needed for a preliminary plan of the engagement.

If this investigation develops that the client desires special information or the necessity for further investigation of special features, e. g., the composition of the capital structure of the client or a possible weakness in the internal control system, this is noted and given proper consideration in preparing the audit program.

As I have said, we think that in initial examinations, at least, it is desirable for the supervisor to do much of this preliminary work.

After the supervisor has learned the requirements and apparent difficulties of the engagement and made his preliminary survey, he is in a position to select the staff to be used. This is usually done with the other partners in making staff assignment. If available the in-charge accountant selected is experienced in the industry to which the client belongs. Obviously, the task of the supervisor will be lighter if the senior accountant is experienced. The assistants are usually selected first with the view of developing them by giving them a varied experience, although availability at the time needed is a very important factor. The advice of the senior as to the assistants selected is desirable.

If the engagement is not a new one, consideration is given to the desirabil-

ity of rotating the staff members used from year to year. Again, availability of the individual chosen has an important bearing on those used. This may be a more difficult problem for the smaller firm with only a small staff to draw on.

After the staff has been selected, the supervisor discusses the highlights of the engagement with them. A more complete discussion is had with the senior in charge.

The memorandum of the preliminary investigation is carefully reviewed with the senior in charge. If the preliminary data includes a general review of the method of internal control (which it probably does, at least on the smaller engagements), this is reviewed and possible weaknesses and audit procedures desirable to guard against them are discussed with the senior.

If no investigation of the internal control has been made, the senior makes a preliminary investigation if this is feasible. In either event, a program is prepared by the senior and reviewed with the supervisor. This review covers the inventory control methods, the instructions for taking and pricing the inventory, and the arrangements made for observing that the instructions are properly carried out. We are more interested in seeing that the methods of taking and pricing the inventory are properly controlled than in actually counting a major portion of the inventory quantities. We find that in most organizations, even the smaller ones, proper control can be maintained if some thought is given to the problems presented. These will vary with almost every business.

Early in the engagement a condensed disposition of funds statement is prepared. Such a statement will indicate activities requiring special attention.

If the engagement is local, the supervisor makes it a point to be in the office of the client every few days as the work is performed. This enables him to learn of the difficulties encountered and assist in their immediate solution. Keeping in close touch with work as it progresses enables the supervisor to form a better opinion of the adequacy of the operation of the system of internal control and the necessity for modification of the audit program.

On these visits, any special problems which have developed are discussed with the proper official.

This close personal contact will speed up the engagement and insure that the work is not delayed. It also gives the supervisor a firsthand knowledge of the problems encountered which expedites the final review.

#### Early General Review

An early general review of the accounting policies of the clients are made to determine that accepted principles are being consistently followed. This review may be made only with the senior in charge or, if necessary, will include discussions with the officials of the client. This is done as soon as possible after the engagement starts so that necessary corrections can be made without undue delay. Ordinarily this does not require a great deal of work on the part of the supervisor. It is probably more important on the smaller engagements than it is on an examination of some large corporation where the accounting policies are clearly and definitely defined.

Out-of-town engagements do not lend themselves to such close day-to-day, on-the-job supervision. These engagements require and receive the more experienced in-charge accountants. The larger engagements permit the supervisor to spend a day or so at the start getting the work properly

underway with perhaps an interim visit or two if the time required or problems arising are sufficient to warrant such visits. Then he will spend the last few days before the completion of the work in the client's office, reviewing the work papers and report. If possible, and especially on out-of-town engagements, the report should be prepared and reviewed in the client's office. A more complete review can be made where the client's records are available.

The smaller engagements are usually reviewed at the completion of the work. Many of the smaller engagements require the performance of work by our staff that larger clients do for themselves. This means that even a closer examination of the accounting policies and procedures are made for the small engagements than for the larger ones. The average engagement is reviewed in the client's office either on a day-to-day basis as outlined herein or at the completion of the report. In making this review, a sufficient examination is made of the work papers, together with the audit program, to see that the program is adequate and has been followed.

The internal control questionnaire, as prepared by the senior in charge, is carefully reviewed with him. If it appears that the internal control system, in its operation, was inadequate, the audit work done to counteract the weakness is carefully considered. Much of this review has been done as the engagement was performed. At the same time, the internal control weaknesses are discussed with the accounting official and a memorandum made so that written recommendations for strengthening the internal control procedure can be made later. In general, the work papers are examined to see that they contain information and evidence supporting the accounts sufficient to warrant the expression of an

opinion on the financial statements as a whole.

On the smaller jobs it is necessary to examine the supporting schedules to see that all of the adjusting entries have been properly made and that they tie in with the adjusted balances in the working trial balance. On the larger jobs, where the in-charge accountant is more experienced, this phase of review is not so important, although we find that test checks of this nature are desirable in any review.

### Some Examples

I think, by a few examples, I can illustrate the work of the supervisor in different situations so that the problems are more clearly highlighted.

One of our clients is actively engaged in the production of oil and gas and the drilling of wells on contract for others. It has an adequate accounting and operating personnel and a good system of internal control. Throughout the year, we are consulted on accounting and tax problems as they arise. The company also operates a small refinery and pipe line system, the operations of which are well controlled.

We are thoroughly familiar with the financial and organizational history of the company, having made the examination for a number of years. From our experience, we know that the most difficult accounting problems arise in connection with their property accounts, particularly the acquisition of properties. Oil and gas properties are acquired and developed usually with others through various types of drilling transactions, and it is these transactions that develop the most difficult accounting and tax problems. After production has been obtained, operation of the property is carried on by the co-owner, usually a larger, unrelated company. Bills for the operating costs received from the co-owner are



carefully checked and reviewed by the management through its operating, materials, and accounting departments.

Planning the work on this engagement is not too difficult. The supervisor, having been in touch with the operations of the company throughout the year, knows generally what has been going on in the way of new development. If there have been any changes in accounting policy, he is aware of it. He will obtain the company's financial statements and verify the fact that the greatest interest will lie in the accounts reflecting the acquisition and development of property. He knows from experience that after the property has been acquired and is developed, the production and operation is controlled both by the company's material and production departments and the co-owner. The production and drilling operations are controlled by the operating department through daily reports and by constant cost studies. This is also true of the operations of the refinery and pipe line.

The examination of the production operation and the refining operation will be limited to determine that the controls set up are being carried out without too great a check of the detail of these operations. If the investigation made develops matters that need additional attention, this will be given to the extent required to satisfy the accountant in charge and the supervisor that the accounts are correct.

After these investigations are made, the interest will center around the current year's development and acquisition of properties. The supervisor will make arrangements with the accounting and materials department for verification of the inventories of materials and supplies, and with the refining department for verification of the inventories of crude oil in storage and refined products. He will see that the

method of pricing refined products is being properly applied and is consistent with the method used in prior years. He will be particularly interested to see that amounts receivable on joint billing accounts are properly analyzed and verified by the co-owner. If any part of the joint billing is chargeable as cost of the company's interest in development and acquisition, he will see that these amounts are cleared.

The estimates of recoverable oil and gas to be used in computing depreciation and depletion will be reviewed to determine that they have been approved by the proper engineering or geological officer and discussed with that officer.

Minutes of meetings of stockholders and directors are reviewed and notes made of items of special interest and these discussed with the senior in charge.

After the audit program has been drawn up, the supervisor will follow the progress of the engagement by discussions with the senior. He will check from time to time to see that the work required by the program is being done within the time required. For example, confirmation of amounts due from co-owners on joint billings must be accompanied by a statement of the open items. It is important that these confirmations go forth early in the progress of the engagement, and the reviewer will check to see that the statements and confirmations are sent out within the proper period. As the analysis of the authorizations or work in progress accounts and the clearances of these accounts to the various property accounts are made, he will discuss these clearances with the senior in charge and the accounting officer in the light of the several contracts. If it is found that adjustments are necessary, these, of course, will be made.

I do not mean to imply by the foregoing that the only accounts that are checked are the transactions in the property account, but these accounts, being most likely to give rise to error, will be the ones that are checked most thoroughly. Of course, all of the usual work in verifying current assets and liabilities will be done.

#### **Problem of Distributor**

Another client is a distributor of petroleum products. It usually sells these products as fast as it buys them and has little, if any, inventory. The principal problem involved, of course, is to determine that all of the products purchased and sold have been properly billed. By machine accounting, the purchase and sales of these products are balanced out both in quantity and dollars each month, and any unbilled purchases are accounted for. The examination then is limited primarily to an examination of the expense accounts and the current assets and current liabilities. The investment in fixed assets and properties is relatively small. Sufficient checking is done on the purchase and sales accounts to confirm the fact that they are properly reconciled each month and that the control procedure outlined is working.

The supervisor on this engagement will, after giving the staff sufficient time to test the control of purchases and sales and to make some preliminary examination of the expenses, hold a conference with the senior in charge to learn whether or not verifications have been sent out, what steps have been taken to check out the liabilities for possible unrecorded purchases, and what the analysis of expense and miscellaneous income accounts has disclosed.

Another client is a wholesale distributor of machinery and equipment with a number of stores scattered through-

out the country. One of the most important phases of the engagement is the verification of the inventory. It is customary for the company to take its physical inventory two months before the close of its fiscal year. Before the inventory instructions are mailed out by the company to the managers of the several stores, they are sent to our office for review and are carefully reviewed with the accounting officer of the client by the supervisor.

Perpetual inventory records are maintained in each of the branches. Some time prior to the inventory date, each store makes a check of its inventory records and it is adjusted to the quantities disclosed by that check. The general office also keeps a perpetual inventory record of the major items by branches.

Inventory sheets containing every item stocked by the company, together with inventory instructions, are mailed to the branch managers prior to the inventory date. We are also furnished with a copy of the instructions, blank inventory sheets, together with the dollar value of the book inventory, at the various stores. From this information, the supervisor determines the stores at which the taking of inventories is to be observed and the items to be noted for the purpose of control. Observing the inventories of a relatively small number of items at a few branches will result in verifying a substantial dollar value of the inventory.

The smaller branches visited are changed from year to year, so that within a period of four or five years, the inventory taking at all the stores is observed. The management feels that this type of check keeps the branch alert, and we are desirous of knowing that the inventory procedures are observed by all the stores.

In connection with the taking of the inventory, the supervisor will observe

the work of our crew in testing two or three of the larger branches.

Immediately following the verification of the inventory, as much interim work as possible is done on the accounts. Usually this means that the operations for the first nine months of the year are checked out. The supervisor spends about a week with the senior in charge and the staff in the home office of the company reviewing the internal control procedures to see that they are being adequately carried out and that no unauthorized changes have crept into the procedures. At that time he also reviews the minutes of the stockholders, board of directors, and works with the senior in charge, revising the audit program for the current year.

After this is done, there is little more for the supervisor to do except that after the interim work has been performed, he will review it with the senior and decide upon any additional

work to be performed after the close of the year.

After the close of the year, the senior and his assistants will return to the home office of the client and complete the engagement as outlined, and some few days before the engagement is completed, the supervisor will return to the home office of the client and there review the work that has been done and assist the senior in the preparation of the report. If the review indicates that some phase of the engagement should be extended, this is done before leaving the client.

Ordinarily, the supervisor will review the financial statements with the client before leaving the office, particularly the provisions for bad debts and other losses that may be indicated.

Information which the supervisor feels should be disclosed in the financial statements is discussed with the management and the disclosures agreed upon.

# The Procedure Followed by the Supervisor in Reviewing the Working Papers and the Report

by **A. Frank Stewart**

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**P**UBLIC ACCOUNTANTS ARE engaged by clients to perform a personal service of a professional character. In view of this the responsibility to see that the service rendered is performed according to the personal standards that attach to a profession devolves upon the reviewing accountants.

It is not possible for the partners of a firm which is retained to make an audit to give individual attention to every engagement. The very nature of the work, its volume, its size, its many complexities, cause most engagements to be incapable of completion by a single individual.

The primary and indefeasible obligation for the accuracy and completeness of an accounting engagement rests upon the firm whose name accompanies the financial statements. The nature of the work makes it necessary that certain duties to be performed may be delegated to subordinates, but the basic responsibility for adequate performance and review to insure such performance cannot be delegated.

Coexistent with the primary responsibility, but not superseding it or substituting for it, are further respon-

sibilities of executive subordinates, such as the supervision of the accountants who are given full field charge of engagements when performance of such engagements is assigned and entrusted to subordinate staff members.

Supervision of an engagement does not necessarily have to be made by one who is known as a supervisor. The elaborate classification of or distinction between accountants such as partner, principal, supervisor, senior, and in-charge accountant does not exist in the small firms for reasons that are obvious. Partners of small firms are oblivious of such things. They apply their specialized knowledge to do the work that has to be done and to render the service their client wants, and this they will continue to do in spite of the misplaced allegations that they are at risk of placing their independence in jeopardy.

A typical case of supervision of working papers and report is all that there is room or time here to consider. Presume that the engagement required the services of a senior accountant, assisted by one or two juniors. The

work has progressed to the point where the senior accountant, who has been actively engaged during the whole course of the audit, is now ready to have a supervisor—or partner—arrive to review the field work and “close,” as it is often called, the audit. What then are the procedures he should employ?

There are two affirmations which must be given if an opinion is to be rendered:

- (1) That the examination was made in accordance with generally accepted auditing standards applicable in the circumstances, and
- (2) That the financial statements have been prepared in accordance with generally accepted accounting principles, consistently applied.

Every review must be conducted in such manner as to meet the test of these two declarations.

If for any reason generally accepted auditing standards have not been followed, the effect thereof on the opinion should be carefully considered. It must be borne in mind that a deficiency in scope cannot be cured by a qualification. If there is a deficiency in the scope of auditing procedures applied, it must be mentioned and procedures alternative to those considered as standard should be employed to such an extent that the accountant is satisfied that no material misstatement of values exists. If he can do this, he can give an opinion, but no opinion should be rendered subject to the omission of required auditing procedures. If he cannot satisfy himself by the use of alternative procedures—and the cases in which he can are rare—he should withhold an opinion on the whole statements, subject, of course, to the materiality rule.

Throughout the entire review of the field work one question must remain ever present. Has a thorough job been done? The degree of detail involved in a field review depends upon the initial planning of the audit program and particularly upon the quality and experience of the senior accountant in charge. In reviewing the work of a capable and competent senior, the principal or partner is often accused of doing no more than asking a series of perfunctory questions as to the performance of the work. To an uninformed listener the questions may sound indifferent or mechanical, but each question has a definite meaning and purpose and unless they are completely and satisfactorily answered, additional investigation is conducted.

The thoroughness of the work can be determined only by an item-by-item review of the working trial balance and the papers supporting the various items. The trial balance provides a view of the entire system of accounts. If it contains new or unusual items they should be investigated. Items of a mixed nature should be analyzed and segregated into their proper elements. Income and expense items should be investigated and classified in order to give them their proper place in the financial statements. Comparison of their amounts with those of the preceding year should be made and material differences satisfactorily explained.

#### Questions to Be Answered

Some, but by no means all, of the salient steps of a field review require that the following fundamental questions be answered with reasonable certainty.

- (1) Were the audit and extent of verification, including independent confirmations, sufficiently comprehensive?

- (2) Are the assets properly valued and clearly stated?
- (3) Has provision been made for all liabilities direct and contingent?
- (4) Do the work papers contain all necessary analysis, schedules and explanation necessary to support the statements and opinion?
- (5) Does the report present correctly, intelligently, and adequately the results of the examination?
- (6) Are there any restrictions on surplus?

Review of working papers can never be reduced to unyielding uniformity because of the following modifying factors:

- (1) The engagement reviewed is a monthly audit, instead of a quarterly, semiannual or annual one;
- (2) The degree and extent of skilled field supervision by the senior in charge;
- (3) The working papers and reports for several previous audit periods were reviewed in detail;
- (4) No major changes have been made in the audit procedure since the previous audit;
- (5) No major changes have occurred in the client's financial condition since the previous audit.

In seeking to be satisfied with the thoroughness of the work done, many thought-provoking questions will arise along the line of "How much is enough?" In our present test and sampling method of conducting audits there will never be an entirely satisfactory or all-inclusive answer to this question as each engagement has features that will indicate that more or less work is required. Proper review intends a search to see that the senior account-

ant and his assistants have applied:

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. (SEC Accounting Series Release No. 64)

After the field work is finished the financial statements must be prepared and the report written. More often than not this work is done by the senior accountant-in-charge together with or in collaboration with the principal or partner who has reviewed the field work.

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. While it is now generally understood that financial statements are the representations of management, nevertheless the fact remains that in many cases the balance sheet and income statement as prepared by the accountant are the first and only ones seen by the client throughout the year. It is a rarity for the average small practitioner to have finished financial statements submitted to him for examination and approval.

During this discussion the accountant is offered a favorable opportunity to explain to the client the significance of the changes and developments that are being made in accounting and auditing procedures and statement presentation. 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.

### Completing the Report

After the field work has been completed, reviewed, the statements prepared and the report written, the next

movement is conditioned upon the policy and size of the accounting firm. In small firms, when a partner has been in attendance throughout the engagement it is the customary practice for the report to receive no further review prior to its typing. Some small firms have adopted the excellent practice of having another partner review the statements, reports, and work papers in the firm's office, but as this is not always practicable it is by no means a general custom. Large firms have established a department for review of all papers after they have been completed to the satisfaction of the principal who served the engagement.

In such cases the reviewer determines that the report is adequately supported by the work papers and that it contains all necessary disclosures. He sees that the work papers contain the information necessary to support the financial statements and that all necessary footnotes are appended to the statements. He sees that any comments of facts are accurate and adequately supported and he passes on any expressions of opinion. He has the authority to decide upon the nature, form and content of the certificate which is to accompany the statements,

and he measures the entire report for clarity, correctness, disclosures, and any misleading inferences that may arise in the minds of its third-party users.

The annual reports now issued by the large listed companies have developed to such an extent that they are now publications of artistic beauty. The report of management accompanied by the financial statements and the accountant's opinion which originally were the reasons for issuing the report are rapidly losing place to colored pictures of factory, field, fabrics, and feminine pulchritude. Advertising experts have been known to express regret that these reports must contain what they consider to be the dry and dull reading of balance sheets and statements of income. That they are making inroads into our province is evidenced by one annual report of last year containing the picture of a beautiful girl on the same page with the accountant's opinion.

Such movements are difficult to combat, but so long as examinations are adequately conducted, thoroughly supervised, and result in well-written statements and reports, a continuance of our progress is assured.

**Case Approach  
to Inventory  
Problems**

## **Testing Quantities and Values of Work in Process**

**by William D. Sprague**

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**I** SUPPOSE WORK IN process is one of the most difficult problems with which an auditor is faced. From an auditing viewpoint, work in process presents all of the problems of inventories generally, plus a few special problems peculiar to the unfinished state. The trouble with work in process is that it is midway between two points of reference—one point of reference being the raw material that is purchased, and the other the finished goods that are sold. Except for bulk commodities, raw materials and finished goods are usually found in a relatively quiescent state and can be identified and counted without too much difficulty. In fact, the objective of raw material and finished goods warehousing is one of orderly availability. No such situation exists with respect to work in process. Work in process is in the area of movement, of activity and change. For these reasons, work in process is a real challenge to the auditor's ingenuity and imagination.

In attempting to single out one overriding consideration in the approach to testing work in process, it seemed to me that the most important was the nature of the particular inventory and the characteristics of the particular manufacturing process. I would like to refer briefly to the textile industry as an illustration of the manner in which the auditor's approach and testing techniques are affected by these factors.

The textile industry provides an example of a continuous operation where relatively large quantities of work in process are involved. From the time raw cotton or wool is opened, scoured, carded, spun into yarn, and finally woven into cloth, a period of several weeks may elapse. Since the process involves literally hundreds of individual mechanical units (such as spinning frames and looms), it is not feasible to maintain the type of inventory control from which the auditor can abstract quantities for test counts. Material is being transformed from one



stage to another, not at regular intervals, but with each turn of the wheels. The first characteristic to be emphasized, therefore, is that this type of work in process usually requires a physical inventory and that the auditor must be present; it is not a situation in which he can make test counts at his convenience by reference to quantity records.

A second characteristic which operates in the auditor's favor is the fixed nature of the machinery. Aside from certain inventory "build up" centers, the auditor is dealing with goods which are "on the machines." By satisfying himself as to the number of spinning frames and looms in the plant (with due regard to inoperative equipment), he has a broad basis for appraising the physical inventory quantities, particularly since the units of equipment are usually of standard size and capacity. It is an important step in his audit program to check the units shown on the physical inventory with those actually in operation in the plant.

A third characteristic is the limiting factor of machine capacity. Since we are dealing with a continuous process, a comparison of total work in process at different dates (in terms of a common denominator, such as pounds) becomes extremely significant. The auditor must investigate thoroughly any material fluctuation which may be ascribed to changes in facilities, shutdown departments, inoperative units, etc.

### **Varying Techniques**

Turning to the actual testing of quantities, several techniques are indicated by the nature of the textile operation.

For example, in the spinning room the auditor can simplify his task by relying on the identical nature of the units. By calculating the number of spools on a spinning frame and multi-

plying first by the number of frames and second by the average weight of a random selection of spools, a reasonably accurate measure of total poundage is obtained. This technique might be called accurate sampling of identical units.

In the weave room, on the other hand, no two looms will contain the same amount of woven cloth. Here a calibrated stick is used to measure from the center of each roll to the outside and arrive at an approximate yardage equivalent. This technique might be described as the rough measurement of a number of dissimilar units.

In bulk treatment processes, such as scouring and blending, materials in process are not easily measured. Here the auditor cannot do much beyond observing the existence of the facilities and must rely on departmental records of quantities placed in the units. He should compare the quantities indicated for various units in order to spot obvious errors. This might be described as the judgment appraisal approach.

Assuming that the auditor is satisfied as to the physical quantities of work in process, he now has the problem of testing the valuation of the inventory.

Continuing with our textile example, if a well developed standard cost system is in use and the auditor has adequately reviewed the methods of setting standards and the results obtained, pricing becomes largely a mechanical procedure of referring to standards established for each stage of the manufacturing process and testing the mathematical accuracy of their application.

If, on the other hand, standards are not utilized, the pricing of work in process in a textile operation will usually consist of a dissection of all elements of the work-in-process inventory

into pounds of cotton, rayon, or wool which is then priced at raw material cost. To this must be added labor and overhead in process. This latter calculation is not subject to test check but must be verified on an over-all basis. It is often accomplished by relating the number of pounds of work in process and the estimated state of completion to the total production in pounds for a year and applying the ratio thus developed to total labor and overhead for the year. This will produce a labor and overhead figure to be added to the cost of raw material components.

In the usual continuous process there is a reasonable presumption that work in process, as a whole, is one-half complete. Therefore, if annual production is ten million pounds and work in process is one million pounds (one-half complete), the amount of labor and overhead to be deferred in inventory might be calculated at 5 per cent of total labor and overhead for the year. The auditor's inspection of the plant may challenge the presumption that work in process, on the average, is one-half completed, in which case a different percentage may be appropriate. Also, he will wish to give due consideration to any changes in wage rates or other cost elements during the latter months of the year.

#### **Inventories at Preaudit Dates**

Up to this point, it has been assumed that a physical inventory of work in process has been taken as of the audit date. Some mention should

be made of those situations in which work-in-process inventory is taken at an earlier date and the balance at the audit date is determined on the basis of charges and credits to work in process during the interim period.

These situations present special problems to the auditor and will require extended audit procedures. The system of internal control over the movement of goods and the basis of relieving the work-in-process inventory must be carefully investigated. Fluctuations in the book value of work in process from the earlier physical inventory must be explained and some correlation must be made of pounds charged to process and pounds produced. After reviewing these factors, the auditor may or may not feel justified in accepting the work-in-process inventory without a complete physical count at the audit date, even though operations may have to be suspended for that purpose.

To summarize, this brief consideration of work in process in a textile operation, of course, merely scratches the surface—but it may serve to illustrate:

(1) Some of the difficulties of identifying and measuring goods in an unfinished state.

(2) The importance of reviewing the characteristics of the process or manufacturing operation before laying out a program.

(3) The fact that techniques of testing are limited only by the variety of situations encountered and the imagination of the auditor.

# Tying in the Observation of Inventory Count with the Final Inventory Representations

by **Paul J. Adam**

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I FEEL CERTAIN THAT all of us are quite familiar with Bulletin No. 1 issued by the Committee on Auditing Procedure with respect to the observation of physical inventories, and as a general rule there is no longer much difficulty encountered in satisfying the requirements of this Bulletin under the usual circumstances which are presented by the medium and larger companies.

I think we can safely assume that every practitioner understands that there are certain conditions under which we can complete our inventory observation work without actual physical test checking by our representatives and still other times when we must make very extensive test counts. Therefore, I believe it might be much more interesting to present a couple of rather unusual cases of which I have knowledge and tell you what was done to satisfy the inventory requirements. You are to be the judges of whether or not compliance was had with the requirements of Bulletin No. 1.

The first case has to do with a company which was being acquired by

another much larger one. The auditors were called on the 5th day of July in 1952 and asked to undertake an audit of this particular company for the year and four months ended April 30, 1952. The report was needed by the 25th of July and the auditors did not get to the plant until the afternoon of July 5. The major problem was that of verifying inventories.

The company involved was essentially a manufacturing company but also purchased completed units which were assembled with the manufactured units. The company classified its inventories as to raw materials, work in process, and finished goods. Finished goods included both manufactured and purchased finished goods.

## Inventory Procedure

Fortunately, it was found that the company took monthly physical inventories, that perpetual inventory records were maintained for the greater portion of raw materials and for all finished goods (work in process constituted only a small portion of the total inventory) and that the inventory controls, viz., records, procedures, instruc-

tions, etc., were excellent. The auditors proceeded along the following lines with respect to the inventories:

(1) Very substantial test counts were made of the physical quantities on July 6, 1952.

(2) The July 6, 1952 test counts were reconciled to the company's June 30, 1952 physical inventory.

(3) The June 30 physical inventory was (a) tested as to prices, extensions, and footings; (b) compared to the perpetual inventory records; and (c) compared with the general ledger.

(4) The steps set forth in (3) were also taken with respect to the April 30, 1952, December 31, 1951, and December 31, 1950 physical inventories.

(5) The perpetual inventory records were reviewed for the period from January 1, 1951 to June 30, 1952—large and unusual transactions were investigated.

(6) The general ledger accounts were reviewed for the period from January 1, 1951 to June 30, 1952—large and unusual transactions were investigated.

(7) Gross profits ratios for the year ended December 31, 1951 and for each month from January to June 1952 were compared—explanations were obtained for significant variations.

(8) The dollar amounts of the various subcategories of each inventory classification as of December 31, 1950, December 31, 1951, April 30, 1952, and June 30, 1952 were compared—significant variations were investigated.

(9) An over-all review was made as to (a) the company's cost system and internal control system; (b) the general reasonableness of the inventories (including the inventory at January 1, 1950); and (c) the existence of obsolete and slow-moving merchandise.

The question here, of course, is whether or not the accountants, being unable to have physical contact with

the inventories at a stock-taking date, have complied with that section of Bulletin No. 1 reading as follows:

. . . 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.

I think there may well be arguments both ways.

#### **Case of Chemical Company**

Another case which seemed very interesting to me involved a chemical company manufacturing and selling fertilizer. This company has an operation for the manufacture of ingredients combining sulphuric acid with phosphate rock to produce superphosphate. The superphosphate is sold and also is used as an ingredient in the manufacture of mixed fertilizer. The company classifies its inventories as to raw materials, superphosphate, and mixed fertilizer. Inventory items are stored in bins or piles and under its ordinary practice, the inventory is adjusted only at the time the bin or pile is exhausted. Perpetual records are maintained for each bin or pile of product. Such records are reconciled daily to books of original entry, i.e., to purchases, production, sales, returns, transfers, etc., as recorded in the accounts. The auditors were requested to make an audit of the accounts for the three years and six months ended June 30, 1952 and one of the most difficult phases of the engagement involved the observation of inventories.

As stated hereinbefore, under the company practice the company's perpetual inventory records are adjusted

only at the time the bins or piles are exhausted, and the company had never taken a physical inventory other than to make a visual estimation at each year end. The auditors proceeded as follows in the verification of inventories:

(1) In company with the various plant superintendents and an independent consulting engineer employed by the auditors, comprehensive test measurements were made of the inventory piles as at June 30. Density tests were made of the piles by filling a cubic foot box with material removed from the pile at various points and attempting to shake it down or pack it to the extent necessary in order to conform to the estimated density at the point the material was removed. This proved a pretty difficult job, since in many cases these materials had been compressed and hardened to the extent that any density test could not possibly be as great as actual density. Accurate density determination could only be made with an adequate means of coring the interior part of a pile of material. In this case the consulting engineer was of the opinion, concurred in by the auditors, that the tests of density used in computing quantities on hand were conservative and would not result in overestimation of quantities.

(2) The auditors' test measurements, determined as explained above, were compared with the perpetual inventory records as at June 30, 1952. Tests were made of prices, extensions, and footings, and inventory amounts were checked to the general ledger.

(3) As to inventories at December 31 of each year from 1948 through 1951, the tests of prices, extensions, and footings also were made. For each year and also for the last six-month period, the inventory quantities were reconciled with production, stock, and shipping records. Purchases were traced to incoming materials records

and supporting invoices and freight bills were examined on a test basis. Production records were examined and production during each year was traced to the additions to stock. Ingredients going into products were reconciled with raw materials used. Tally sheets, accumulating materials by mixes, were examined in support of production records on a test basis. Bin record adjustments were reviewed for the entire period. The shrink allowance factor on each ingredient and product was reviewed for the entire period and comparison made between years to ascertain that shrink allowances were taken on a consistent basis.

(4) The general ledger accounts were reviewed for the entire period for a large and unusual transactions, an over-all review was made of the cost system and of the system of internal control, and inventories were checked for obsolete and slow-moving materials.

Having made the examination explained above and obtained satisfactory explanations for significant variations, the auditors prepared the following paragraph for inclusion in their certificate:

We made tests of the physical existence of the inventories at June 30, 1952 but we did not do so with regard to the inventories at preceding fiscal year ends inasmuch as those dates were prior to the time of our engagement by the Company as independent accountants. However, our tests of the accounting records for the years 1949, 1950, and 1951 have given us no reason to believe that the inventories at January 1, 1949, December 31, 1949, December 31, 1950, and December 31, 1951 have not been fairly stated.

In our opinion, with the foregoing explanations as to inventories for certain years, the accompanying

In view of the company's practice to adjust inventory records only upon the exhaustion of an inventory pile,

and never to measure inventories, the question here is whether the auditors, even with their extensive tests, could satisfy the requirements of Bulletin No.

1. It would appear to me they have; and that further, the precedent for the inventory procedures is explained in Bulletin No. 16.

## **Can the Auditor Detect Misrepresentation of Quality?**

by **John J. McIsaac**

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Member of the Council of the Institute

**T**HE DETECTION OF misrepresentation of quality of inventory materials is a problem which we as independent certified public accountants are faced with on many occasions.

*Extensions of Auditing Procedures*, dated October 18, 1939, as modified and approved at the 1939 annual meeting of the American Institute of Accountants, includes certain procedures with regard to the certified public accountant's responsibility as to examination of inventories. The report of the special committee which recommended such procedures contained the following: ". . . the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials." The report further states: "It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public ac-

countant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition, and does not hold himself out as a general appraiser, valuer, or expert in materials."

The value at which inventories are stated in a balance sheet is based on representations of management, which representations include quality. In connection with the verification of inventories, the auditor can be expected only to carry out generally accepted auditing procedures, but he cannot be responsible for quality because of his inadequate technical training. There is a possibility of serious misunderstanding among credit grantors and other readers of financial statements as to the certified public accountant's responsibility with respect to inventory quality. This matter is of such importance that it should always be stressed

in any publication dealing with the certified public accountant's responsibility.

In connection with the verification of inventories, the auditor is expected only to carry out generally accepted auditing procedures; but in cases where he cannot qualify as an expert because of his inadequate technical training, and where quality is an important factor, his responsibility is such that he should recognize his limitations and where necessary engage the assistance of those qualified as experts in determining quality.

Often it is impossible for a professional auditor to detect misrepresentation of quality while making test checks and observations of inventory taking. He, of course, should be able to distinguish between different objects but he may not be able to distinguish between different qualities of a particular object. However, the auditor can and should review the items comprising the final inventory for the purpose of determining that the quantity of goods, especially of fine and expensive grades, appears reasonable. Items of question should be investigated by reference to production records to determine that the quantities of such quality goods have actually been purchased or manufactured, and by reference to sales records to determine that such articles have been and are being sold and at a profit.

Some of the difficulties encountered by the auditor may be illustrated in the following:

In the case of a jewelry concern where the inventory includes precious stones, naturally the auditor should not be expected to tell a genuine diamond or emerald from an imitation simply by examination of the merchandise, as he is not so qualified. However, he can determine that the weights of the stones as represented are in agreement with the perpetual records and that stones

of such weights have actually been purchased by reference to purchase invoices. It would be doubly difficult for a dishonest individual to substitute not only an imitation for a genuine stone but also to substitute an item of exactly the same weight.

In connection with the verification of inventories in a textile mill, it should not be difficult for a professional auditor to distinguish between wool and cotton, but in order to determine the quality of various grades of wool several years of experience as a sorter would be required. It would be exceedingly difficult for an auditor to detect misrepresentation in cases where wool has been upgraded by a dishonest employee who is in collusion with an outside wool dealer and purchase invoices are on file to support the prices paid for such wool. However, if the inventory contains what appears to be an unreasonable amount of high quality grades, an investigation should be made to determine that it is the company's practice to use such high grades in the manufacture of its product. A review of the production and cost records and the amounts at which the products are subsequently sold should assist the auditor in his investigation to determine that the quantities of such high quality grades are reasonable.

Many other examples could be cited where the auditor would encounter problems of determining quality, such as furs, shoes and other wearing apparel, tea and coffee, perfumes, chemicals, etc.

A valuable resource available to the auditor for the detection of misrepresentation of quality is that of taking samples of various materials and submitting them to laboratories for analysis by qualified experts. This procedure would not be used in every case where a question of quality arose, but it is available and is being used in some instances,

The program for verification of inventories should be developed after a careful review of the internal control and visits should be made to the inventory locations, giving due consideration to the procedures to be employed in the taking of the inventories. The program should include instructions to the auditors carrying out the actual work to be on the alert for quality of important and expensive items peculiar to the particular concern involved. The auditor should also determine that the employees actually taking the inven-

tory are responsible employees and familiar with the various qualities of materials involved.

The verification can only be carried out by professional accountants as such and not as technical experts familiar with determining qualities of materials. However, I believe the certified public accountant does have the responsibility of exercising sound judgment which in some cases would require supplementing his work by resorting to outside experts for the purpose of detecting or preventing misrepresentation of quality.



# How Does a One-Office Firm Deal with the Problem of Serving a Client with Inventories in Distant Locations?

by *Hatcher A. Pickens*

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**T**HE CLIENTS OF A one-office accounting firm seldom have as highly effective a type of internal control, if any, as do practically all the national businesses. So, with respect to the operation of branches, our first function, as I see it, is to urge and plan a proper internal control. Such a system provides information not only as to what should be the content of the year-end inventory, but accounts for the disposition of purchases and production and serves as a check on the regularity and effectiveness of branch activity in general.

Another opportunity for service under these conditions has to do with the branch personnel and general business performance. True, the branch plant is generally closed down for inventoring, but observation of the unit in operation is worth the spending of some additional time to accomplish. We should constantly bear in mind that most small companies do not have as highly trained accounting personnel as do the larger enterprises, and recommendations by the independent accountant as to accounting and operating methods are often of as great, or

greater, value to them than is certification of financial statements. This comment is particularly applicable to distant branches, due to their remoteness from general management supervision.

With regard to the actual observation of distant inventories, it is of course understood that it is not necessary for the accountant to have representatives at all points. But we will assume the necessity exists, for certification or other purposes, for observation of the inventory of at least one distant location.

Adequate advance preparations for the year-end inventory are essential. Such preparations should include clearly detailed instructions issued by the client setting out the mechanics to be employed in the inventory count providing, among other things, for sectional numbered marking of the plant and warehouse area, duplicate count sheets in indelible pencil, and dual inventoring following by comparison, with immediate recheck in event of discrepancies. Custody over one copy of the inventory sheets should be maintained by the observer.

It may be considered reasonable to modify or even eliminate some of the instructions just mentioned if perpetual inventory records are kept.

#### Four Methods

We now consider the problem of physical observation of the distant inventory. Following are four methods for the accomplishment of this objective:

1. By the independent accountant's personnel;
2. By representatives of a correspondent accounting firm in the area of the inventory location;
3. By representatives of a firm of inventory specialists; and
4. By the client's personnel from the home office.

From the standpoint of the accountant's certification, the first two methods (by the client's independent accountant or by a correspondent accounting firm) I believe to be acceptable. The last two (by inventory specialists or by the client's home office personnel) should not, in my opinion, be endorsed.

The most desirable procedure is, of course, observation by the accountant's own staff. However, the addition of traveling expense to the compensation for services may result in such a relatively high cost to the client that he may be loath to incur it. In this event other arrangements may well be made.

An alternative is for the accountant to arrange to be represented by an independent accounting firm, of favorably known reputation, with an office in the area of the particular inventory location. The correspondent firm would be furnished with a fairly complete outline of the procedures to be employed by its men, together with a copy of the inventory instructions issued by the client. Such firm would report direct to the principal account-

ant, also supplying a copy of the inventory count sheets.

As to the acceptability of this means of inventory substantiation and its effect upon the report of the principal accountant, it is a logical view that he has effected the observational procedures through his qualified representatives, even though they were not of his own staff. It is noteworthy that certified public accountants in general accord full recognition to, and follow in practice, high standards of auditing and well considered principles of accounting.

Consequently, it is my unqualified opinion that an accounting firm is justified in relying upon the reports of a like correspondent firm, of good repute, as to inventories which are located at a considerable distance from the accounting principal's office. However, if such inventories are relatively substantial in amount, I feel that disclosure of the situation should be made in the scope section of the report, but that no necessity exists for reference to it in the opinion paragraph.

#### Inventory Specialists

A third possibility is the retention of a firm of outside inventory specialists, if available, for the assignment. But there is this important distinction between such a plan and that of engaging a correspondent firm of independent public accountants: the specialists, so far as I know, are not the beneficiaries of a widespread spirit of professional thinking which has so taken root among them that they consider it a "must" to measure up to a high standard of performance.

Further, it is a reasonable presumption that they are not possessed of enough accounting background to develop such necessary information as purchases recorded but not received, merchandise billed but still in stock pending shipping instructions, various

elements relating to "cut-off" time, and the like, all of which have a direct and sometimes considerable effect upon the inventory valuation. In the Auditing Practice Forum of the February, 1950, *Journal of Accountancy*, the following statement was made:

If the client engages a competent, independent service company to perform that work on his behalf, there would appear to be in effect a degree of internal control with respect to the inventory which should give the accountant considerable assurance. However, as in other cases where the internal control appears to be good, the accountant should not rely upon it without investigation to satisfy himself that it is operating in a satisfactory manner.

The logical conclusion, under these circumstances, is that the accountant should have a representative (either of his own staff or of a correspondent accounting firm) present at the inventory count. If this is done, and the amount involved is material, then

mention should be made in scope section of the report; and, if the accountant has not satisfied himself by other means as to the item, he should also state an exception in the opinion paragraph, or, if the exception is significant enough to negative an opinion, he should disclaim an opinion. (In general practice, in cases such as this, I think the necessity for disclaimer would be a rarity.)

Presence of the client's representatives from the home office at a branch inventory results in somewhat the same effect upon the accounting firm's responsibilities as when outside inventory specialists are engaged. That is, it is no more than an element of internal control.

To sum up, the accountant, under the circumstances recited, should first urge maintenance by the client of effective control over branch operations; second, observe general branch operations and personnel; and third, substantiate the existence of the stocks of goods which are represented to be there.

# What Auditing Can Be Done on Inventories Prior to the Year-End Closing or Subsequent Thereto?

by *Erwin Heinen*

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**T**HE PROBLEM OF TESTING inventory procedures and observing taking of inventories before or after the audit date involves consideration of many factors relating to the particular business being audited.

The types of companies in which this problem is encountered fall between these two extremes:

Company A which (a) maintains perpetual inventories in units and dollar amounts tied into the inventory records; (b) makes adequate internal audits of such records and has available written reports on such audits; (c) makes periodic checks of physical quantities throughout the fiscal year; and (d) adjusts the general records to agree with the results of such periodic checks.

Company Z which (a) maintains perpetual inventory records in units only or keeps no inventory records; (b) maintains no internal audit staff; (c) does not take periodic inventories during the year; and (d) maintains no cost records or, if maintained, does not tie them into the general records. In this area, companies such as Company Z are frequently encountered.

In large, in well organized companies, most or all of the factors mentioned in the first type of company (Company A) are more likely to be present. This will minimize the problem of satisfactorily examining the inventory before or after the audit date. At the date selected for physical inventory, the normal inventory auditing procedure would be applied. These procedures obviously should be sufficient to test satisfactorily the transactions between the date of inventory taking and the audit date. In such cases, where adequate internal control and records are present, the problem is relatively simple, and need not be discussed at length.

Where the conditions approach those outlined in the second class of company (Company Z), the problem of reliance on observation of the inventory, either before or after the balance-sheet date, becomes increasingly difficult and may become impossible of solution, necessitating a qualification or exception in the auditor's report if inventory is material in relation to current assets, to working capital, to surplus, and to determination of oper-

ating results. As this difficult situation, exemplified by companies operating under conditions between Company A and Company Z, is approached, consideration should be given among other things to:

- (a) Kind of business.
- (b) Internal control over inventories, starting with receipts of materials and supplies, continuing through conversion operations and finished stock including shipments; and any internal audit procedures that may be followed with respect to inventories.
- (c) Relative importance of inventory to total current assets, to working capital, and to surplus.
- (d) Degree to which inventory amount is a material factor in determining operating results.
- (e) Character and dependability of cost records and whether or not they are tied into general records.
- (f) Physical layout, storage, and protection of inventory; the two latter items being a phase of internal control.
- (g) Organization of, and procedures for, physical inventory taking.
- (h) Availability of records of physical inventory taking and means of authenticating such records.
- (i) Any perpetual inventory records maintained.
- (j) Size and number of inventory items and whether bulk of dollar amount is concentrated in a relatively small number of items.
- (k) Size and number of transactions affecting inventories between audit date and date of taking of inventories, and possibility of satisfactorily checking or test-checking the accounting for such transactions.

- (1) Previous audits made and experience with dependability of previous inventories, though such experience is not necessarily conclusive but may be persuasive as to the dependability of the inventory as of a particular date.

If a sufficient number of these factors are satisfactory, the inventory might well be taken at other than the balance-sheet date.

The problems of pricing the inventory taken at a date before or after the audit date are substantially the same as those if the physical inventory is taken at the audit date. Inquiry into the method of pricing will involve questions of replacement cost, net realizable values, obsolescence, etc. The kind of business, whether trading or manufacturing and, if manufacturing, the availability of cost finding data, are all subjects which must be considered.

#### Case Studies

Case studies presented are those of companies which fall between the extremes of the first and second type of companies described.

One company was a small equipment distributor, operating on a calendar year basis. For years it had taken complete physical inventories at the end of the year, but decided to take physical inventories at November 30. This company took no interim inventories and kept no perpetual stock records. Its monthly operating statements were based on estimated gross profits. In this case, the accountants observed and tested physical inventory procedures and made tests of pricing and clerical accuracy of inventory computations at November 30. The company costed sales having a high unit price, which comprised a substantial portion of the sales total, for December. The accuracy of this costing of sales was tested by reference to ven-

dors' invoices, which together with a comparison of the gross profit realized on such sales compared with actual gross profit for the first eleven months, and a test of purchases charged for December, enabled the accountants to be satisfied with the inventory amounts stated at the end of the calendar year.

Another company was in the business of manufacturing and distributing chemical products, which were stored in many locations, as consigned inventory. The company maintained stock records in units, and supplemented these by stock records maintained by the consignees, but had practically no test counts and had inadequate internal control.

During the first audit a very substantial number of the inventories held by consignees were counted either before or at the audit date. In the cases of those inventories in which physical quantities were counted before the audit date, reconcilements of shipments to the consignees and deliveries by them during the period between the date of count and date of the audit were made. Inventories also were confirmed by direct correspondence with the consignees.

Moreover, improvements in the company's internal controls were suggested in order to overcome the difficulties encountered and enable satisfactory testing of inventories prior to the audit date in subsequent years. These improvements included having written procedures for test counting and reconciling consignees' inventories

during the year; having a company internal auditor make tests throughout the year on a staggered basis; having internal audit reports and reconcilements available for subsequent inspection; and having the independent auditors accompany the internal auditor at various times during the year and test not only procedures followed but also accuracy of counts made.

In cases where a company's inventory records and internal control are adequate, little difficulty will be encountered in auditing inventories prior to the year-end closing or subsequent thereto.

In cases where the records and internal control are inadequate, it may be extremely difficult, if not impossible, to make a satisfactory audit of inventories at other than the balance sheet date.

In between these two extremes lie the cases where it may be possible for the auditors to satisfy themselves by combining the ordinary inventory procedures with adequate testing of intervening transactions.

Where conditions preclude satisfactory auditing procedures with respect to inventories taken prior or subsequent to the audit date, the company should take inventories at the audit date. Constructive suggestions should be made for improving the company's inventory accounting to permit in future years the taking of inventories prior or subsequent to the audit date and the application of satisfactory auditing procedures to such inventories.

# Inventory Observation Problems Peculiar to Certain Industries – the Oil Industry

by **A. G. Schlossstein, Jr.**

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**I**N ORDER FOR US TO be capable of observing the measuring and sampling of crude oil and refined products we must be thoroughly familiar with the general procedures followed in properly performing those tasks. The procedures may vary with different types of storage facilities and it would be impractical to try to cover in this paper all of the possible procedures. For the most part, crude oils are stored in atmospheric tanks with fixed roofs and floating roof tanks; refined products are stored in the same type tanks and in addition may also be stored in variable vapor space tanks and in pressure tanks.

Atmospheric tanks with fixed roofs are generally used for the storage of low vapor pressure stocks and are the most common and the least costly type of tank in use; floating roof tanks are second in usage and are used for the storage of volatile crudes and products; variable vapor space tanks include breather roof, balloon roof and gasometer roof tanks and are used for long-time storage of finished volatile stocks; pressure tanks are used for the storage of stocks, such as propane and

butane, which at normal temperatures and at atmospheric pressure exist as gases and for the storage of aviation gasolines. This paper will be limited to the preferred procedures for measuring and sampling crude oil and refined products in the above-listed types of tanks.

It should be remembered that measuring and sampling are everyday (almost every-hour) chores for field employees, for quantities of crude oil and refined products moved from one location to another are determined by measuring and sampling the contents of the receiving and discharging tanks before and after the movements.

First, however, a word of caution. The safety rules prescribed by your client should be strictly adhered to. The dangers involved in observing inventories of crude oil and refined products run the gamut from snake bite to explosion, from sunburn to asphyxiation, and from heatstroke to frostbite.

## Location of the Inventory

The normal flow of crude oil from the well through the refinery to the

consumer is set forth in a general manner in Chart I. The oil flows first into a lease tank wherein production is measured; from the lease tank it flows into a pipe line and the quantities run into the line are determined from opening and closing gauges adjusted for temperature and basic sediment and water. The pipe line carries the oil to a tank farm or storage farm where the crudes are gathered and sorted. From the storage farm the crude oil is moved by pipe line to the refinery where it is stored in large crude oil storage tanks until it is drawn into the various units of the refinery.

In the refinery there are numerous processes and many intermediate products; those intermediate products are generally stored in small or medium-sized tanks called run-down tanks. The finished products of the refinery are stored for the most part in large storage tanks and may move by pipe line, tanker, barge, or tank car to marketing terminals or bulk plants. From the terminals or bulk plants the products are delivered to retail outlets or to the wholesale customers of the company. From this brief summary it may be seen that inventories are found in the following locations:

**Crude oil—**

- Lease tanks
- Storage tanks at tank farms
- Storage tanks at refineries
- Pipe lines

**Refined products—**

- Storage tanks at refineries
- Run-down tanks and processing units
- Terminal and bulk plant storage tanks
- Retail outlet storage tanks
- Pipe lines

Chart II sets forth a typical percentage distribution of the quantities among the various foregoing storage locations. Lease tanks are usually no larger than 1,000 barrels (the three common sizes

being 210, 500 and 1,000 barrels) and as may be seen from Chart II the total quantities of crude oil in lease tanks are not material in relation to the total quantities of crude oil in the inventories of a company. It is not, therefore, customary to observe the gauging of the lease tanks; clerical and other test checks are made in the head office of the computed inventories in lease tanks.

**Storage Tanks**

Storage tanks on tank farms are large tanks with capacities up to 120,000 barrels and it is obvious that it is necessary for us to observe the gauging processes at some of these tank farms. Timing is no particular problem as the daily gauge and temperature readings can be reconciled forward or backward to the nearest month-end by the use of data recording movements into and out of each tank.

Similarly, storage tanks at refineries are large capacity tanks containing either crude oil or finished products. The observation of the gauge and temperature readings of these tanks should preferably be made at the month-end to facilitate tracing the observed readings into the company's records; however, it is possible to observe the gauging at any time during the month and to reconcile the observed readings to the nearest month-end recorded inventory.

Refinery run-down tanks and processing units are generally not of sufficient capacity to warrant observing the taking of the inventories therein. Terminal and bulk plant storage tanks are commonly not of large capacity but there may be a large number of locations and it may be desirable to visit one or more of the locations to observe the inventory procedures.

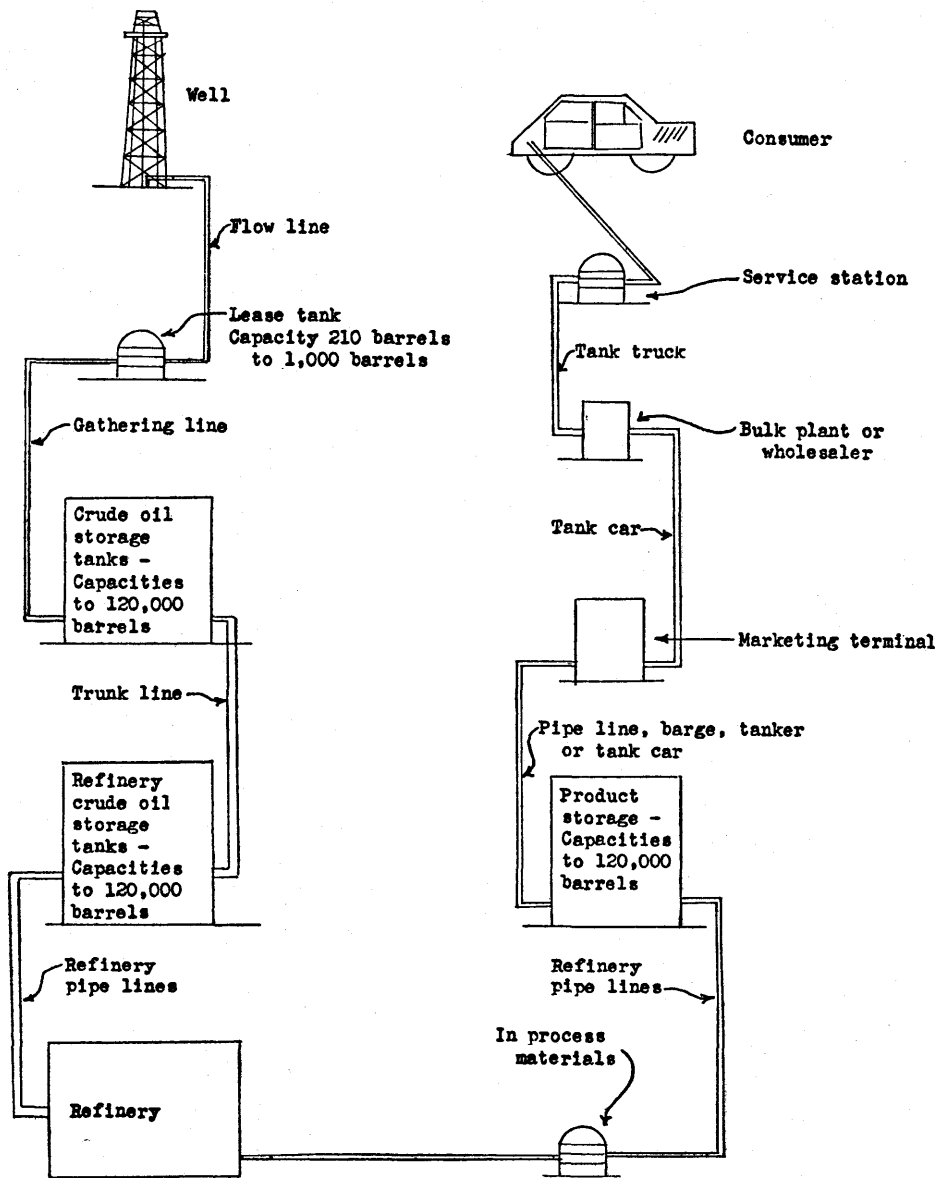
Retail outlet storage is usually insignificant and no observation of those inventories is ordinarily made. The



trend of the oil companies is away from company-owned and operated stations and to leased and other independent outlets; in the latter outlets the inventories are the property of the station operators.

Crude oil and products in pipe lines are determined from engineers' charts of line capacities and are based on an assumption that the lines are always full. These inventories cannot be observed, but are checked by reference to line capacity charts. This step is useful as a cross-check of the property

**CHART I: FLOW OF CRUDE OIL FROM WELL TO CONSUMER**



records of the pipe lines as it will indicate new lines added, old lines abandoned, etc.

**Determination of Quantities**

The determination of quantities of crude oil and refined products stored in tanks is usually made in accordance with the general procedures prescribed by the American Petroleum Institute (API Code 25—Measuring, Sampling and Testing Crude Oil, and API Code 50B—Measuring, Sampling and Testing Natural Gasoline and Other Light Liquid Petroleum Hydrocarbons). Many of the oil companies have their own manuals or pamphlets describing in considerable detail the precise procedures to be followed in gauging tanks. Generally speaking the quantity of merchantable oil in the tank at a standard temperature of 60° Fahrenheit is determined by obtaining the gross height (in feet and inches) of the oil at the observed temperature, converting the reading to gross barrels by reference to a tank table, deducting

therefrom first the nonmerchantable oil (B. S. & W.) in the tank bottom (determined by measurement) and second the quantity of basic sediment and water in suspension (determined by sampling and testing). The resulting quantity is the quantity of merchantable oil at the observed temperature and is converted to net barrels at 60° Fahrenheit by reference to standard temperature correction tables. (See Chart IV.)

Now before you start, be sure you know which measurements, etc. you wish to record and use a small bound book that can be slipped in your pocket. Your hands should be free to climb the tanks—there are no escalators.

**Gauging**

The gross oil in the tank can be determined by one of three methods, innage, outage, or glass gauge or automatic gauge reading. (Refer to Chart III). These methods may be described as follows:

1. **Innage —**

To ascertain the depth of the oil (crude oil or refined products) by the innage method, a tape measure, suitably weighted by a plumb-bob of non-spark generating material, is lowered through a hatch in the top of the tank until the bob lightly touches the bottom of the tank. At this time a reading is taken of the tape at a predetermined reference mark on the gauging hatch in order to ascertain that the bob touches the tank bottom. If the bob touches the bottom of the tank the reading at the reference mark will agree with the reference reading stencilled on the hatch at that point. The tape is raised and the oil level reading is taken and recorded in feet and inches to the nearest 1/8 of an inch. For crude oil and light refined oils the reading will show plainly on the tape. For gasolines and other light petroleum products it may be necessary to

**CHART II: CRUDE OIL AND REFINED PRODUCTS INVENTORIES**

Quantities by Locations —  
Per cent to Total

	Per cent
Crude Oil (39% of inventory value on balance sheet)—	
Lease tanks	7
Storage tanks at tank farms	68
Storage tanks at refineries	8
Pipe lines	17
	<u>100</u>
Refined Products (61% of inventory value on balance sheet)—	
Storage tanks at refineries and in processing units	86
Marketing terminals	9
Bulk plants and retail outlets	3
Pipe lines	2
	<u>100</u>

treat the tape with an oil-finding paste to obtain a clear-cut reading. Two separate readings should be taken, one as a check of the other.

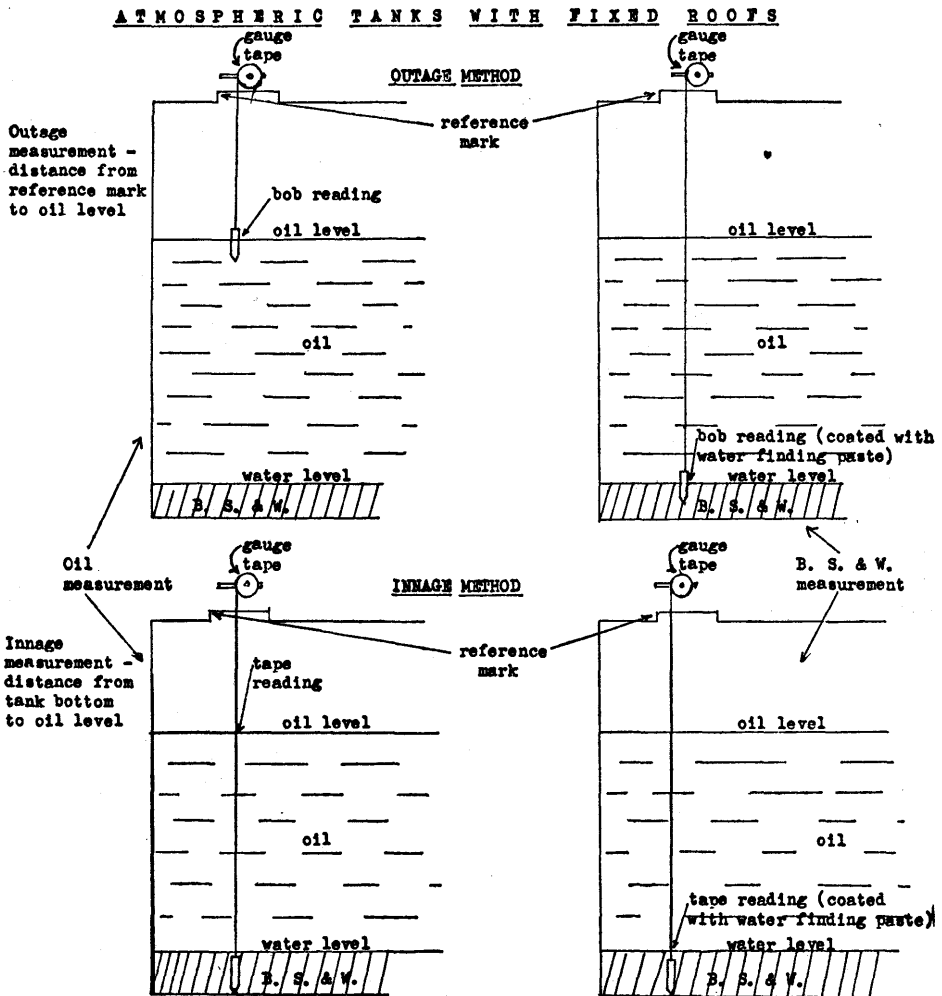
If the tank is a floating roof or variable vapor space tank it is necessary to take an innage gauge.

2. Outage —

To ascertain the depth of the oil (crude oil or refined products) by the outage method, a tape measure, suitably weighted by a plump-bob of non-

spark generating material is lowered through a hatch in the top of the tank until the bob enters the liquid. (See Chart III). A reading to the nearest 1/8 inch is taken and recorded of the feet and inches shown on the tape at a pre-determined reference mark on the gauging hatch. The tape is raised and a reading is taken and recorded of the depth to which the bob penetrated the oil. The latter reading is deducted from the former reading to obtain the

CHART III: GAUGING DIAGRAM



measurement of the air space (outage) in the tank. The air space measurement is deducted from the inside height of the tank (reference reading stencilled at the reference mark on the inside of the hatch); the resulting measurement is the depth of the oil. As in the innage method it may be necessary to use an oil-finding paste to obtain a clear-cut reading of the penetration of the bob. Two separate readings should be taken, one as a check of the other.

An outage gauge can only be taken on an atmosphere tank with a fixed roof.

### 3. Glass gauge or automatic gauge reading —

All pressure type tanks have automatic gauges of one type or another. Highly volatile petroleum products (liquid petroleum gases) are stored in pressure type tanks in order to reduce vapor losses. These tanks do not have hatches and the readings of the depth of the contents are obtained from glass gauges or other automatic gauges. The gauge will show the depth of the oil and it is only necessary to record the reading.

Since the war a number of electronic gauges have been installed at crude oil tank farms making it possible to gauge the tanks without leaving the pump stations; however, month-end inventory gauges are still taken by the old-fashioned method of climbing the tanks.

### Temperature Readings

Almost all inventories of crude oil and products are stated in net barrels at 60° Fahrenheit. In order to convert the barrels ascertained from the gauge readings to net 60° barrels it is necessary to obtain the temperature of the crude oil or refined product at the time of measurement. In nonpressure type tanks a closed bottom brass cup thermometer is used. It is a known fact

that the temperature of the oil in the tank may vary at different depths and it is customary to take several readings and to average those readings. Temperature readings are generally taken near the bottom of the oil, near the middle of the oil and near the top of the oil. The three readings are then averaged. According to the API code the thermometer should be suspended in the oil at each depth for not less than 5 minutes. Some companies insist on 20 minute immersion for heavy crude oils. The thermometer must be raised rapidly and the reading taken immediately to prevent atmospheric effect on the temperature reading.

The gauger will usually suspend a thermometer in the liquid while he takes a gauge reading; on some tanks a thermometer may be permanently suspended in the tank.

Pressure type tanks are equipped with built-in thermometers from which readings are taken.

B. S. & W. is basic sediment and water and is heavier than crude oil or products and will eventually settle to the bottom of the tank. The B. S. & W. in tank bottoms measurement is taken on fixed roof, floating roof, and variable vapor space tanks with the tape weighted by the plumb-bob and may be taken by the innage or outage method (See Chart III). The bob (for outage method) or the tape (for innage method) should be coated with an approved water-finding paste; when the tape is raised the reading is taken and recorded. A second measurement should be taken as a check on the first measurement.

Pressure type tanks frequently have outlets through which water in the tank can be bled. If so, the water should be bled before the gauging is started. Other types of pressure tanks are equipped with glass gauges which will reflect the water level in the tank. Product tanks usually contain only

## CHART IV: TANK FARM REPORT AND INVENTORY

<u>Tank number 1128</u>		<u>7 A.M. July 1, 1952</u>		
		<u>Measurement</u>		<u>Barrels</u>
Gross gauge		41'	2¾"	78,938.55
B. S. & W. in tank bottom		3'	4"	6,391.79
				<u>72,546.76</u>
	<u>Top</u>	<u>Middle</u>	<u>Bottom</u>	<u>Average</u>
B. S. & W. in suspension	2/10	2/10	2/10	2/10
Gravity	35.1	35.2	34.7	35.0
Temperature	84	84	78	82
Deduct for B. S. & W. in suspension 2/10 of 1% of net barrels above (72,546.76)				145.09
				<u>72,401.67</u>
Multiply 72,401.67 barrels by a factor of .9891 representing temperature correction from 82° to 60° Fahrenheit for 35 to 50.9 gravity oil to compute net inventory barrels				<u>71,612.49</u>

water; basic sediment is peculiar to crude oil tanks.

As previously mentioned the B. S. & W. in tank bottoms is deducted from the gross oil to determine the merchantable oil. Some companies do not make this measurement but deduct arbitrary quantities based on field estimates. Still other companies make the B. S. & W. in tank bottoms measurement but arbitrarily increase that measurement in recording their inventories. It is a proven fact that B. S. & W. piles up in tank bottoms (opposite the intake pipe) and does not lend itself to accurate measurement. If your client's methods of determining B. S. & W. in tank bottoms are reasonable and are consistently followed they should be accepted.

Samples of crude oil in tanks are taken to determine gravity and B. S. &

W. in suspension. You, as an accountant, will be interested in obtaining samples for laboratory test. This can be done by informing the gauger of your needs in advance so that sample bottles can be carried with you. Sample bottles should be numbered and a corresponding number indicated on the gauge reading for the tank from which the sample was taken. The samples (unidentified except for the number assigned) may be given to the company laboratory or to an independent laboratory for analysis. The laboratory determination of the contents should agree with company records of tank contents. Generally speaking a limited test-sampling will suffice.

Samples are obtained by the use of oil thieves, either bottle type or bottom closure type. The thieves are lowered into the liquid to a predetermined level

and tripped (closure type) or uncorked (bottle type) allowing them to fill. Generally three samples are taken, one at the top, one at the middle, and one at the bottom of the merchantable oil. Each sample is tested for gravity by the use of a hydrometer, and the temperature of the sample is obtained at the same time. The gravities and temperatures of the samples are recorded.

The B. S. & W. in suspension of each sample is determined by the use of a centrifuge. The percent of B. S. & W. in suspension is recorded for each sample for proper correction.

You have now completed the observing of the inventories; your immediate problem is to obtain a copy of the company's regular tank report and to record thereon in permanent fashion the readings you have observed. You may then wish to make your own conversions and adjustments, or you may decide to check the company's computations. An example of the computations is set forth on Chart IV. On your way home or to the hotel be sure and pick up a bottle of liniment for if you have climbed very many tanks you will need it.

## **Inventory Observation Problems Peculiar to Certain Industries—a Lumber Mill**

by **James C. Goldrainer**

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**B**EFORE CONSIDERING THE problems incident to the observation of inventories of a lumber mill, it is necessary that we first become familiar with the various types or classes of inventories that a lumber mill might have as well as the problems which are peculiar to each.

The various inventories that might be found depend upon the type and size of the particular mill. For example, some operators have their own timber supply and carry on their own logging operations, while others purchase their logs in the open market. A mill that has its own timber operations would have logs in the woods that

have been felled and bucked and logs in the woods which are cold-decked, that is, logs which have been assembled for temporary storage before shipment to the mill. In addition this class of operator, as well as the operator who purchases his entire log supply, would have logs at the mill which are either cold-decked there or in the mill pond adjacent thereto or in rafts in the river.

Both operators also would have an inventory of lumber at the mill which may be in various stages of manufacture. There are also various inventories of by-products such as lath, broom handles, box material, and molding.

Furthermore, the really large mills are now utilizing the waste by putting all such materials through a large machine known as a "hog" which chips or grinds the pieces into small fragments. These fragments are used in the production of hard-board and various other types of wood products. This discussion is limited to mills sawing logs into lumber and excludes those used for special operations, such as the production of wood pulp, veneer, and plywood products.

In speaking of the inventories of a lumber mill, the largest value, of course, is in logs and lumber. A lumber mill, however, like many factories also has substantial inventories of manufacturing supplies, repair parts, and materials. I do not consider it necessary to spend any time on a discussion of this class of inventories for two reasons. First, many operators do not inventory manufacturing supplies, repair parts, and materials. Secondly, where it is the practice to inventory these items, the taking of the inventory and the observation in connection therewith present no peculiar or unusual problems.

### **Need for Specialists**

The correctness of the quantities and the values of the log and lumber inventories depend upon the accuracy with which the inventory is taken, the method of pricing, and the correctness of the extensions and footings. The accuracy with which the inventories are taken depends upon the experience of the log and lumber men who make and record the count and the orderly manner in which the inventorying methods are followed. The taking of log and lumber inventories, in most instances, requires men having specialized training and experience in that field. It is believed that in most instances the public accountant does not possess the special skill necessary to enable him to check the accuracy

of the physical count or cope with the special problems relating to species, grades, and quantities.

I do consider, however, that the independent accountant can do much to satisfy himself as to the general accuracy of the inventories through a review of the plans, methods, and procedures before the taking of the inventory is begun. Later during the taking of the inventory, he should through observation determine that the employees have followed the predetermined inventorying plans in an orderly and thorough manner. In those instances wherein the log and lumber inventories are a material factor in relation to the current or total assets of the company, the independent accountant might find it desirable to engage the services of competent scalers and lumber inspectors. This matter will be discussed later in this paper.

Because of the limited time that is available for this subject, the problems peculiar to the observation of inventories are confined to that of log and lumber inventories found in an average mill conducting its own logging operations in the Pacific Northwest. It was previously mentioned that in this type of operation the actual logs on hand may consist of those felled and bucked in the woods, those cold-decked in the woods, those at the mill which are either cold-decked there or are in the mill pond adjacent thereto or are in rafts in the river.

In many instances logs felled and bucked and cold-decked in the woods do not present a problem to the auditor for the reason that they are not inventoried. In such cases the value of the timber in the log remains in the timber account, and the labor incurred in falling, bucking, etc. is absorbed in current expense. In other cases where an inventory value is placed on logs in the woods, the auditor is presented with an entirely separate and distinct problem. As a rule

the inventory is not taken by measured count as is done in the case of logs in the water at the mill but is generally an estimate made by the logging superintendent as to the footage felled, bucked, and cold-decked. In many cases he may arrive at this estimate of quantities through a count of the number of trees that have been cut, together with his estimate of the size and length. In other instances the superintendent may make his estimate solely from records showing the footage felled and bucked by the woodsmen, which records also form the basis of determining their compensation.

Since logs in the woods felled and bucked may be scattered over many acres of ground and since the inventory is based upon an estimate made by the logging superintendent, the auditor is presented with practically an impossible inventory observation problem. In this connection the auditor should make inquiry before the close of the accounting period to learn if the company intends to inventory logs in the woods which are felled and bucked and their approximate value. If the item is of a material amount, he should engage the services of an independent scaler or timber cruiser.

### **Special Problems**

The inventory of logs in rafts in the water and logs in the cold deck at the mill present special problems. The taking of the inventory of the logs in rafts requires special skill in determining the grade and footage thereof, while the taking of the inventory of logs in the cold decks at the mill is usually a matter of approximation based on book figures.

It is essential that the grade and footage of logs in rafts in the water be determined by competent scalers. The company could have a river full of logs and the accountant could see

that there was a tremendous number; however, if he did not have special training as to the scaling and grading of logs, it would be impossible for him to check the footage or grade involved. A river full of logs therefore might have a tremendous value or relatively little value depending upon the grades of the logs. It can be readily seen what a difference in value could develop when you realize that in the Pacific Northwest a No. 4 sawmill log, or what is known as a wood log, sells for approximately \$12.00 to \$16.00 per thousand feet while a No. 1 peeler log sells from \$80.00 to \$110.00 per thousand feet. These two logs could be side by side and the inexperienced man wouldn't know that there was a difference between them.

In the case of logs in rafts the auditor should, prior to the date of taking the inventory, determine from the company records the various locations of the rafts. If he intends to accept the inventory taken by the company's scalers, he should first determine if qualified personnel has been assigned for the work, after which he should accompany them to the various locations and observe that they actually scale and grade the logs. If the auditor does not intend to accept the company's figures, he should engage the services of an independent scaler and observe the procedures followed by him.

One of the most difficult problems confronting an auditor is in respect to logs contained in the large cold decks at the mill. Due to the changes in methods of logging and transportation in recent years in the Pacific Northwest, it has become necessary for many mills to accumulate a large supply of logs during the summer so that the mill will have a supply on hand to enable it to operate during the winter. This excess supply of logs, which has been accumulated during the summer months, is piled in long, high stacks



which may be the length of several city blocks and 50 to 75 feet high.

The scaling of a log in this type of cold deck presents an impossible problem due to the fact that only one end of the log can be seen at one time while the body of the log cannot be seen at all. In addition, it is not possible to tell whether the end that is being observed is the big or the small end of the log. Because of these conditions, the auditor's work in satisfying himself on this type of inventory cannot possibly be accomplished through the process of observation.

In most instances, operators keep perpetual records of the footage of logs added to and taken from the cold decks and do not attempt to physically scale them for inventorying purposes. The inventory used is determined from the figures shown by such perpetual records. In this case it is necessary for the auditor to satisfy himself as to the inventory by proof of the underlying records rather than through the method of observation. This problem presents an interesting sidelight bearing on the use of the natural business year, particularly for mills in the Pacific Northwest. It will be seen that the accuracy of the inventory can best be determined after the close of the winter operation when the cold deck is completely used or is at a minimum.

The last inventory to be discussed is that of lumber, which is entirely different from that of logs and usually lends itself to a fairly accurate determination. Here again, however, as in the case of logs, the value of the inventory depends to a great degree on the grade and species as well as actual measurement as to quantities. For the most part lumber is manufactured in one quick operation in which the log is readily sawn into rough green lumber. In addition to this you will find lumber which has been dried and/or surfaced. In all of

these various stages, the lumber would have a different valuation.

#### **Review Inventory Plan**

Before the lumber inventory is to be taken, the auditor should review the inventorying plan and inquire as to the experience of the employees assigned to take it. The auditor should then accompany the men taking the inventory to see that they perform their task in a logical and orderly manner. As a part of the observation function the auditor should satisfy himself that no part of the inventory has been taken twice and that none of the items has been missed.

Although the auditor may not possess the special skill and experience required in checking the measurement or the grade of the lumber, he will find it helpful to observe the lot markings. The larger mills assign lot markings to lumber which has been cut and segregated on special orders as distinguished from that which has been cut for stock. It is the practice, when inventorying lumber, to put the lot markings on the tally sheets. The auditor can observe that the employees are properly recording the lot numbers. Later he can use this information to determine through the check of specific sales orders whether the grade of the lumber is correctly stated, as well as having an independent check on the quantity shown on the inventory.

In unusual circumstances the auditor should give consideration to the employment of independent scalers and lumber inspectors in order to assure himself that the inventories are proper. Even when such qualified, independent personnel are engaged to assist the auditor, he should accompany them and observe their procedures in the taking of the inventory. When independent personnel are used by the auditor to satisfy himself as to the accuracy of the inventory, he

should engage them and pay for their services directly.

Although there are many other important and unusual aspects in regard to the inventories of a lumber mill, this paper is restricted to those relating to observation. On his first audit of a lumber mill, it might seem to the accountant to be a hopeless or

useless task to attempt a verification of the inventory. However, experience have proven that, although qualified personnel are needed in the taking and recording of the inventory, the auditor's review of the inventorying plans and the observation of the individuals taking the inventory will be of material aid in his appraisal of the accuracy.

## **Inventory Observation Problems Peculiar to Certain Industries—a Meat Packing Plant**

by **Oliver W. Seifert**

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**T**HE MAJOR PROBLEMS encountered in the taking of the physical inventories of a meat packing plant are related to the perishable nature of the product, the continuous shrinkage which takes place in the handling and storage thereof, and the difficulty of obtaining accurate counts and weights. The procedure followed in the taking of the inventory differs according to the character of the product and the physical conditions under which it is stored.

I would like to review a few of the problems which we encountered in an actual observation of an inventory of a typical meat packing plant in the Midwestern part of the United States.

We accompanied the inventory crews on their original count, observed the procedures followed, made

our own test counts of a number of the items, and indicated the items counted by us on a duplicate copy of the inventory which was retained by us.

### **Livestock**

The livestock inventory consisted of hogs, cattle, and lambs which had been segregated in pens according to lots as received. The company's inventory, listing the number of head and total weight of each lot, had been prepared in advance of our test check. Our verification consisted of: (1) a count of the number of heads in selected lots and (2) a test check of the weights for those lots to the receiving reports. Our test check was made late in the afternoon of the last day of the fiscal year. Livestock in

transit received up to midnight of that day was added to the inventory and subsequently verified by examination of related receiving reports and invoices.

The inventory in the fresh pork department consisted chiefly of carcasses hung in coolers on hooks suspended from rails. We counted the number of carcasses and compared our count with that of the company's employees. The carcasses represented the entire kill of the previous day and the kind and weight was checked to the killing records for that day.

Practically all of the hogs slaughtered and dressed are converted into cuts within 24 or 48 hours thereafter. The primal cuts which include hams, shoulders, loins, etc. were sorted by grades and weight and placed in hand trucks. The weight of the hand truck was painted on the truck and this weight was deducted from the gross weight to arrive at the net weight of the product. We observed the weighing and listing of a number of the hand-trucks.

The first operation following the production of the fresh meats is that of curing. Products may be sweet pickled or dry salt cured.

The products to be sweet pickled are placed in curing vats, and a vat tag is prepared at that time showing: (1) Vat. No., (2) Lot No., (3) Description of Product, (4) Number of Pieces, (5) Weight, and (6) Date In. This same information is entered in the curing cellar record. The inventory of this department was compiled from this record as it is considered to be quite accurate and a physical inventory is not practical. We selected a number of items from the curing cellar record and compared the description and weight thereof with that recorded on the Vat Tag attached to the Vat. These same items were then traced to the inventory sheets.

The products to be cured by the dry salt method are placed in piles with alternate layers of salt. Similar records are maintained for this product as for sweet pickled meats. We counted the number of pieces in certain piles and obtained the approximate weight thereof by multiplying the number of pieces by the mean of the weight range. This weight was then compared with the weight recorded in the curing cellar record from which the inventory was prepared.

### **Smoked Meats**

Operations in the smoke house include the soaking and washing of cured product, tying and hanging on trees, smoking, wrapping, and packing. A record is maintained to show date and weight in and out of smoke, Lot No., number of pieces, and kind and grade of product. Our verification of the inventory "in smoke" was made by comparing the inventory with the reports showing the product coming "out of smoke" in the following period. We observed the weighing of the product already taken "out of smoke" which is hung on trees.

The raw materials in the sausage department consisted of meats and seasonings which did not present any particular problem. The finished product consisted of fresh sausage and dry sausage packed in casings and hung on racks. The sausages were of uniform weight for each kind of product and the different kinds were segregated on the racks.

We observed the counting of the fresh sausages, in casings, and made our own test counts.

The processing of dry sausage requires storage for a considerable length of time. As the sausage is put into storage, a record is prepared showing the kind, location, lot number, and "green" weight. The sausages are hung on "sticks" (a form of rack),

a standard number being placed on each stick. The dry sausage inventory was compiled from the records in the department. Our verification was made by counting the sticks of a representative number of kinds of dry sausage and converting this count into weight by multiplying the number of sticks by the number of sausages per stick which, in turn, was multiplied by the average weight per sausage.

In a plant processing cattle and calves, hides and skins are an important item. A hide cellar record is maintained showing the number and location of each pack, kind of hide, number of hides, the green weight put down, the date on which it was closed, the cured weight, and percentage of shrinkage. The inventories were prepared from this record and checked by the company employees. Our verification consisted of (1) a test count of the number of hides in a representative number of packs and (2) a test of the weights used by reference to the hide cellar record.

The products of certain departments must be kept frozen or chilled until shipped or until ready for further processing. These products are stored in large refrigerated rooms, known as freezers. A record is kept of all products going into and coming out of the freezers. The inventory was compiled from these records and checked by the company's employees. We made a test check of a representative number of items in the freezers.

The temperature in the freezers may be as low as 20 degrees below zero. For the auditor who is accustomed to sitting in an office where the temperatures range from 70 degrees to 80 degrees above zero this represents a substantial change. For this reason we arranged to make a test count of the inventory in all the freezers simultaneously when all the assistants employed on the inventory observation were available. By so doing no one person was particularly penalized and the work was in this manner expedited.

# Relation of Cost Records and Inventory Prices in the Case of Manufactured Articles

by **Ralph L. Stauffer**

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**H**ELPFUL IN PRESENTING a paper of this sort is a brief description of the writer's concept of the subject matter with which he will deal. To this end, therefore:

"Relation" connotes a link connecting inventory prices with cost records or a dependency of inventory prices on cost records;

"Cost Records" are systems, methods or other records having to do with costs whether or not such systems, methods or records are integrated with the general accounting system and books of the manufacturing enterprise;

"Cost" as applied to inventories means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location (this description or definition of cost is taken from Statement 3 of Accounting Research Bulletin No. 29 entitled "Inventory Pricing"); and

"Manufactured Articles" means articles manufactured, processed, fabricated or assembled, but not purchased as such.

Accounting Research Bulletin No.

29 contains the following statements which are extremely important in a brief discussion of the subject of this paper:

1. The primary basis of accounting for inventories is cost . . .

2. Also, except for the portion of general and administrative expenses that may be clearly related to production, it is generally accepted accounting practice to include such items as period charges and to exclude them from inventory costs (product charges).

3. Selling expenses constitute no part of inventory costs.

4. It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure.

5. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market."

The preceding excerpts Nos. 1 and

5 from Bulletin No. 29 state important reasons for "costs" and, therefore, "cost records." Excerpts Nos. 2, 3, and 4 state in generalities the criteria for "cost" determination which the "cost records" should include, and, as well, the exclusions from "cost" determination which should be recognized.

### Consistency a Factor

The concept of "cost" such as standard, actual, average, etc., that may be employed by the enterprise, provided it is within the bounds of the criteria just enumerated, is not as important as the consistent use of the same concept from period to period. Of great importance, however, is the soundness and reliability of the records from which the concept of "cost" is molded into a dollar amount that becomes a meaningful symbol to those who audit, use, and rely on financial statements.

Unless the "cost records" are susceptible to the application of generally accepted auditing procedures, their soundness and reliability can not be established. It is dangerous to take for granted something which can not be substantiated by objective means.

A significant characteristic to be attributed to "cost records" is that of completeness. In other words, such records should contain, by articles, clearly identified direct material, labor, and other costs, and appropriate indirect charges or overhead costs making up a total cost which may be assigned to the respective manufactured articles.

Whether such groupings of costs are to be found in a standard, an actual, or any other type of cost system, integrated with the general books of the enterprise, or on memo records not integrated with the general books of the enterprise is of secondary importance to the basic requirement

that the items grouped should be proper costs and should be evidenced by reliable supporting data. It is the end results of this grouping process that are applied to the physical quantities of manufactured articles in the inventory, and for this reason such inventory prices or costs should be as usable, acceptable, and satisfactory as invoice costs would be if similar articles were purchased.

A cost system integrated with the general accounting system of a manufacturing enterprise is a much more satisfactory record for the certifying accountant to work with than a cost system or other cost records not integrated with the general accounting system. The reasons should be quite obvious and should require no further discussion for present purposes. Suffice it to say that extreme caution is a necessity when the "cost records" are not an integral part of the general accounting system.

### Difficulties in Specific Cases

A brief paper written in terms of generalities is relatively easy to prepare. It is the application of generalities to specific instances that causes so much trouble at times. In cases where there is no cost system integrated with the general accounting system, the problems of proper cost determination are accentuated. Generally in these cases, the substantiation of direct material costs may be accomplished with some measure of satisfaction by reference to bills of materials, engineering specifications, blueprints, material requisitions, and other documents of similar import.

The problem of substantiating direct labor costs, particularly in the case of multiple operations, is not an easy one to solve where the records are, in effect, only memorandum in form and at the best, based on trial runs for particular operations at different times

throughout the period under audit. The conditions and circumstances of each case, particularly in respect to the adequacy of departmental or operational production records, and the good judgment of the accountant offer the best clues to a solution of this problem. In any event, the determination of proper direct labor costs warrants extremely careful consideration where the "cost records" are only memo in form because of the prime importance of labor costs in the final result and, also, because in many instances such labor costs are used as a basis for the allocation of overhead to product costs.

In the areas of overhead determination the problems of inclusion and

exclusion are always present. Consistency of policy as to determination and allocation is a most important factor in arriving at the sum of the applicable expenditures and charges directly and indirectly incurred in bringing a manufactured article to its existing condition and location.

To summarize, "cost records," whatever may be their form, must be reliable; must clearly identify the various cost components; must produce a result that is as acceptable as an invoice cost of a similar article purchased as such; and above all, must be susceptible to the satisfactory application of generally accepted auditing procedures to substantiate the foregoing requirements.

# **Auditor's Responsibility for Inventory in Public Warehouse**

**(a) In Audit of Warehouse**

**(b) In Audit of Company Storing  
Goods in Warehouse**

**by J. F. Stuart Arthur**

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**T**HIS SESSION IS BILLED as a technical session, as one dealing with the "case" approach to inventory problems. I take it that "case" is used in the connotation of specific practical example, or perhaps problem, relating to the subject at issue.

As tail-end-man of this group of eleven making observations on the present subject, which is that of "Inventory Problems," I am relieved to find that there is a final switch in thinking of what should be discussed. All the prior speakers were concerned with problems of detail, and of technique in which the accountant revels, or at least it is believed he should.

My assigned portion of the subject is simple, in that it deals not with technicalities, but with an ethical concept stated in the program to be, "Auditor's Responsibility." That should be simple, but unfortunately it too seldom is. It should be noted that the full designation of the topic of this paper is "Auditor's Responsibility for Inventory in Public Warehouse, (a) as to the audit of the warehouse, and (b) as to the audit of the company storing goods in the warehouse."

The auditor's responsibility is not for the inventory, fortunately; he is not a warehouseman, he is not a watch dog. The Federal Warehouse Act, or the various state warehouse acts and regulations were enacted in the hope of controlling the warehouseman's responsibility for the inventory.

## **All the Facts**

The auditor's responsibility is to ascertain all the facts, or sufficient of them to warrant expression of an opinion on financial statements in which inventories are material factors, both as to financial position and as to costs of sales or operations. Outsiders will rely on this opinion. The auditor has a further responsibility to his client who is relying on the fact that the inventory is there. The client may be a warehouse storing assets for others, or may be a company whose inventory is stored in a warehouse. The former has a potential liability for nonperformance, the latter relies heavily on the existence of the claimed asset.

It is quite a matter of repetition to remind you of the numerous inventory cases which could make front page



news, commencing in 1938, and perhaps continuing to the moment, if only we could know of them. One simple expedient might have resolved the question of existence or not, if it had been applied, but then a reading of the testimony before the SEC Examiners should let us know that possibly every accounting technique but that of actual visitation, observation, and touch was applied, to no avail, in the face of deliberate, detailed, and skillful collusion and manipulation.

Confirmation of bank accounts, which are no more than receivables from banking institutions—at least in certain periods of the 1930's that might have been startlingly true—rests in part at least on confirmation from the depository, the custodian—but we are not expected to go and look at the accounts on the other side of the fence. We do not observe the custodian's procedures or touch and sample his reputed holdings of our client's assets. The custodian's statement that he has "X" belonging to our client is the basis of our satisfaction as to fulfilled responsibility. Our client's records may indicate that "X" must be adjusted for plus or minus "Y" of items which the custodian does not know of at the moment, but which he will know of later. Of course, it is part of our responsibility to verify these "Y" items.

However, when we come to our responsibility as to inclusion of inventories at fair amounts in financial statements, we find we have accepted a further responsibility.

Since these observations are supposed to be responsive to a "case" approach to inventory problems, what better commodity can I choose than that of cotton, which, for this State in which we hold our annual meeting this week, is a commodity of paramount importance. The sequence of responsibility noted in the program, first in respect of the audit of the warehouse,

and second in the audit of the company entrusting and storing, is good; it is a natural sequence—if the warehouse does not exist, if it is not reliable and responsible, both as to adherence to local and federal laws, as well as to financial status, our cotton merchant trader, exporter, buyer, or seller may find himself with a mythical claim and not a tangible asset.

### 15 Tests

dent auditor as to inventories in the examination of the affairs and financial statements of a warehouse storing and handling cotton for its customers should be in settlement of the following aspects of the case, summarized below. In this summary, I leave technique of procedure and approach aside—responsibility is the reference to my assigned section, not method. The auditor's responsibilities to be satisfied, before expression of opinion is given—and omitting method from the summary—are at least these:

(1) Does the warehouse exist? It does you say, because you are examining its accounts. But perhaps the accounts are in Houston, and the warehouse (one of several in the chain) is reputed to be in Lubbock. Why not go and take a look at it; even a local tax receipt or local stationery may be misleading.

(2) Is the warehouse authorized to be in business as such, under state law and regulation or under the Federal Warehouse Act? If it so wishes to qualify and if a further refinement is desired, has it complied with the applicable regulations of the United States Department of Agriculture, or the Commodity Credit Corporation, or such other more recent governmental agency as for the moment has undertaken to control its existence, behavior, and destiny?

(3) Has the warehouse secured the necessary surety bond from a first

class surety company for its operations and responsibilities to its customers, and if handling government cotton has it posted bond with the CCC or the USDA?

(4) Has its tariff for storage and service charges been approved by the states in which it operates, if such state regulations are in existence? As of August last, U.S. interference with such tariffs—I was about to say lapsed—has been withdrawn.

(5) Is adequate insurance coverage in existence in favor of the state, the CCC, the USDA, or for the specific protection of its clients?

(6) How are its warehouse receipts printed, by whom, and under what control?

(7) Who is authorized, and by what method, to sign its warehouse receipts?

(8) How are its warehouse receipts controlled after printing, while unissued, and while being issued?

(9) How are its warehouse receipts controlled on presentation for delivery or shipment of the cotton represented by such bale receipts, and how meticulously is its bale book—its storage record—maintained?

(10) What is the client's policy—or procedure, sometimes a very different affair—as to lost cotton, misshipped cotton, and damaged cotton? And as a related subject, what does the client do with loose and damaged pickings of cotton, and how does it assure itself that it obtains at least a modicum of salvage income that should accrue from the sale of such pickings?

(11) Do you test—I think you should—that open items in the bale book, by tag and receipt number, are in fact to be found in the warehouse? And on the other side, do you test that specific bales in the warehouse are to be found as open, unshipped items in the bale book?

(12) Is your warehouse an entirely independent concern, and not a sub-

sidary or controlled operation of the shipper?

(13) Are its bale receipts—its warehouse receipts—currently acceptable in banking circles as collateral?

(14) In those remote cases—I have had practical experience of some—where the warehouse is controlled by another concern whose purposes might be served by negligence or manipulation on the part of the subservient warehouse, testing as suggested previously would not avail, and only complete physical control and count would serve to satisfy the auditor's responsibility.

(15) Perhaps another responsibility to be covered would be served by testing, by direct correspondence with customers, the recorded liability of the warehouse as to the quantities and descriptions of the inventory of which it is custodian.

As a conclusion to the first part of these observations on the subject, I might note that for a number of years an independent auditor was engaged to undertake examinations, possibly three or four times a year at his timing, in respect of one cotton warehouse here, and another one of completely different ownership in a nearby port. The examination covered accountability for warehouse receipts, issued and unissued, and included testing, by physical inspection, the presence of cotton held in storage, the accuracy of the recorded open items in the storage register, and the validity of warehouse receipts issued in favor of the warehouse's parent corporation, which parent was engaged in the cotton export business. The periodic reports made on such examinations, when presented to the cotton shipper's bankers, seemed to serve as added force to the bale tickets or warehouse receipts being used as collateral.

Now, the other part of our subject resolves itself into fewer aspects, I be-

lieve, and in the main rests on direct confirmation with the warehouse, if your client represents that portions of his inventory are so housed. However, may I suggest that first the client's own records and internal control procedures should be investigated as to inventories stored in public warehouses.

#### Inventories in Public Warehouses

What do you find of monthly (or even more frequent) reports from the warehouse being checked to your client's own quantitative records, which should be maintained on a perpetual inventory basis, separately, warehouse by warehouse? In fact, the more modern cotton merchant knows or attempts to know, as to each warehouse, exactly what cotton is in storage, as to bale number and weight, as to classification, and as to the date of its being placed in storage. Control over movements into storage, over issuance of shipping orders, and the period for which compress charges may be made is essential. The control over use and release of warehouse receipts must be watertight and it should be possible at any moment to have a "tag-list," that is a listing of bale numbers, made which immediately could be verified by the warehouse in which the cotton is stored.

The following matters should be disposed of in connection with cotton inventories in public warehouses:

- (1) Is the warehouse in existence?
- (2) Is the warehouse entirely independent of your client, or is it a subsidiary, or is it controlled? In the last two cases, you cannot be satisfied this side of physical inspection or test of existence of the inventory.
- (3) Is the warehouse fully responsible and operating under the applicable regulatory laws?
- (4) Is the warehouse responsible financially, and is it satisfactory as to the protection provided by surety bond and loss insurance, and more particu-

larly are these in proper relation to the size of the inventory involved at that particular point?

(5) Do you select a number of warehouses, at scattered points, and covering a good cross section of your client's inventory? For these there should be complete "tag lists" prepared and sent to the warehouse for direct confirmation to you that the bales of cotton listed are in existence in the warehouse, and are so recorded in its records.

(6) Do you request *all* warehouses storing cotton for your client to render directly to you, as of the inventory date, bills for compress and storage charges accrued? And having done that, do you match the quantitative inventory representations of your client with the quantities disclosed in such compress bills?

(7) Negotiable warehouse receipts may be good, and may be readily acceptable as collateral, but in the finality they are only as good as the responsibility of the custodian of inventory. There may be no inventory, there may only be a claim to be litigated against a warehouse, whose only asset of value is its surety bond, and in most cases of that character, your client will only share with others similarly situated. Within the last 12 months there have been a number of classic examples in this state of such a situation in connection with the storage of other commodities. Fortunately, cotton warehouses have not recently been involved.

I cannot say that I have touched on all points which should be covered in assuming responsibility for expression of opinion as to the existence of a cotton inventory, but I believe that if the points I have noted are resolved to your satisfaction, even the most critical of complainers would have difficulty in sustaining an assertion of negligence on your part, in respect of inventory ex-

istence. I have not mentioned quality or condition of the inventory, but this has been a case study, and I chose the cotton inventory as appropriate to this part of the world. Since cotton is bought and sold at prices varying according to combinations of "X" grades, "Y" classes, and "N" characters—depending on the locality and market—I

would hesitate to suggest that the auditor should venture into this field. It is one which keeps engaged a corps of USDA classers, the highly skilled and recompensed employees of the private trade, and all in the end subject to arbitration and counter arbitration between buyer and seller, shipper, and spinner.

Professional  
Conduct

## Professional Ethics and the Public Interest

by **Edward J. McDevitt**

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man of the Committee on Professional Ethics

**T**HE COMMITTEE ON Technical Sessions which had the responsibility for arranging the program for this meeting decided that it was appropriate and timely to include a session devoted to a discussion of professional ethics. They did so because it is of intense interest to all practitioners and surrounds their everyday occupation. It is a subject of which they should be conscious at all times and some years have elapsed since it was discussed at an annual meeting of our organization.

### Definition

The best definition of professional ethics from the standpoint of public accountants which I have been able to find is contained in a paper by Lincoln Kelly which was delivered at the Mountain States Accounting Conference in June of this year. It reads as follows; "For us public accountants, professional ethics embodies a system of moral principles to govern the relations of our own members with each

other, with our clients and with the public; the promulgation of which sets us apart as a professional group in our society as distinct from a commercial enterprise or business."

The principles referred to in that definition have been developed through years of experience, by our profession and by other older professions and, in so far as they apply to us, have been accumulated and published in the Rules of Professional Conduct of the American Institute of Accountants as well as in the Codes of Ethics of the various state societies of CPA's and of some State Boards of Accountancy. As you all know, the latest revision of our rules which was made in December 1950 contains sixteen rules. The interpretation and administration of those rules become the duty of our five-member Committee on Professional Ethics.

Those of you who are or have been members of Council know that our committee classifies the matters which come before it into two groups, viz:

inquiries as distinguished from complaints; or cases, as we identify them. It is gratifying to be able to report that we receive many more inquiries than we do complaints, which indicates that most practitioners, desiring to operate within the spirit as well as the letter of the rules, ask advice before entering into borderline situations. On the other hand, many of the complaints which we receive result from violations of the spirit of the rules without actual violation of the letter of them.

In each of the recent fiscal years of the American Institute, the committee has responded to approximately 50 inquiries and has considered about 25 complaints. Other inquiries have been answered by the Administrative Secretary, relying upon precedent established by predecessor committees. Almost one-half of the inquiries received in recent years have related to advertising and many of the complaints have involved charges of advertising or solicitation which is why those subjects are included in today's program.

### Responsibility to the Public

In his excellent book entitled *Professional Ethics of Public Accounting* which was published in 1946 and has served as guide and counsel for our committee and its predecessors since that time, our own John Carey very appropriately divides the rules of professional conduct applicable to public accountants in the order of their importance, as those relating to:

I The Interest of the Public

II The Interest of the Client

III The Interest of the Profession

Every practicing public accountant should have a copy of this book and would profit from a frequent reading of it. I am sure that if all practitioners

were frequently reminded that their responsibility to the public comes first and that of their clients comes next before their own interest or that of fellow practitioners, many of the matters which come before our committee would never arise.

In keeping with the relative importance of the subject matter, as explained earlier, the first part of our program is devoted to a discussion of the ethics of our profession from the standpoint of the public interest. Directly related to that interest is one phase of professional ethics which is not covered by any code, except perhaps the moral code of the practitioner, and that is the matter of performing services for persons engaged in illegitimate business. This matter was brought forcefully to the attention of the American Institute in some of the press releases relating to the investigations of the Kefauver Committee in which it appeared that, at least from the viewpoint of counsel for that committee, accountants who had prepared tax returns or performed other services for persons under investigation were just as much public enemies as were the gamblers, tip sheet publishers, and others for whom the services had been performed.

Fortunately, when the final report of the Kefauver proceedings was published, it did not indicate any serious breach of ethics by any of our members but the earlier releases did serve to emphasize the undesirable position in which a CPA places himself when he renders service to clients engaged in illegitimate business. It seems clear that a practitioner can not control the publicity or other harmful effects which may result from such engagements and the entire profession suffers therefrom.

## Professional Ethics as Viewed by the Securities and Exchange Commission

by Earle C. King

Chief Accountant of the SEC, Washington, D.C.

**A**N EXAMINATION OF Securities and Exchange Commission publications indicates that considerable publicity has been given to the viewpoint of the Commission with respect to the ethics of the accounting profession; consequently, my comments, to some extent, will be repetitious.

That the Commission should have a direct interest in, and therefore hold considered views upon, the ethics of accountants stems from statutory requirements of the Acts administered by the Commission. The Securities Act of 1933<sup>1</sup> provides that financial statements required to be filed with the Commission "shall be certified by an independent public or certified accountant," and the Securities Exchange Act of 1934,<sup>2</sup> the Public Utility Holding Company Act of 1935,<sup>3</sup> and the Investment Company Act of 1940<sup>4</sup> permit the Commission to require certification by "independent public accountants." The Commission's rules require, with minor exceptions, that

financial statements filed pursuant to each of these Acts be so certified.

The word *ethics* connotes an ethical system. *Ethical* is defined by Webster as "that which is professionally right or befitting; conforming to professional standards of conduct."

The American Institute of Accountants long ago promulgated Rules of Professional Conduct applicable to its members, and the fact that these rules are familiar to, and honored by, most Institute members is indicated by the relatively few instances of record in which they have not been lived up to.

Your own John Carey's book, *Professional Ethics of Public Accounting*, familiar, I am sure, to all of you, states very clearly what is expected of a practicing accountant.

Your rules and Mr. Carey's book, together with numerous articles appearing in *The Journal of Accountancy* and other professional publications from time to time, should leave no doubts in the minds of the readers thereof as to what constitutes ethical (and unethical) professional conduct.

The Commission has promulgated

<sup>1</sup> Schedule A, paragraphs 25 and 26.

<sup>2</sup> Section 13(a) (2).

<sup>3</sup> Section 14.

<sup>4</sup> Section 30(e).

no code of professional conduct, as such, pertaining to accountants certifying statements filed with it. Its rules in this respect are confined principally to those dealing with the professional status of accountants and the relationships between them and their clients. Thus Rule 2-01 of Regulation S-X states:

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

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

Paragraph (c) of the foregoing rule was adopted<sup>5</sup> subsequent to the original promulgation of Rule 2-01. Its adoption was announced in Account-

ing Series Release No. 37 wherein it was stated that:

The amendment makes it clear that, in determining whether certifying accountants are in fact independent as to a particular company, there should be taken into account the circumstances surrounding not only the work done in certifying statements filed with the Commission, but also other work done for the particular company by such accountants, including the certification of any financial statements which have been published or otherwise made generally available to security holders, creditors, or the public.

It will be noted that independence of accountants with respect to their clients is the main theme of Rule 2-01—a subject upon which the Commission's views have been expressed sufficiently, I think, not only by the rule itself but also in the numerous published releases and opinions of the Commission,<sup>6</sup> particularly an address of Chairman Cook of the Commission at the annual meeting of the Institute in Boston in October 1950.

I shall therefore direct my remarks to other considerations which, although perhaps they do not involve ethics at all, are highly important to the Commission in determining whether certifying accountants are fulfilling their part in the presentation to the investing public of financial statements which contain full and fair disclosure of all material facts necessary for the making of financial decisions.

High on the list of such considerations is the failure of some accountants to make themselves familiar with the Commission's rules and regulations pertaining to financial statement presentation and the accounting principles upon which such statements are based. There can be no acceptable reason or excuse for an accountant

<sup>5</sup> Paragraph (c) has since been amended for clarity. See Accounting Series Releases Nos. 44 and 70; the latter announced, on December 20, 1950, a general revision of Regulation S-X.

<sup>6</sup> See, for example, Accounting Series Releases Nos. 2, 22, 47, 48, 59, 67 and 68.



who is practicing as such, and particularly one who has certified or proposes to certify financial statements filed with the SEC, to be uninformed in this respect.

It is, or should be, well known that the Commission's rules governing the form and content of financial statements filed pursuant to the 1933, 1934, 1935 and 1940 Acts are contained in a single regulation titled Regulation S-X which was originally adopted in February 1940 and was revised in December 1950. Both the original promulgation and the subsequent revision were submitted to the accounting profession for suggestions and comments before being issued. The October 1949 *Journal of Accountancy* contained an article commenting upon the proposed revision and urging that suggestions and views of Institute members thereon be submitted to the Commission. Many members of the profession submitted comments, criticisms, and suggestions, some of which now are reflected in the revised regulation.

Issuance of the revised regulation was announced in Accounting Series Release No. 70, copy of which was sent to the several thousand accountants on our mailing list, and many others requested and obtained the release and a copy of the regulation. In addition two articles appeared in the February 1951 *Journal of Accountancy* discussing the regulation and particularly the changes therein and their significance.

Implementing Regulation S-X are the Accounting Series Releases, of which there are now 72, which were started in 1937 for the announced purpose "of contributing to the development of uniform standards and practice in major accounting questions." This series of releases serves as one means of acquainting the profession and industry with the Commission's views—its policies, actually—with re-

spect to accounting principles and practices upon which either the opinions of the accounting profession have not become settled or there is disagreement as to the acceptability thereof.

### Reports to Congress

Each year since the Commission was established there has been transmitted to the Congress, pursuant to statutory requirements, a report outlining the activities of the Commission under the various statutes administered by it. Each of the 17 such reports issued to and including the one for the fiscal year ended June 30, 1951, has included comment upon matters of interest to accountants, particularly those practicing before the Commission. Beginning with the fifth of these reports (for the fiscal year ended June 30, 1939) a separate section has been devoted to accounting and auditing activities. Many problems, some new, some old but rejuvenated, but most of them controversial, have been dealt with therein and the Commission's views thereon expressed.

These have included: the "all-inclusive" versus the "current operating performance" type of income statement; the "statement of financial position" and "single step" income statement versus the orthodox balance sheet and income statement; corporate consolidations, reorganizations, and mergers; reporting of so-called "tax savings" or "charges in lieu of taxes"; relations between and inconsistencies in financial and tax accounting practices; accounting for "emergency facilities" and the tax effect of "certificates of necessity" issued in connection therewith; employees' pensions; inventory and other reserves against future losses; depreciation provisions based upon estimated replacement cost of fixed assets as compared with the generally accepted accounting concept that such provisions should

amortize the cost of such assets over their anticipated useful lives; development of new terminology for reserves and surplus; "lifo" inventory method; and "buy-sell-lease" financing.

Notwithstanding the publicity thus given our rules and regulations and the Commission's views on accounting and financial statement presentation, it is almost a daily occurrence that some accountant inquires where our accounting rules are to be found; or admits that he is not familiar with Regulation S-X—we have had instances where the accountant has never heard of this regulation; or whether we will accept a "single-step" income statement in lieu of the orthodox one; or whether goodwill or other intangibles may be written off against capital surplus; or whether the loss on sale of a fixed asset may be charged to earned surplus.

Then there are those who ignore our requirements, sometimes with the explanation, when we find the statement deficient, that they have found precedent therefor in statements of other companies filed with the Commission or in reports to stockholders. Usually it develops that the statements upon which they relied either have not been examined by the staff, or have been examined and deficiencies cited but not yet complied with; or the statements filed with the Commission were different from those contained in reports to stockholders. Others ignore, or appear to ignore, our requirements because they have misconstrued them; more often than not because of legal interpretations made without regard to accounting proprieties.

Occasionally an accountant disagrees in principle with some specific requirement and, without making his point of view known to us, certifies statements which ultimately may be required to be amended.

Unfortunately, most instances of

noncompliance are not brought to our attention until statements are filed, and amendments therefore are necessary. As a result, in the case of statements under the 1933 Act, it often delays, and sometimes even stops, the offering of securities. The extent to which amendments are necessary to financial statements filed with the Commission before they may become effective is indicated by the fact that during the first six months of the current year deficiencies were cited with respect to 160 statements out of a total of 385 filed pursuant to the 1933 Act. Each of these deficiencies resulted from failure to comply with our requirements and never should have been necessary.

#### **Need for Consultation**

Regardless of the reasons why certifying accountants many times fail to comply, or obtain compliance, with our requirements, it is of extreme importance to all concerned that they be complied with and any accountant who certifies or intends to certify statements filed with the Commission should make certain that he is completely familiar with the applicable rules and regulations; if he disagrees with or has any questions concerning them he should contact the Commission's staff *well in advance of filing* and make certain that the statements are properly prepared. Failure to do so, in my opinion, results in disservice to his client.

An example of the type of situation I have just referred to involved the reflection in an investment company balance sheet of a provision for federal income taxes in respect of unrealized appreciation on investments—a specific requirement contained in Rule 6-02-9 of Regulation S-X. In this instance no such provision was made although to have done so would have reduced the net asset value of the company's shares (a significant item to investors in such companies) more than 15 per cent.

Amendment of the statement was required.

In another case a registrant included in its balance sheet (contained in a 1933-Act-proposed-filing) a substantial write-up reflecting the estimated value of oil reserves. After discussion with the staff the balance sheet, minus the write-up was filed almost immediately. It was clear that the accountant had some doubt that the statement as proposed would meet our requirements and he had therefore prepared two balance sheets, one with and one without the write-up, either of which it is assumed he would have certified without qualification.

The examination of another recent registration statement by the staff indicated possible relationships between the certifying accountant and the registrant which cast considerable doubt upon the accountant's independence. These relationships proved to be such as to place the accountant in violation of Rule 2-01 of Regulation S-X notwithstanding his admission that he was familiar with the rules but nevertheless considered himself "completely independent." It was necessary for the registrant to obtain another, and independent, accountant and a new audit, with the result that the offering of securities was delayed several weeks.

Commission requirements are not the only presumed-to-be well-known pronouncements with which too many accountants are unfamiliar, or choose on occasion to ignore or disagree with. The accounting and auditing procedure bulletins issued by the Institute, the articles and editorials appearing in *The Journal of Accountancy*, and even the Institute's rules of ethics, fall into the same category.

For example, while preparing this paper I received a phone call from an accountant inquiring whether, in making an audit for the purpose of preparing financial statements to be in-

cluded in a registration statement, it was necessary to confirm accounts receivable and verify inventories. (Incidentally, the accountant had been auditing the company's accounts for several years but had never performed either of these procedures.)

Recently an accountant certified a statement which in a material respect was not in accord with an Institute accounting research bulletin. He sought to justify his action by reliance upon the dissent of a member of the Committee expressed in the bulletin. Another accountant stated that he does not pay too much attention to Institute bulletins because they are merely recommendations or suggestions of a group of individuals and carry no enforcement authority. Still others appear to "pick and choose" the bulletins or parts thereof when they will best serve to support a particular procedure which they or their clients favor.

One of the Institute's Rules of Professional Conduct which apparently has not received as much attention as it should is Rule 5(d) which reads as follows:

In expressing an opinion on representations in financial statements which he has examined, a member or associate shall be held guilty of an act discreditable to the profession if \* \* \* 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.

It is not an uncommon occurrence for an accountant's certificate to include exceptions which completely negative his certification. For example, one recently filed contained the statement:

These amounts [referring to certain receivables] have been estimated by the company on the basis of developments and information available to date, but we are not in a position to verify or confirm the tentative accrual of \* \* \* [these

amounts] and the accounts correspondingly affected thereby.

\* \* \* \*

Subject to the qualifications stated in the preceding paragraphs, in our opinion [etc.].

The amounts referred to represented more than 25 per cent of the registrant's total assets and more than 50 per cent of its net assets.

Obviously this certificate was unacceptable for registration purposes and, in my opinion, was violative of the Institute's Rule 5(d).

Reference was made previously to an investment company balance sheet in which the required provision for income taxes applicable to unrealized appreciation on investments was not reflected. Notwithstanding the fact that this balance sheet failed to meet our specific requirements, and was amended, the company's report to stockholders—which pursuant to the 1940 Act<sup>7</sup> is required to be submitted to stockholders and to contain financial statements which are not materially different from those filed with the Commission—did not reflect the necessary provision for income taxes. Thus there was a material difference between the two financial statements; nevertheless, the accountant's certificate was the same in each case.

This situation raises a serious question as to the propriety of the action of an accountant in furnishing the same unqualified certificate with respect to materially different financial statements, each of which purports to present the financial position of a company "in accordance with generally accepted accounting principles." We have had to deal with several such cases, particularly where reserves for depreciation of fixed assets are deducted from the applicable assets in statements filed with the Commission but, in reports to stockholders,

are shown on the liability side of the balance sheet.<sup>8</sup> In my opinion such practice is subject to criticism, if for no other reason than that the growing inclination of investors to place dependence upon certificates of certifying accountants can only be retarded thereby.

#### Broker-Dealer Statements

One more matter which has given accountants, the Commission's staff, and the public headaches, especially within recent months, concerns the financial statements filed by broker-dealers. There are more than 3,000 of these statements filed each year on a form (X-17A-5) prescribed, pursuant to the 1934 Act, in Commission's Rule X-17A-5. The purpose of these reports is to furnish a basis for determining whether certain capital requirements of securities brokers and dealers, prescribed by statute, are met and to protect their customers with respect to funds or securities held for their account.

During the past year at least half a dozen cases have come to our attention where officers, partners, or employees of these broker-dealers have violated their trust and have misappropriated amounts of as much as several hundred thousand dollars. In each instance the financial statements were certified by presumably qualified accountants. Whether or not any of these "shortages" could have been avoided, or disclosed sooner, had the certifying accountants done any more, or proceeded differently, in their examination of the accounts involved, can, of course, only depend upon the facts in each case. I mention them only for the purpose of emphasizing the extreme importance to accountants engaging upon examinations of this type of making themselves entirely familiar

<sup>7</sup> Section 30(d).

<sup>8</sup> See, for example, E. I. du Pont de Nemours & Company.

with brokerage practices; with our *minimum* audit requirements which are prescribed in detail in the instructions applicable to Form X-17A-5; and with the standard audit practices of the profession.

While the several federal statutes designed for the protection of investors, as well as the expressed viewpoints of the Commission, point up the extensive dependence placed upon the accounting profession in carrying out the purposes of the statutes, the responsibilities of the profession to investors have long been recognized. Much has been said and written on the subject. One statement which I think is particularly apropos is the following made in a lecture entitled "The Accountant and the Investor"

delivered at Northwestern University School of Commerce in 1932 by Mr. George O. May:

I would not have you think that because the investor is not his immediate client the accountant owes nothing to the investor except legal duties and ethical obligations. This is not, of course, the fact. It is to the investor that he owes his entire practice in the field of financial auditing, and it is only because the investor exists, and attaches weight to an accountant's report, that the banker employs the accountant's services in this field. And the continued success of the accountant is dependent on his retaining the confidence of the investing public. An enlightened self-interest, therefore, as well as self-respect calls for the maintenance of a proper ethical standard by the practitioner.

## Practice of Two Professions

by Percival F. Brundage

Partner, Price Waterhouse and Co., New York;  
Past President of the AIA; Chairman of Its  
Committee on Relations with the Bar

**W**ITHIN THE LIFETIME of those attending today's meeting there has been an amazing increase in the field of human knowledge. This applies to the professions as well as to science and business. Taking the medical profession as an example, in the early years of the century the general practitioner or family doctor was more common than the specialist. Today we have all kinds of specialists. Only recently in New York State there were doctors who specialized in eye, ear, nose, and throat ailments. Today this field has been further divided. The eye specialist no longer considers himself qualified to handle diseases of the ear, nose, and throat.

The day when a person of advancing years, finding it difficult to read, could go into a store and try on a number of different spectacles from a selection on the counter has long passed. Even an optician today is unable to give prescriptions. We must go to an oculist to have our eyes examined and obtain a prescription to filled by the optician. The family dentist now refuses to pull teeth or straighten them and we have to send our children to

separate specialists to obtain the best attention.

There has been similar specilization in the engineering profession and in the law. A mechanical engineer will not undertake work in the field of the electrical engineer and the new area of electronics is already developing several different specialists. A trial lawyer in the big cities will refuse to handle questions of corporate law or trusts or estates which are separate fields of specialization.

In accounting we have specialists in cost accounting, in system work, in hotel accounting, in chain-store accounting, and in many other fields.

It is sometimes said that we may have gone too far towards specialization. Most of us still call in a general practitioner when a member of our family becomes ill. We can't go to a professional diagnostician to find out what specialist should be consulted whenever someone has a fever.

In the public accounting profession we have felt that a general knowledge of accounting theory and practice, auditing, commercial and tax laws should be required before one became quali-

fied to apply for a CPA degree regardless of what specialized phase of accounting might later be selected. The same requirement of a general background of professional knowledge is demanded by other professions. It has been considered to be in the interests of the general public as well as the professional practitioner to require this background of knowledge as well as a specialized experience in the particular field which may be selected.

### Three Approaches

Assuming, therefore, a broad general background of knowledge and the selection of a narrower field for specialization, we find that there may be several different approaches. We have at least three fields of specialization in the accounting profession which can be approached through other professions. An accounting firm may offer its services in industrial engineering and management. This is a field which accountants entered early in the century and in which their experience and training fits them to advise the public. This field, however, can be approached through the engineering profession.

In doing work for government subdivisions or bankers on bond financing a knowledge of higher mathematics is sometimes required. At least one accounting firm includes in its practice advice to executives in setting up pension plans. This field overlaps that of actuarial science.

In tax practice we are all familiar with the fact that this is a field overlapping that of the law and raising questions which are perhaps as difficult as any we are facing today.

Six years ago the National Conference of Lawyers and Certified Public Accountants submitted to the American Institute's Committee on Professional Ethics and to the American Bar Association's Committee on the Unauthorized Practice of the Law, three ques-

tions concerning professional relations between certified public accountants and lawyers. The questions concerned the employment of lawyers by a firm of certified public accountants, the employment of certified public accountants by a law firm, and the practice of two professions by a lawyer who was also a certified public accountant.

The replies of the Ethics Committee of the American Institute and of the Unauthorized Practice Committee of the American Bar Association were dissimilar. While both organizations have firmly established codes of ethics, the Institute committee felt that our rules of professional conduct did not deal with the specific questions raised, while Canon 27 of the American Bar Association Rules of Professional Ethics against advertising or solicitation was held by that Committee to bar anyone from practicing another profession directly or through others because the other activities might inevitably serve as a feeder of the law practice.

Canon 33 was also quoted. It states: "Partnerships between lawyers and members of other professions or non-professional persons should not be formed or permitted where any part of the partnership employment consists of the practice of law." Canon 35 also deals with this subject: "The professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer."

The third and fourth of our own rules of professional conduct read as follows:

(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.

If a certified public accountant is also a lawyer there is no doubt that the word "laity" refers to others than lawyers and accountants. In any case, I am inclined to think that it refers primarily to nonprofessional people. Our rules relating to advertising and nonsolicitation will be discussed by other speakers at this session.

#### Differences in Practice

In the case of the three questions posed in 1946 our own Ethics Committee expressed the opinion that an employee of a firm of certified public accountants who was also a lawyer should render accounting services only to clients of the accounting firm during normal working hours but that on his free time he was not barred by our rules of professional conduct from independently practising law. Likewise that committee held that a law firm could employ a CPA to assist the law firm on clients' legal matters that involved accounting, and that the CPA on his own time was not barred by our by-laws or rules of professional conduct from rendering purely accounting services to the client on his free time or during leaves of absence.

The Unauthorized Practice Committee of the American Bar, however, held that lawyers employed by CPAs could handle accounting matters only and CPAs employed by lawyers could work only on matters within the field of the law, whether during normal working hours or on free time.

The practice of two professions simultaneously by the same individual in separate offices was held to be not contrary to our code of ethics but to

be contrary to the canons of ethics of the American Bar Association. The answers to the questions propounded were published in the February 1947 issue of *The Journal of Accountancy*.

The Ethics Committee of the American Bar Association had rendered two opinions, Nos. 239 and 269, prior to the submission of the three questions already referred to. In the second of these opinions it was held that if a lawyer goes into a partnership and conducts an accounting business he can no longer with propriety hold himself out as a lawyer or continue to practice law since this field is open to laymen. The opinion then goes on to say, "If he prepares a tax claim, his employer must understand that he is not acting as a member of the bar, but solely as an accountant."

The New York County Lawyers Association, however, gave a different answer to a similar question in the latter part of 1949. The question related to two brothers, both members of the New York Bar and also CPAs in New York State. They practiced accountancy and law in the same office in New York City, placing on their office door the legends

C & C

Attorneys and Counselors at Law  
and below that

C & Company

Certified Public Accountants

It was held that so long as the two brothers in the practice of their profession as certified public accountants adhered to the professional standards applicable to attorneys at law with respect to advertising and solicitation as well as the code of ethics of the American Institute of Accountants there was no violation of Canon 27. The proposed legends on the door were held to merely identify the firms occupying the premises and the professions practiced by them therein and



did not constitute either advertising or solicitation.

A subsequent case decided by the New York County Lawyers Association the following year related to an individual who was both a lawyer and a CPA who had formed a partnership with a layman. It was held that he could not properly conduct his law practice in the same office in which his partnership was practicing accounting.

A more recent case, however, which was published in the *New York Law Journal* in February stated that an individual who was both an attorney at law and a certified public accountant can print an announcement card with his two professions indicated thereon, i.e., attorney at law and certified public accountant. He may also use both titles on his office door so long as he adheres to the professional standards applicable to attorneys at law with respect to advertising and solicitation.

#### Area of Agreement

While there have been a number of cases, perhaps a dozen or so, in which complaints have been made by lawyers against the invasion of their field by accountants in tax work, they are actually the exception rather than the rule. Throughout our professional work we have constant occasion to use the services of lawyers, and likewise lawyers engage accountants and consult them on frequent occasions. We have the closest fellowship with those in the great profession of law which is probably the closest of any to our own profession of accountancy. As part of our professional training a thorough knowledge of commercial as well as tax law is a prerequisite and all candidates for the CPA examinations are questioned in these fields.

The few cases in which disputes have arisen between our two profes-

sions, however, have received considerable publicity and it is important to explore the minor differences in viewpoint that have arisen between our two professions to see if we cannot come to some closer meeting of the minds.

I have suggested that the Ethics Committees of our two national organizations might profitably hold a joint meeting to explore the questions at issue. I am sure that the members of the National Conference of Lawyers and Certified Public Accountants would be glad to join them or to consider any questions that might be referred by the respective Ethics Committees. It might be helpful to the Ethics Committees if we were to join with them in their deliberations.

The Virginia Society's Committee on Cooperation with the Bar recently reported that the question of employment of licensed lawyers by accounting firms had been discussed at some length by the Virginia Conference of Lawyers and CPAs. The lawyer members did not object to the employment of lawyers by CPAs but did object to the maintenance of their licenses and other credentials to operate in the field of the law even if restricted to taxation matters. They did not feel that the public interest required or should permit accountants to pay for the services of lawyers in legal matters which were then sold to clients. This question seems to be the only one causing difficulty in Virginia at the present time. It was not covered by the Statement of Principles adopted by the National Conference and has not been officially considered by that body since the three questions to which I have referred were propounded in 1946.

#### Overlapping

The National Statement of Principles recognizes, as do all lawyers

and accountants familiar with taxes, that the accounting and legal aspects of federal income tax practice overlap to a considerable extent. No attempt was made to draw a fine line of demarcation between the two nor in my opinion can any such line be drawn. It is up to the individual judgment of the members of our two professions to keep within their respective fields, bearing always in mind the welfare of the general public.

Wherever the experience and capabilities of a tax practitioner have been long demonstrated and he is recognized as qualified by both professions, some of the difficulties involved in separating legal and accounting points surely do not arise. Fortunately neither the law nor the accounting professions are closed and it is always possible for an ambitious, capable member of either profession to acquire the technical knowledge of the other. Furthermore, the daily work of a public accountant requires a working knowledge of commercial and tax law. He is unable to prepare a balance sheet or income statement today without resolving a number of legal questions such as the title to stocks on consignment, merchandise billed but not shipped, compliance with provision of bonds indentures, etc. He must also compute the tax liability and arrive at a fair estimate of the income and other taxes to be deducted in the income statement. If he specializes in the tax field, an extensive knowledge of the tax law, rulings, and decisions is necessary whether or not he obtains a law degree. I know several lawyers who have never studied accounting nor thought of obtaining an accounting degree, but who through long practice have acquired a better understanding of accounting than some CPAs.

### Conclusions

My own conclusions, therefore, may be stated as follows:

1. In this age of specialization it is in the interest of the general public that anyone entering the accounting profession should have an extensive knowledge of the broad field of accounting, auditing, commercial and tax law and a more intensive knowledge of the special field to which he intends to devote himself. If he specializes in cost accounting or system work, he should learn something about engineering, production, and marketing as well as finance and accounting. If he specializes in taxes he must devote a considerable time to the study of the tax law, Treasury rulings, and court decisions.

2. In his practice a CPA can give his client the best service by a willingness to consult freely with representatives of other professions in any overlapping fields unless he is also officially qualified in that other profession. In that case I can see no detriment to the general public nor conflict with our rules of professional conduct if he practices within his field of specialization even if it falls within the range of two professions. I do feel, however, that he should limit that practice to a sufficiently narrow field to be able to render the most expert service, and that even then he should be willing to consult with representatives of other professions whenever he is uncertain as to the course to be followed or the procedures to be adopted.

The accounting profession has grown so rapidly in recent years because of the quality of the service it has rendered to business. It will continue to expand if we maintain the highest standards of professional conduct and consider the public interest to be paramount.

## Advertising and Solicitation

by Samuel W. Eskew

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**F**OR A NUMBER OF years the American Institute has had among its rules of professional conduct one which says that a member shall not advertise his professional attainments or services. It has also had a rule against solicitation.

The present rule with reference to advertising is Number 10 and reads as follows:

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 American Institute of Accountants, CPA, or other professional affiliation or designation), class of 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.

The rule against solicitation is now Number 7 and reads as follows:

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.

An examination of the reports submitted by the Committee on Professional Ethics of the American Institute over the past several years will show that more inquiries are received by that Committee with reference to the rule against advertising than with reference to any other of the rules of professional conduct.

In order to understand more thoroughly what the Institute attempts to prohibit, let us consider the meaning of the word "advertising." What is the purpose of advertising? Commercial advertising consists in presenting a commodity in print, by radio, or television to the people in such a way

that they may be induced to buy it.

In a broader sense, advertising includes somewhat more than commercial advertising, as, for example, advertising done in connection with political campaigns, charitable organizations, churches, solicitations of funds, and the like. In this broader sense, advertising may be defined as the presentation of a proposition to the people in such a way that they may be induced to act upon it. This broader definition will include those forms of publicity which are used to influence people in other respects than in buying and selling, such as influencing public opinion, advertising the importance of public safety, sanitation, strike prevention, and the like.

As contrasted with publicity and other forms of propaganda, advertising messages are identified with the advertiser, either by signature or by oral statement.

The word "solicit" has been defined as "to entreat; importune; now, often, to approach with a request or plea, as in selling, begging, etc." Another definition is "to plead for, to tempt; to lure."

Formerly, this rule did not prohibit solicitation *per se*, but was applicable only to the solicitation of clients of other public accountants. However, the rule, as it now stands, is, as I understand it, a direct prohibition against solicitation of clients.

#### Ethics Designed to Meet Needs

The fundamental ethical issue regarding advertising is the degree to which influence and persuasion on the part of sellers or others are to be permitted and the manner in which they may be used. The use of influence in commercial relations is one of the attributes of a free society, just as persuasion and counterpersuasion are exercised freely in many walks of life in our free society—in the home, in the

press, in the classroom, in the pulpit, in the court, in the political forum, in legislative halls, and in government agencies. In each of these areas, there are ethics governing the use of influence. In each, practical considerations determine the formation of ethical rules or standards which apply; they are designed to meet the needs of people in specific social relationships at particular times.

A study of ethics shows that ethical standards are in constant evolution and have varied with the passage of time. Rules that meet the needs of one period are not suitable for those of another. Moreover, codes of ethics and ethical standards for different callings, professions, or occupations at any one time are not uniform. They are appropriate to the needs of particular circumstances. Thus, the ethical standards which govern the conduct of a judge are not those which apply to the lawyer, whether he be prosecutor or defense counsel. Ethical rules require that a judge be impartial, but a lawyer is expected to present one side of the case to the best of his ability. Again, because the relationship between a doctor and his patient is different than that of a businessman and his customer, the ethical standards which have evolved to guide the physician in the solicitation of patients are different from those applied to the businessman in the sale of merchandise. The same thing is true with reference to the ethical standards which have evolved to guide the public accountant in this dealing with clients and the public.

Just how much of advertising is to be deemed unethical depends upon the viewpoint and the standards of the individual critics. Surveys made within the past several years show the public considers much of present-day advertising as improper and unethical even in business transactions. The

creation of better business bureaus and other organizations of that nature indicate that attitude on the part of the general public.

Why are rules of professional conduct needed? Wherever groups are found, rules, either written or unwritten, are also found and are necessary. Rules are essential to organized cooperation. The absence of rules is anarchy.

Rules of professional conduct are distinguishable from most rules in that they are designed not only for the advancement of the interest of those who constitute the profession, but they are also designed for the protection of the interests of those who are served by the profession—that is, the public.

The services of an accountant consist largely of expressing opinions on financial statements, which are frequently of immediate concern to a large number of persons other than the client himself.

The existence of any profession depends upon public confidence in the determination of the professional man to safeguard the public interests. This confidence can be maintained only by evidence of both technical competence and moral obligation.

The rules of professional conduct are a pledge to the public that in consideration of public confidence the profession will protect the public interest.

### Profession Maintains Ethics

One of the essential things about any profession is that a layman is not capable of judging the quality of the services rendered by professional men. Usually the special skill or knowledge of a professional man is beyond the power of the laymen to evaluate. The professional man may mislead those who rely on him. The protection which the public has is in such standards of competence and integrity as are maintained by the profession itself.

The public accountant is a professional man in this standard. The accountants have standards of admission to the practice of accountancy, so that the incompetent and the unfit may be excluded. We have codes of professional ethics so that reliance may safely be placed in the work of the accountant.

The rules of professional conduct now in force as to public accountants have developed by the evolutionary process over a period of years. They are not the ideas of any one individual. They are the product of hundreds of minds, guided by the experience of years. Many of these rules have resulted from incidents which were considered unfortunate though probably not specifically prohibited by rules.

Webster defines the word "ethics" as "the science of moral duty; more broadly, the science of the ideal human character and the ideal end of human action."

In connection with the practice of a profession, the word "ethics" has been defined as "professionally right or befitting; conforming to professional standards of conduct."

Among other definitions of the word "profession" is the following: "A vocation in which a professional knowledge of some department of science or learning is used by its practical application to the affairs of others, either in advising, guiding, or teaching them, or in serving their interest or welfare in the practice of an art founded on it."

The word implies professional attainment in special knowledge as distinguished from skill; a practical dealing with affairs as distinguished from mere study or investigation; and an application of such knowledge to uses for others as a vocation as distinguished from its pursuit for its own purposes.

The rules of professional conduct, then, are such rules as the members of

the profession feel should be followed by its own members in order that the public may accept them as being ethical, moral, and honest.

The rules against advertising and solicitation are not intended as an expression that accountants look with disfavor upon advertising or upon solicitation. These rules, however, are an expression of opinion of the members of the profession that it is not ethical for members of the profession to engage in advertising and solicitation in connection with their practice of the profession.

Some of the most frequent inquiries with reference to Rule Number 10 regarding advertising are as follows:

Is it permissible to place a bronze plaque on the outside wall of a building or to place lettering on an outside office window?

The Committee has consistently ruled that there is no objection to placing a bronze plaque on the outside wall of a building so long as it is modest in size and not in such a form as to be considered advertising. This opinion of the Committee, however, is based upon the assumption that the building does not have a directory in its lobby which could be used by clients and prospective clients in locating the accountant's office. In other words, it seems that a different rule is applicable where an accountant occupies office space in a large office building and a case where another accountant occupies all or a part of a small building in a small city or town and the building does not have a directory in its lobby.

Another frequent inquiry is with reference to mailing tax bulletins prepared by someone other than the accountant, but with the accountant's name imprinted thereon.

The Committee has taken the position that it is proper for a public accountant to mail these tax bulletins to

his clients. The Committee, however, feels that such tax bulletins should not be mailed either to former clients or prospective clients. As a matter of fact, many members of the Committee look with disfavor upon any public accountant sending out such tax bulletins with his own name imprinted thereon. The thought is that sending out such bulletins is in itself misleading in that the recipient might feel that the material in the bulletin was prepared by the accountant. In other words, it seems that this borders closely on a violation of both the rule against advertising and the rule against solicitation.

Certainly, an accountant has a perfect right to transmit any information which he may desire to his own clients.

#### **Books by CPAs**

In recent years, the Committee has had a number of inquiries with references to advertisements by publishing houses in connection with books and pamphlets prepared or written by public accountants.

The Committee has ruled that there is nothing unethical on the part of the public accountant if a publishing house in an effort at distribution of a book advertises that the author is a certified public accountant.

The position of the Committee is that this is an advertisement by the publishing house in an effort to sell its publication, and not an advertisement by the public accountant. The theory is that a publishing house has a much better chance of selling a book if it convinces the public that the author is one qualified to write such a book.

The rule of conduct of the American Institute says that a member shall not advertise his professional attainments or services. It does not say that he must prevent others from mentioning these matters.

It is unreasonable to ask the profession to discourage its members from writing books. If such books are to be published, the publishers must sell them. Prospective purchasers naturally want to know who the author is, and whether or not he has the necessary qualifications to write such a book.

As a professional man, the accountant may be expected to use his influence to keep such publicity within the bounds of good taste. Any attempt to evade the rules of conduct through publicity or advertising emanating from others would be cause for criticism.

The inquiries which cause headaches on the part of the Committee on Professional Ethics are not those which deal with direct, outright advertisements such as running an ad in a newspaper. It is those questions which are in the twilight zone and on the borderline.

It is inconceivable that any public accountant would even consider running an advertisement in a daily newspaper stating that he was professionally qualified to serve the public as an accountant. Neither are there very many members of the American Institute who would even suggest the propriety of writing form letters to various business houses soliciting his employment as a certified public accountant.

There was a time when certain accounting firms actually engaged in paid advertising and direct solicitation. I think the experience of those firms fairly convinced all public accountants that aside from the ethical viewpoint, such activities did not produce the desired results.

No prospective client, in my opinion, is going to employ a certified public accountant merely because of a newspaper advertisement or upon a direct solicitation by an accountant. It has been my experience that clients employ their accountant upon the recommendations of friends or business as-

sociates who have had an opportunity to judge of the skill and integrity of the accountant.

One satisfied client is, in my opinion, worth more to a public accountant than all of the paid advertising he could afford.

#### States Without Regulations

Another serious problem with which the Committee on Professional Ethics has had to deal is that in states which do not have regulatory legislation, public accountants are not under the supervision or control of either the State Board of Accountancy or the State Society of Accountants. The man who is practicing public accountancy without being a certified public accountant, or a registered public accountant, can, without violating any rules of professional ethics, advertise his professional attainment and solicit clients. It is very difficult indeed to convince the young certified public accountant in that state that it is wrong for him to advertise or solicit when the man across the hall from him has no prohibitions at all in this respect.

As I have said many times before, the public generally will never fully accept accountancy as a profession until such time as all of those who are engaged in accounting work are subject to the same rules and regulations and follow the same professional ethics.

Many businessmen, and even lawyers, seem to be surprised to find that public accountants have a code of ethics as rigid if not as lengthy as that of other professions. There are few outside the profession who have any conception of the obligations which the code of ethics of the American Institute of Accountants imposes upon its members.

No young man should enter public accounting practice without having a clear idea of just how far he is willing to go in satisfying each client, to

just what extent he may subordinate his personal preference, just how much he can compromise, and exactly at what point he is determined to refuse to go further with a polite statement of the reasons. This kind of attitude can be developed only through a thorough understanding of the ethical concepts of public accounting reinforced by the knowledge of why it is in the ultimate self-interest of individual practitioners to observe them. This understanding and knowledge should be a part of the training a man

acquires while studying accounting in college.

The problem of ethics in so far as it applies to the accounting profession is less a problem of policing than a problem of public relations. The need seems to be that the public be convinced that certified public accountants are as good as they are. This can be accomplished only if the members of the profession thoroughly understand their ethical obligations and so conduct themselves that those with whom they associate also understand them.



## Independence

by John H. Zebley, Jr.

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IN THE STATEMENT ON Independence approved by the Council of the American Institute of Accountants at its mid-year meeting in 1947, it is stated that legislation requiring an audit of public companies to be made by someone not associated with management was enacted in England about a century ago for the protection of the investing public.

In those days a committee of stockholders often reviewed the records maintained by management and satisfied themselves as to the financial condition of the enterprise in which their money was invested. However, it soon became apparent that technical competence in accounting in addition to independence was needed for such work. But "historically independence was the first requirement."

From such beginnings came the certified public accountant of today whose primary contribution to the economy is the impartial and objective examination of financial statements, although his activities may extend through many other fields of accounting, including system installation, tax practice, and practice before regulatory bodies.

In the evolutionary process there has been compiled a mass of accounting principles, rules of professional conduct, and standards of performance which indicate the manner in which the professional accountant is expected to conduct his practice.

By way of illustration I need only mention the growth of the literature on accounting which represents the efforts of many individuals and state and national groups interested in the subject. I do not need to detail here the subject matter of such publications of the Institute as the Accounting Research Bulletins, the Statements on Auditing Procedure, or the recent codification thereof, the case studies on auditing techniques as applied to special industries, and to internal control, all of which relate to technical competence. Nor do I need to repeat here the formal Rules of Professional Conduct subscribed to by all members of the American Institute of Accountants.

It is interesting to note, however, that the Rules of Professional Conduct of the Institute do not contain any direct reference to independence. There is no definition of independence con-

tained in the rules. But there have been created within the framework of the rules certain objective tests which may be applied to conditions found to exist with regard to a member's work or to his relations with his client to determine whether he has maintained a disinterested and impartial point of view throughout a particular engagement.

The Institute's rules of professional conduct which bear on the subject of independence are:

- No. 3, on the receipt from, or payment to, others of commissions for work obtained or business done;
- No. 4, on incompatible occupations;
- No. 5, on rendering an opinion on financial statements that are false or misleading, or based on an inadequate examination;
- No. 9, on rendering professional services when the fee to be received is contingent upon the results obtained;
- No. 13, on expressing an opinion on financial statements of enterprises in which the member has a substantial financial interest.

Failure to observe not only the rules of conduct which have to do with professional independence but also any of the other rules of professional conduct may result in a member being summoned to appear before the Trial Board of the Institute to answer the alleged violations. If he should be found guilty of infringing any of the rules of professional conduct he renders himself liable to disciplinary action under the by-laws which could result in expulsion from membership in the Institute. Undoubtedly any such action would come to the attention of the State CPA Board under which the disciplined member was certified. If such State Board had adopted rules of ethics or professional conduct which the action of the dis-

ciplined member contravened, there would be a good possibility that loss of his certificates would result.

While not every State CPA law contains a code of ethics or a provision for the establishment of such a code by the State Board, there is a growing tendency for the creation of codes of professional conduct having statutory authority. New York State just amended its CPA law to provide for a code of ethics under control of the Board of Regents.

Thus it is apparent that the members of the accounting profession are not only fully conscious of their responsibility to the public to maintain a high standard of technical competence and complete impartiality and objectivity in the pursuit of their work but also have created a process of disciplinary action designed to secure adherence to the high standards which the rules of professional conduct imply.

### SEC Regulations

In addition to being bound by the rules of professional conduct of the American Institute of Accountants or of their State professional society or Statutory code, members who express opinions on financial statements of companies whose securities are registered with the Securities and Exchange Commission must meet the tests of independence which the SEC has prescribed.

The laws granting to SEC authority over the issuance of, and dealing in, the securities of registered companies provide that the Commission may by regulation require the financial statements filed with it to be certified by independent certified or public accountants.

The rules of practice of the SEC provide with regard to all persons including independent public accountants practicing before it, as follows:

## Rule 11

(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.

Regulation S-X promulgated by SEC prescribes the form and content of financial statements which are required to be filed with the Commission. Regarding the independence of accountants who certify the financial statements filed, the regulations state the following:

## Rule 2.01

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and

will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

It is clear from the foregoing that the SEC has added several more examples of situations or relationships having a bearing on the independence of accountants who certify financial statements filed with it than are contained in the rules of professional conduct of the Institute.

Generally speaking the difference between the rules relating to independence as prescribed by the Institute and those of the SEC is that the Institute rules permit certain relationships between client and CPA to exist without bar to acceptance of the accountant's opinion provided disclosure of the existence of such relationships is made, whereas the SEC rejects the technique of disclosure and insists upon the elimination of any dual activities on the part of the certifying accountant, such as promoter, underwriter, voting trustee, director, officer, or employee. These activities are stated in the rule to be examples and consequently should not be considered to be the only activities which the SEC may hold to impinge upon the independence of the CPA. Reference has been made to the holding of substantial financial interests in the client by the certifying accountant being a violation of Rule number 13 in the case of publicly held companies. This rule was the same in both the Institute's rules of conduct and in the SEC rules until the recent amendment of regulations S-X which substituted the word "any" for the word "substantial." Prior to that change the word "substantial" had been held to mean investment of 1 per cent or more of the certifying accountant's personal fortune in the securities of the company on whose financial statements he expressed an opinion.

The Illinois Society of Certified

Public Accountants has recently amended Rule 13 of its rules of conduct to follow more closely the present rule of the SEC relating to the conditions under which a member may express an opinion on financial statements. The amendment will become effective on June 1, 1954. It reads as follows:

A member will not be considered independent with respect to any person, organization, or affiliate thereof, in which he, his partners, or members of their immediate families living in the same household have any financial interest, direct or indirect; or with which he or his partners are, or were during the period of report, connected as promoter, underwriter, voting trustee, director, officer or employee.

#### **No Dual Standard**

To persons outside the accounting profession it must sometimes appear that there are two standards of independence which might be expected to produce different results and that the CPA whose opinion is not used in connection with the financial statements of companies whose securities are publicly distributed or registered with the SEC is not held to as high a standard of professional performance as is the CPA who must meet the requirements of the SEC regarding independence.

Nothing is further from the truth. The technical requirements to be applied to produce an acceptable financial statement are the same under both sets of rules. The professional judgment of two CPA's in the application of principles and procedures may vary and the resulting financial statements may differ in form and content although presented for similar enterprises and purposes. But this is not to say that there is a dual standard of performance or that the variation in treatment or in result was caused by bias and a lack of independence on the part of either CPA under the conditions stated.

The SEC is required by law to protect investors in companies whose securities are registered with it by seeing to it, among other things, that adequate and accurate financial data is available to them. However, other regulatory duties relating to stock exchanges, public utility holding companies, investment companies, etc. are important and time consuming activities of the SEC. The independence of public accountants occupies but a very small part of the time of the Commission and its staff. Its work is facilitated by having a larger number of objective tests dealing with independence of accountants than are contained in the Institute's rules of conduct. Thus the field is narrowed within which the Commission or its staff must make decisions as to the acceptability of the certificate of the auditor filed with it.

It should be remembered that the financial statements are primarily the representations of management. The CPA's opinion in connection therewith is the representation of a disinterested person. The objective tests of independence to which a certifying accountant is held by the SEC do much to avoid not only the opportunity for, but also the appearance of bias, prejudice, or the possibility of undue influence on the part of a client.

The accounting profession as a whole has not accepted the SEC rules on independence for application in every instance in connection with the expressing of an opinion on financial statements not filed with the SEC, even though such statements might be used for credit purposes or otherwise with third parties. Rules of conduct generally require a full disclosure in the accountant's report of any relationships which may exist that might be considered as possibly influencing his professional judgment, such as ownership of a financial interest, personal relationship to management or owners, official

or semi-official connection with the affairs of client, etc.

Disclosure is never a substitute for failure to observe adequate auditing procedures and under no circumstances should an opinion be expressed on the basis of an inadequate examination or if exceptions are of sufficient magnitude to negative the expression of an opinion.

#### Accounting Services

One point of difference in connection with accountants' independence on which the attention of the profession has been focused recently has to do with the expression of an opinion when the CPA has rendered some service of an accounting nature in connection with the actual maintenance of the books of account, such as the preparation of journal entries to record certain transactions or the posting of the general ledger.

The SEC holds that such activities fall into the category of employee relationships and accordingly render the accountant who performed them not independent, and his certificate as to the financial statements of that client will not be accepted by the SEC.

While it is generally recognized that a person may not audit his own accounts, there are many within the accounting profession who do not believe that the giving of accounting advice on the handling of a particular business transaction or even the summarization and posting of the books of account to the general ledger should preclude a CPA from expressing his opinion on the financial statements when generally accepted auditing procedures have been applied. It is well recognized, however, that the keeping of the books of account is no substitute for the application of generally accepted auditing procedures.

This question was given consideration by the Institute's Committees on

Professional Ethics and on Auditing Procedure. While no formal pronouncement has been made, the two Committees agreed that no infringement of the rules of professional conduct of the Institute would be deemed to occur if an opinion should be expressed under the above described circumstances.

It was indicated that generally speaking disclosure of such bookkeeping assistance would not have to be made in the accountant's report but the reservation was held that the circumstances of each such case should be given consideration in deciding whether or not to make disclosure. An article to that effect appeared in *The Journal of Accountancy* for October 1950 written by Carman G. Blough, Research Director.

#### Practice Before the Treasury

There is another government agency which exercises a measure of control over the activities of certified public accounts and which is interested in the professional conduct of those practicing before it. I refer to the United States Treasury Department.

Certified public accountants in good standing may receive permission to practice before the Treasury Department as enrolled agents under rules and regulations established by its Committee on Practice, formerly known as the Committee on Enrollment and Disbarment. Among those rules are certain prohibitions against advertising and solicitation which are not dissimilar in import to those found in the Institute's rules of professional conduct. The use of due diligence in the preparation and certifying of financial statements for clients is specifically required. Furthermore, it is held to be the duty of each enrolled agent to observe the ethical standards of the accounting profession.

Under such circumstances is there

any reason why the financial statements on which an unqualified opinion has been expressed by a certified public accountant should not be accepted as a basis for tax determination without further audit by representatives of the Treasury Department? True, adjustments would have to be made for statutory exclusions and special treatment of particular types of income such as capital gains, involuntary conversions, nontaxable income, etc. But why subject to a second audit the operating results of a corporation when such results have been determined and certified by persons whose professional existence is dependent upon the maintenance of an impartial and unbiased approach to the determination of income?

This is not to say that the Treasury Department should not review the tax return and make suitable inquiry into matters which might be subject to adjustment from a statutory standpoint. However, where the independent certified public accountant has already accepted the responsibility for a fair determination of income a vast duplication of effort could be avoided if

the Treasury Department would rely thereon in those cases where an unqualified opinion has been expressed.

In conclusion, attention is invited to the fact that there is usually a time lag in the formalization of public opinion into rules of conduct or procedure. The public has properly learned to expect a high degree of objectivity and impartiality from the certified public accountant in whatever he undertakes. At present the rules of professional conduct may not consider certain relationships between client and certifying accountant to be an impairment of his independence; but it would be well for all certified public accountants to review carefully, and adjust if necessary, any material relationship with a client which third parties might consider to be more representative of a management activity than of the activity of an independent adviser. If this be done, criticism of the certification of the financial statements of any such client may be avoided. The certified public accountant will rise higher in the opinion of the public as a professional practitioner if he disciplines himself in this regard.

# Adherence to Accepted Accounting Principles and Auditing Procedures

by **Donald M. Russell**

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man, Committee on Professional Ethics

**O**UR RULES OF PROFESSIONAL Conduct go somewhat beyond the usual rules adopted by a profession, in that they provide for disciplinary action in the event that a members fails to maintain minimum standards in the quality of his professional services, that is if he fails to adhere to generally accepted accounting principles and generally accepted auditing procedures.

It has been the view of the American Institute ever since our Rules of Professional Conduct were adopted in 1917, 35 years ago, that our profession cannot tolerate dishonest or careless auditing or inadequate reporting. It may be of interest to review the wording of the rule expressing this viewpoint, which was in effect from 1917 to 1941. It read as follows:

The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential or material fact

not specifically shown in the balance sheet itself shall be *ipso facto* cause for expulsion or for such other discipline as the Council may impose upon proper presentation of proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable.

Although this wording is obsolete today, it shows clearly that our members have since 1917 been required to adhere to certain standards of technical performance in their daily tasks. The need for this requirement lies, of course, in the nature of our work. We serve a public interest, in addition to serving our clients. Our professional opinions attached to financial statements cause them to be accepted by the public as true statements prepared in accordance with certain well recognized conventions. Businessmen rely upon such statements for vital business decisions. Dishonesty or negligence in auditing undermine not only the continuing existence of our profession but damage the entire economic system, dependent as it is upon credit and mutual confidence.

The problem of upholding technical

competence and performance after members have been admitted to a profession is primarily a problem of continuing education and some might ask why we should not allow the matter to rest on educational effort alone, as do several of the other professions. The record shows that we have taken formal disciplinary action in only a few instances, and we have, in fact, relied heavily upon educational processes. There have been several reasons for this.

It is essential to any effort to provide control over technical competence and performance that standards of comparison be established against which actual performance can be measured. The codification of such standards of comparison has been a major activity of Institute committees from 1938 up to the present time. The problem has been complicated by the fact that even our basic concepts of standard performance have not been static but have been constantly undergoing improvement. We must remember also the very human tendency of all of us to keep on doing that which we were first taught to do. Sam Walter Foss in his poem *The Calf Path* makes fun of us all when he tells us that we are inclined to follow certain mental paths, much as we have followed highways that were originally made by cattle. In his words:

*For men are prone to go it blind  
Along the Calf-path of the mind,  
And work away from sun to sun  
To do what other men have done.*

As individual members of a profession, we cannot afford to be satisfied to rest upon the technical competence which admitted us to the Institute, but we must grow as the profession advances. Certain time-lags should be permitted, however, in order to allow for assimilation of changes in view-

point as to accounting principles or auditing procedures before the changes are made a basis for disciplinary action.

I am sure that the individual members of the successive Committees on Professional Ethics have been keenly aware of the responsibility involved in taking any action that would influence adversely the livelihood of any member, by being indirectly the cause of starting a lawsuit, influencing a lawsuit already under way, or damaging the reputation of a member. Pleas of ignorance and assurance that failures would not be repeated have been given proper consideration. Thus, a considerable part of the work of the Committees on Professional Ethics has in itself been educational work within the profession. The instances where disciplinary action has been taken have usually been those in which serious damage has been done to the public interest or to the entire profession.

Nevertheless, each member should be keenly aware of the methods that we have created, through the Committee on Professional Ethics and the Trial Board, for disciplinary action based on inadequate technical performance. Each member should realize that his own technical performance is important to the standing and prestige of all other members. Faulty performance is news, whereas good performance is no more than is expected. Therefore, a few faulty performances can offset the major programs of improving public relations and educating the public as to the value of our services, on which the Institute is so ardently engaged. The policing of the technical performance of our profession is the responsibility of each member to be performed by his own conscientious and intelligent adherence to accepted accounting policies and auditing procedures.



### Standards of Comparison

The Institute has done much to codify the fundamental procedures of auditing through its formal Statements on Auditing Procedure, begun in 1939, and its other pamphlets issued as far back as 1917 and culminating in the Codification of Statements on Auditing Procedure published in 1951. Certain fundamental principles of accounting have been enunciated in the series of Accounting Research Bulletins of the Institute Committee on Accounting Procedure, beginning in 1938. The American Accounting Association, the Securities and Exchange Commission, the New York Stock Exchange, and other associations and organizations dealing with accounting matters have issued opinions on auditing procedures and accounting principles. The formal statements issued by the several organizations have not always been in agreement, but certainly to the extent that they do agree they represent an authoritative expression of general acceptance as to basic auditing and accounting concepts. In the event, therefore, of the necessity for discipline, we now have a substantially well-defined standard of comparison as to basic concepts, for the measurement of actual performance of a member, and for the guidance of the Trial Board which is to evaluate that performance.

### The Present Rule 5

Our present rule concerning technical performance is Rule 5, reading as follows:

- (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 material omission of generally accepted auditing procedure applicable in the circumstances.

It will be noted that Rule 5 cannot apply unless a member has expressed an opinion on representations in financial statements. Thus this rule does not apply to technical performance in the preparation of tax returns or tax work generally, to system work, to accounting or general business advice, or to any activities other than opinions expressed on financial statements. Charges can, however, be brought against a member, based upon technical incompetence or willful wrongdoing in these other areas, under Section 4 (d) of the By-Laws. This Section gives the Trial Board power to consider any "act discreditable to the profession." The Trial Board

would, however, be required to form its opinion as to the acts complained of, without the benefit of specific definitions such as are set forth in Rule 5 for opinions expressed on financial statements.

Subparagraphs (a) and (b) of Rule 5 relate more to good faith than to competence since both refer to failures *known to the accountant* but not disclosed or reported.

Subparagraph (c) relates to "material negligence." The interpretation of the word "material" in reference to the degree of negligence is the responsibility of the Trial Board. The Trial Board is to exercise its judgment in the light of all the circumstances of each particular case. I believe "material negligence" is a sound criterion of the necessity for disciplinary action.

Subparagraphs (d) and (e) contain the words which bear upon the concept of technical competence and competent performance.

In subparagraph (d) the portion reading "he fails to acquire sufficient information to warrant expression of an opinion" may apply to the situation where, although not "materially negligent in the conduct of his examination"—which would bring him under subparagraph (c)—the auditor permits the scope of his examination to be restricted with the result that "he fails to acquire sufficient information," but nevertheless he expresses his opinion. The portion reading "or his exceptions are sufficiently material to negative the expression of an opinion" is necessary to take care of situations where the auditor may express a favorable opinion even after relating material exceptions which render the opinion of no service to the reader.

Subparagraph (e) may now be considered obsolete since mere disclosure of departures from generally accepted accounting principles or generally accepted auditing procedures is, of itself,

inadequate unless the effect of such departures upon the financial statements taken as a whole is explained. The wording implies that if the auditor merely discloses that such principles or procedures have not been followed, he may escape discipline even though he expresses the opinion that the principles or procedures followed nevertheless result in a fair presentation. To permit this is to void the requirement to follow such principles and procedures as have gained "general acceptance."

#### Rule 5 Should Be Revised:

Since the wording of Rule 5 was adopted in 1941, there have been two changes in the basic concepts of auditing and reporting procedure which may warrant revision of Rule 5: (1) the Statement 23 procedure concerning disclaimers and (2) the inadequacy of disclosure without qualification.

At the 1949 annual meeting, the membership of the Institute approved a formal statement which included the following:

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.

The procedure of identifying financial statements as "Prepared from the Books Without Audit" may be considered for this discussion as one form of disclaimer.

The formal statements of accounting principles and auditing procedures are numerous and detailed, and matters of detail should not be written into the Rules of Professional Conduct. The Rules should make reference to only those basic concepts which are so fundamental that failure to observe them is *ipso facto* discreditable to the

profession. Serving the *public interest*, which was the original controlling reason for a rule on technical competence in 1917, should be the basis of consideration now as to whether the wording of Rule 5 should be broadened to recognize the importance of disclaimers.

Statement 23 was adopted because so many accountants in their long-form reports did not make their position clear either as to whether they were satisfied with the scope of their examinations or whether, in their opinion, the financial statements were fairly presented. The proposition that we should not permit our reports to be ambiguous or to lend themselves to misrepresentation by our clients or others who may use them in seeking credit is very close indeed to the most fundamental of all principles, that we should tell the truth without equivocation. Is not the public damaged if it cannot read our reports and understand whether as experts we have made an adequate examination and what the opinion is that we have reached as a result of our examination? I believe that this proposition is equally essential to the public interest and equally necessary to maintaining public confidence in the profession as the requirements that we should not fail to disclose material facts or fail to report misstatements, already included in Rule 5.

I suggest that Rule 5 be rewritten to include two sections, paragraph (A) to require that the auditor make his position clear by an opinion or a disclaimer of an opinion and paragraph (B) to be substantially the same as the present wording (except as to subparagraph (e)).

Solely to provide a basis for discussion, it is suggested that the wording of a revised Rule 5 might be similar to the following:

(5) A member may be held guilty

of an act discreditable to the profession if

- (A) he permits his name to be associated with financial statements purporting to present fairly the position of an enterprise or the results of its operations in conformity with generally accepted accounting principles, without making clear his position as to the scope of his examination and his conclusions by either
- (1) expressing an unqualified opinion;
  - (2) expressing a qualified opinion; or
  - (3) disclaiming an opinion on the statement as a whole;
- (B) in expressing an opinion on representations in financial statements which he has examined,
- (1) he fails to disclose a material fact known to him which is not disclosed in the financial statement but disclosure of which is necessary to make the financial statements not misleading; or
  - (2) he fails to report any material misstatement known to him to appear in the financial statements; or
  - (3) he is materially negligent in the conduct of his examination or in making his report thereon; or
  - (4) 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

- (5) he fails to qualify his opinion for any material departure from generally accepted accounting principles or for any material omission of generally accepted auditing procedures applicable in the circumstances.

In the above suggestion, the wording of paragraph (A) is based upon the 1951 Codification of Statements of Auditing Procedure. Paragraph (B) follows the present rule except that subparagraph (5) requires qualification whereas the corresponding subparagraph (e) of the present rule requires only disclosure.

If it is agreed that standards of reporting are an integral part of auditing procedures, it would be possible to substitute for the present Rule 5 a very brief wording stating only that we require compliance with generally

accepted auditing procedures. My personal preference, however, would be to retain the present subparagraphs (a) and (b) relating to good faith and subparagraph (c) referring specifically to "material negligence," in the form I have suggested.

I have learned, since I prepared this paper, that the Committee on Professional Ethics has considered recommending a revised Rule 5 but has deferred its decision pending completion of the research now being conducted by the Committee on Auditing Procedure concerning the extent of actual compliance with the published standards of auditing and reporting. When the time comes that the Committee on Professional Ethics considers revision to be timely, it will undoubtedly receive numerous drafts of proposed wordings. I submit the suggested revision proposed in this paper as one item for its collection.

**Governmental  
Accounting  
and Auditing**

**Progress in Municipal Accounting  
and Auditing**

**by E. Lynn Crossley**

City Auditor of Dallas; President of the Municipal Finance Officers Association

**U**PON BEING ASSIGNED this subject, I could not help but look back over the nearly 25 years I have spent learning municipal accounting. That long ago it was just a poor grade of old time bookkeeping. I believe that those of you who have taken the time to make a comparison of municipal with other branches of accounting will be willing to admit without argument that the greatest progress has been made during the last 25 years in municipal accounting. No doubt, large cities had an adequate bookkeeping system in the late 20's, but many of the smaller cities had a comparatively poor record of cash receipts and disbursements. As a matter of fact, in many small units which have been absorbed by the City of Dallas the records were so poor that it was impossible to make a satisfactory determination of their financial status.

I shall treat the assigned subject by illustrating the progress in municipal accounting and auditing and attempting to describe the present high standards.

If you will pardon the personal reference, I believe that this can well be done by outlining the methods and progress of the City of Dallas, which city had a comparatively high standard 25 years ago and which has kept pace with progress.

One of the reasons for the comparatively high standards of the City of Dallas is the foresight of the people who wrote the City Charter of 1907. This charter provides that the chief accounting officer, the City Auditor, shall be selected by the presidents of the Dallas banks. All accounting systems and all auditing are under the complete control of the City Auditor, and there is no interference by the elected governing body or the City Manager. Although this method is unique to Dallas, I believe it could be used advantageously by other municipalities.

At first thought, I am sure you might feel that for an officer to prescribe the methods of accounting and audit himself would lead to collusion and poor auditing practice; however, this has

been avoided in two ways. The City Auditor and the members of his staff do not handle any cash. The methods of receiving and recording income by the departments are prescribed by the City Auditor. These methods include adequate controls. All monies received must be reported daily to the City Auditor and deposited within 24 hours with the City Treasurer, which is the bank, upon a warrant issued by the Auditor's office after examination of the income records. Disbursements are made by the City Auditor only after proper Council authorization and purchase procedures and certification by the various departments that the charge is correct. Prior to payment on the signature of the Auditor and the City Manager, it is mandatory that the Auditor determine that the charge is proper, including price, and has been authorized.

The second most important step in preventing poor practice is the charter provision added in 1931 whereby annual independent audits of all financial records of the city must be ordered by the City Council. These audits must be made by one or more certified public accounts who, for the three years next preceding, have held a certificate issued by the State Board of Accountancy of the State of Texas or by other states with similar standards.

### Introduction of Machine

To illustrate the improvement in methods of income control, I shall describe the systems of accounting and auditing used for *ad valorem* tax. The accepted method used to be the preparation of tax rolls and statements on the typewriter by employees of the Tax Department from assessment sheets, these assessment sheets having been brought forward in pen and ink from the previous year's record and discussed, when deemed necessary, with the taxpayer. As you can readily see, as the volume of work increased, this

hand transcription was likely to allow errors to slip in. There was also the possibility of the Tax Assessor being more considerate of one taxpayer than another. This could be prevented only by the diligence of the various taxpayers to see that their assessment was in line with their neighbor's.

Upon completion of a tax roll the City Auditor's staff made a detailed examination and set up a control figure for taxes receivable. However, because of the volume it was difficult to make any comparison of the assessment figures. After control was established, a daily examination of the collections was made and a warrant issued for the deposit by the Tax Collector with the City Treasurer. At the end of the current tax collection period the City Auditor made a recapitulation of all collections from duplicates of the receipts issued and determined the amount of unpaid items on the tax roll to prove the control figure. This amount was then added to the delinquent controls which were audited continuously in a similar manner. No item once accrued on the tax roll could be taken off unless it was paid or ordered cancelled for good and sufficient reason by the City Council.

This was an adequate control except for the failure to make sufficient examination of the assessment records and our failure to make audit confirmations of the unpaid items. We were able to carry out these methods until the volume became so great that we felt it was impractical from an expense and space standpoint to maintain a sufficient staff to carry on such personal examinations.

After effecting all possible modifications and speed-ups in the above methods, it was decided that a completely new system would be necessary. The method decided upon was IBM punch card accounting operated by the City Auditor's office. Cards were made

for every item on the then existing current tax roll. This duplicated the control of items then in the process of collection. From this starting point list sheets are made each year from the previous year's record for use of the Assessor in determining the new assessment. If there are any changes, they are made by the Auditor's office. Changes of assessment can be examined daily and further investigation made if necessary. Upon completion of the changes, a continuous control has been maintained and the cards are ready to produce a new tax roll. Because of the likelihood of rate changes, the records are all based on values only. By use of the calculating punch the amount of tax is automatically punched into the cards at a very rapid rate.

By a system of account numbers the cards are sorted into alphabetical order for the production of a tax ledger in multiple copies. The original is used by the Tax Department for citizen contact. This record is hand posted daily from collection reports prepared in proper order by the IBM Division. The duplicate tax ledger is used in the Assessor's office to keep a memorandum record of changes for use in citizen contact during the year. The accounting cards are later sorted into geographical order by lot and block number, and a similar roll is prepared for cross reference purposes. This is prepared in several copies and is useful to other departments of the city as quick ownership reference.

Tax statements with punch card stubs are prepared from the accounting cards. These are mailed direct to the taxpayers by the Auditor's office. Several times daily during the collection period the punched stubs are picked up from the Tax Department cashiers by the IBM Division and balanced with collections. These items are sorted in the same order as the tax roll and a daily cash report prepared, from which

the Tax Collector posts payments to the alphabetical roll referred to above. It of course is mandatory that the Tax Collector deliver to the City Treasurer the amount collected each day. The accounting cards for paid items are also removed from the file by the collector. Unpaid items are then billed, including penalty and interest, and mailed direct to the taxpayers nine times each year. This gives us a complete audit confirmation.

#### Reduced Unit Cost

It is difficult to prove because of the continued increase in volume, but I am confident that this method has reduced our unit cost of tax billing. From this method we have gained a very tight control and continuous audit at almost no cost. I am confident also that monthly reminders to delinquent taxpayers have been a contributing factor in keeping our current collections above 98 per cent. I do not offer this as the perfect system, as we are always looking for improvements and shall appreciate any constructive suggestions.

During the same period described above for tax accounting and auditing, the growth in the waterworks accounts receivable billing and auditing was becoming more acute because of its frequency. We were using a stub system with cycle billing, often referred to as self-auditing. With less than 60,000 customers it was possible to make detailed examination of the departmental records often enough to maintain an adequate audit. This billing was produced on NCR machines and hand-delivered. During the mid-40's when it was impossible to obtain additional equipment and practically impossible to obtain sufficient help at a fair price, we changed our billing period from monthly to bimonthly.

During recent years, when it became necessary to increase water rates and

when our volume increased greatly, it was mandatory that we change methods. We were unable with our existing system to maintain billing schedules on a bi-monthly basis, and it was impossible for the existing staff of the Auditor's office to make sufficient detailed examination of the records. It also appeared, from the viewpoint of the City Council, desirable to bill the customers monthly so that their complaints about large bills, brought about by a recent rate increase, would be lessened.

We have just completed the integration of the waterworks accounts receivable, accounting and auditing, into the IBM punch card division. The methods used are very similar to those used for the Tax Department. Here again, I am confident that we reduced the unit cost of accounting and obtained the auditing at almost no cost.

This department especially received many useful by-products from the system, the greatest, on a long term basis, being statistical information for rate-making purposes. The most spectacular, and of course the most needed at the present time, was a public relations service. For many years it had been customary to allow during the summertime a reduction in the price of water used in excess of the winter average. Because of the large increase in permanent improvements, it was necessary to discontinue this for two years; however, it was again instituted this year. The by-product which we consider very valuable in this line is our ability to figure rapidly with the computing punch the actual saving for each customer and print it in a special box on the face of his bill. This also gives management an accurate figure on the cost to the city of the summer rate. This saving to the customer is substantial and has, I am sure, reduced the number of high bill complaints. As a matter of fact, it has caused a great deal of favorable comment in spite of

the fact that during the long dry summer our billing has run far in excess of all estimates.

I have described in detail the above income accounting and auditing methods because they are the most drastic changes effected; however, during the period referred to, continuous improvements have been made in other methods. As in other cities, our greatest source of assistance has been from the Municipal Finance Officers Association. We have also profited from the advice and counsel of the CPAs who have conducted the 21 independent audits of the records. I think also, from many contacts with the independent practitioners, that they too have profited from the services of the Municipal Finance Officers Association.

### **Comparison of Methods**

I should like now to devote some time to the comparison of the use of IBM punch card methods of accounting and auditing disbursements with methods previously used. The first section to be converted was payrolls. As in the case of income, we had a very tight control, with a few minor exceptions, but too much time was devoted to the preparation of payroll records by the operating departments and the Auditor's office. This of course became more evident as the size of the organization increased and demands were made for withholding and other deductions. It has always been the duty of the Auditor's office to determine that every person appearing on the payroll was properly employed and certified, that sufficient appropriation was available, and that each person was entitled to the amount shown on each period payroll. In order to do this it was necessary to compare each payroll presented with the previous payroll and account for additions and deletions. The mathematical accuracy then had to be determined before pay checks



were written. It was also necessary to test the expenditure against appropriations. As you can see, this caused considerable repetition in that the department had to rewrite the employee's name and calculate the gross, deductions, and net each time, which calculations had to be rechecked by the Auditor's office. Because it was not required, we did not furnish the employee with a check stub to account for his various deductions.

Another undesirable feature was our dependence on the department for a certification of the time worked. This was shown in one single figure, and if we wished to determine the daily time record of an employee, it was necessary to go to the department and check the time book. In the case of clerical and administrative employees, this was usually kept by the exception method, and there was ample opportunity for various types of leaves to be overlooked.

With the application of punch-card accounting and auditing we were again able to produce the accounting record more cheaply and obtain adequate auditing without additional cost. Under this method every employee has a master card with an employee number selected so that he may be sorted into alphabetical order. This card designates his department and division, position title, pay rate, tax class, and appropriation out of which he is to be paid. By the use of these master cards, there is prepared at the beginning of each pay period a time sheet for each division's authorized employees, showing each employee's rate of pay for the period. Time keepers are required to make a daily record of attendance for each employee. If at any time there is doubt that the employee is being recorded on duty when he is not there, it is simple enough to refer to the time sheet. The time sheet is then completed by extending into the earnings column only the amounts that

are different from the authorized rate. This is then certified to the Auditor by the department head and becomes the payroll.

The preparation of this payroll for check writing is comparatively simple. Instead of the detailed comparison of each employee as in the past, it is only necessary to observe the time column to see that any earnings more or less than the regular amount have been extended properly and checked for proper authorization of employees added or deleted during the period. Upon receipt of the preaudited payroll by the IBM Division, cards are punched with the employee number and amount for persons whose earnings are not standard. The balance of the information is transcribed into payroll cards from the master cards by use of the duplicating punch at a very rapid rate. These reproduced payroll cards are processed automatically by the computing punch, which figures the withholding tax, pension contribution, and net pay.

From the processed cards the payroll register is prepared which becomes a permanent employee pay record. The same cards are used to prepare the pay check. This is a card check with stub in which the number is prepunched. This stub gives the employee complete information which he did not have under the old method. The prepunched check, when returned from the bank, is compared with the earnings card by the collator. The remaining earnings cards, representing outstanding checks, give us a quick and economical bank reconciliation.

#### Valuable By-Products

There are several valuable by-products of this method in addition to payroll accounting and auditing. It gives a quick method of accounting for and reporting withheld taxes and the preparation of W-2 forms. It accumu-

lates with little extra effort earnings and contribution records for the retirement fund. It enables us to tabulate employees by class and age for use by the actuarial consultants for the retirement fund. We believe that this reduces the consultants' fee to the city. It is also necessary from time to time to furnish the personnel and budget departments with various tabulations for use in the consideration of salary changes.

Another very important phase of municipal accounting and auditing is the control of appropriations, expenditures, and commitments. This probably is a bigger headache to municipal accounts than to commercial accounts, inasmuch as the law, in addition to good business practice, requires a strict control. The problems of this phase, as in all others, were multiplied by the city's growth. Here again, the writers of the City Charter were wise in making it mandatory that the City Auditor make no disbursements in excess of appropriations.

In addition to this legal control, the first and subsequent city managers have gone further in requiring the various departments to state at the beginning of the fiscal year the amount necessary out of each appropriation for the operation of their various functions each month. This is not based on one-twelfth of each appropriation item but on the amount judged to be necessary for the actual operation. This practice of monthly splits has saved the taxpayers an untold amount of money during the past 21 years.

All commitments, outside of payrolls and utility charges, originate in the form of purchase orders or contracts. Prior to their release, these commitments are submitted to the Auditor, where they are checked to determine that they are a proper expenditure, that the price is not excessive, and that there is sufficient appropriation available. These commitments, along with

nonpurchase order items which are properly authorized, are tested for appropriation availability before checks are written.

By the maintenance of this continuous commitment control it is possible to produce rapidly on the tabulator once each week a status report of every appropriation item for the various departments. This relieves the departments of maintaining detailed commitment controls and advises them continuously of the unspent appropriations. A copy of this report is prepared for the City Manager so that he may determine if the departments are operating within the monthly splits. At the end of each month a combined statement of appropriations, expenditures, and commitments is made quickly, showing the total appropriations, current and cumulative expenditures, and a comparison of the actual expenditures and commitments with the estimated expenditures and commitments. This report shows also the over-run or under-run for the period and the amount available in each code for the following month. In addition to administrative records for the City Manager, this produces for the Auditor's office a cash and appropriation control.

Here again, we are not of the opinion that punch-card accounting is the complete solution to the problem. As in the case of income, we have continuously improved disbursement methods with the assistance of the Municipal Finance Officers Association and consultation with the certified public accountants who have audited our records.

Like commercial accounting, municipal accounting has grown from a simple record of receipts and disbursements into an important part of management. As a matter of fact, it is thought by some to be more important in municipal accounting because of the change in management caused by

elections—at least in those governments below the Federal level—as compared to continuity of management in most private industries.

Another factor which increases the importance of municipal accounting is the present need of all growing cities for large sums of money to make permanent improvements. Although cities do not have to make detailed reports for the SEC, as in the case of private industry, proper reporting is just as necessary in obtaining a fair credit rating. The National Committee on Governmental Accounting, of which your member and former president of MFOA, Joe Lowery, is chairman, has established standards of reporting which will produce annual financial statements in proper form to satisfy bond holders and municipal financial rating organizations. This form of reporting should improve the credit of many localities and enable cities to make comparisons for management purposes.

In order to discharge his duties properly, a municipal accountant must first acquire sufficient knowledge to carry out the mechanical part of his duties. Experience should teach him to use good judgment in advising the successive elective governing bodies. The elected representatives of the people are entitled to dictate the policies; however, because many of them are inexperienced, they are also entitled to the advice and assistance of

competent municipal finance officers. In the absence of experience, as a background for judgment in the finance officer, here again he can obtain assistance from the many years of experience represented by the inquiry service of the Municipal Finance Officers Association. Following the lead of the American Institute of Accountants, the Municipal Finance Officers Association is attempting to raise the standards of its members.

To sum up briefly, municipal accounting and auditing is a fairly easy profession if the finance officer outfits himself with a few simple tools. He should acquire the knowledge necessary to design systems of income control from numerous sources, many of which are irregular and difficult to trace. Likewise, he should acquire the ability to devise methods of auditing both income and disbursements, which are handled in many cases by inexperienced help. Because of the loss of confidence in government brought about by the branches not commonly referred to as municipal, he must be able to protect persons responsible for handling city money from constant accusations of dishonesty. The municipal accountant is fortunate if he is outfitted with a charter that assists in high standards of accounting and auditing. He must acquire the competence to advise successive elective bodies and stay out of politics. With these few simple tools, his job should be easy.

# Standardization of Municipal Accounting and Auditing

by **Joseph M. Lowery**

Auditor-Controller, Los Angeles County, Chairman, Committee on Governmental Accounting of the Municipal Finance Officers Association

**Y**OU HAVE HEARD Mr. E. Lynn Crossley, President of the Municipal Finance Officers Association of the United States and Canada, present this subject from the standpoint of a governmental finance officer and Mr. Osa Alexander present the subject from the standpoint of the practicing certified public accountant; now I will attempt to look at the question from both sides of the fence.

Many of us do not appreciate the fact that governmental accounting is a very specialized field, and that we cannot install an adequate accounting system or properly conduct an audit unless we have a sound understanding of its special problems. There are two major differences between governmental and private enterprise accounting. First, governmental accounting is accounting by law because a governmental agency may do nothing except by legal direction, whereas private enterprise accounting is subject to a minimum of legal control. Second, success or failure of governmental service is not measured by profit or loss, whereas private enterprise, with few exceptions, is established for the pur-

pose of earning a profit and its success or failure is measured by the degree of profit earned or loss suffered. These differences give rise to many special procedures and controls in a public agency not found in private enterprise.

One of the main problems with which we as public accountants have to cope in relation to audits of governmental agencies is the problem of overcoming a condition of bad public relations with public officials. This bad public relations condition has been developing over a long period of time, principally because of an improper and unjustified perspective on the part of a great many accountants engaging in audits of public agencies. Some of us immediately assume the role of the auditor defined by Elbert Hubbard when we start on such an assignment. We presume nothing about the operation of a public agency could be good; and it would be heresy to write any favorable comment in a report because good practice and procedure is not news; therefore we play up everything we can criticize.

Occasionally the report is built upon volume rather than quality of

content. Sometimes the only constructive results of our audit is that we have schooled some of our staff members in the techniques of governmental accounting at the expense of the taxpayer. Public officials resent this attitude and as a result many of them advocate laws requiring audits of local governmental agencies to be made by or under control of a state department.

#### **Pitfalls**

We often make the serious mistake of not discussing the draft of our audit report with the persons involved and suffer great embarrassment when one or more of our comments or criticisms are shown to be without foundation. To have such a thing happen puts all of our opinions and conclusions in the category of being unreliable and worthless. Even those of us who are considered skilled in the field of governmental accounting sometimes fall into this trap because, as I previously stated, governmental accounting is accounting by law, and we might overlook a resolution, order, ordinance, charter, or statute provision and criticize some accounting procedure ordained by this overlooked law, or we might overlook a court decision or a legal opinion which interprets the law in a given case considerably at variance with our interpretation—and of course a judicial interpretation would govern no matter how much we might disagree with it.

Another example of a pitfall is that there may be several laws which could be used to authorize a certain operation or special program, and while these laws might be somewhat similar, they may differ in some major point or points and you might criticize the procedure followed because of your review of one of the enabling acts whereas the procedure was put into effect under the provisions of the other enabling act and is perfectly proper.

More than this, the technique of having a preview of the report allows those concerned to have their "day in court," so to speak, and any proposed comments, criticisms, or recommendations which they have not been able to "wash out" will not be attacked by them when the report is issued and you stand upon firm ground.

These faulty attitudes and viewpoints are fast disappearing because much has been done in recent years by those concerned in developing better accounting, auditing, and reporting for public agencies. A proper viewpoint for a certified public accountant in relation to an audit of a public agency could be acquired if we fully realized that our responsibility is far greater than it would be in the conduct of an audit for a private enterprise activity because our report is made to the public at large instead of being made to several officers and a comparatively few stockholders. It is also well to remember that all criticism should be constructive and that there are at least two ways of presenting any situation. You are always on the right side when your comments are expressed in the kindest way. You would not deliberately antagonize your private enterprise client if you could reasonably avoid doing it.

Of course not all of the faults causing this condition of bad public relations lie with us. Some of them exist on the side of the public official. You often find an attitude among school superintendents, engineers, doctors, and other professional people in government that they are not bookkeepers. We are here to educate children, build highways and bridges, conduct hospitals, etc. In too many cases the chief accounting officer is an elected officer who does not necessarily have to have any qualifications for the job other than his vote-getting abilities.

This could be corrected and we can possibly help by trying to influence public opinion. A city attorney must be an attorney, a city engineer should be a licensed engineer, a city health officer should be a doctor, why should not the city's chief accounting officer be an accountant?

### National Committee

Only a few short years ago, accounting, budgeting, and reporting by local governmental agencies followed the ideas and knowledge of local individuals, and might be fair or even good, but were usually bad. Two or more agencies might follow the same general pattern only by coincidence. This deplorable situation was long recognized by the members of the Municipal Finance Officers Association of the United States and Canada, who finally in 1934, sponsored the organizing of the National Committee on Municipal Accounting. Remember, this happened only 18 years ago.

Those responsible for the form of organization of the National Committee on Municipal Accounting were uncanny in their wisdom as time has shown. Some of the best brains in the field of governmental accounting were brought together to consider the problems, and they in turn carried the message of their solutions to the governmental accountants and finance officers in all of the states and provinces.

The following nine organizations were requested to, and did, appoint a Municipal Accounting Committee:

1. American Association of University Instructors in Accounting (now the American Accounting Association);
2. American Institute of Accountants;
3. American Municipal Association;
4. American Society of Certified Public Accountants (now merged with

the American Institute of Accountants);

5. International City Managers' Association;

6. Municipal Finance Officers' Association of the United States and Canada;

7. National Association of Cost Accountants;

8. National Association of State Auditors, Comptrollers and Treasurers; and

9. National Municipal League.

The chairman of each of these "advisory" municipal accounting committees automatically became a member of the National Committee. A representative of the Census Bureau of the Federal government served in a liaison capacity. The National Committee worked largely through an executive committee of those members and a secretary. The chairman of the Municipal Finance Officers Association Advisory Committee served as the chairman of the executive committee, and the Director of the Municipal Finance Officers Association served as the secretary of the executive committee. The composition of this executive committee at the time of its organization, and for years after was:

Frank J. Flanagan, Finance Committee Staff of the City of Chicago, Chairman;

Lloyd Morey, Comptroller and Professor of Accounting at the University of Illinois, Vice-Chairman;

F. H. Elwell, Dean of the School of Commerce, University of Wisconsin;

Carl H. Chatters, Director of the Municipal Finance Officers Association, Secretary; and

Irving Tenner, Staff Accountant.

The aims of the National Committee were:

- to set up principles and standards of municipal accounting; to develop standard classifications and

uniform terminology for accounts and reports;

and most important of all—

to carry on an educational campaign to sell these principles and standards to governmental fiscal and accounting officers to the end that they would adopt them.

How well they succeeded is now a matter of history. They planned well and succeeded beyond their expectations.

The first release by the National Committee, issued in 1934, was titled: "Tentative Outline—Principles of Municipal Accounting." These nine principles have been since augmented and somewhat revised, and appear on pages 1, 2, and 3 of the new publication *Municipal Accounting and Auditing* as fourteen principles and eight standard procedures. They are as follows:

### Principles

1. A municipal accounting system must make it possible (1) to show that legal provisions have been complied with and (2) to reflect the financial condition and financial operations of the municipality.

2. If legal and sound accounting provisions conflict, legal provisions must take precedence. It is, however, the finance officer's duty to seek changes in the law which will make such law in harmony with sound accounting principles.

3. The general accounting system should be on a double-entry basis with a general ledger in which all financial transactions are recorded in detail or in summary. Additional subsidiary records should be kept where necessary.

4. Every municipality should establish the funds called for either by law or by sound financial administration. It should be recognized, however, that funds introduce an element of inflexibility in the financial system. Accordingly, consistent with legal provisions and requirements of sound financial

administration, as few funds as possible should be established.

5. Depending on the legal and financial requirements mentioned immediately above, the following types of funds are recognized: (1) General, (2) Special Revenue, (3) Working Capital, (4) Special Assessment, (5) Bond, (6) Sinking, (7) Trust and Agency, and (8) Utility or Other Enterprise. This classification of funds to the extent required should be followed in the budget document and in the municipality's financial reports.

6. A complete balancing group of accounts should be established for each fund. This group should include all of the accounts necessary to set forth the financial condition and financial operations of the fund and to reflect compliance with legal provisions.

7. A clear segregation should be made between the accounts relating to current assets and liabilities and those relating to fixed assets and liabilities. With the exception of Working Capital, Utility or Other Enterprise, or Trust Funds, fixed assets should not be carried in the same fund with the current assets but should be set up in a self-balancing group of accounts known as the General Fixed Assets Group of Accounts. Similarly, except in Special Assessment and Utility Funds, long-term liabilities should not be carried with the current liabilities of any fund but should be shown in a separate self-balancing group of accounts forming a part of the General Bonded Debt and Interest group of accounts.

8. The fixed asset accounts should be maintained on the basis of original cost, or the estimated cost if the original cost is not available, or, in the case of gifts, the appraised value at the time received.

9. Depreciation on general municipal fixed assets should not be computed unless cash for replacements can legally be set aside. Depreciation on such assets may be computed for unit cost purposes even if cash for replacements cannot legally be set aside providing these depreciation charges are used for memorandum purposes only

and are not reflected in the accounts.

10. The accounting system should provide for budgetary control for both revenues and expenditures, and the financial statements should reflect, among other things, budgetary information.

11. The use of the accrual basis in accounting for revenues and expenditures is recommended to the extent applicable. Revenues, partially offset by provisions for estimated losses, should be taken into consideration when earned, even though not received in cash. Expenditures should be recorded as soon as liabilities are incurred.

12. Revenues should be classified by fund and source; and expenditures by fund, function, department, activity, character, and by main classes of objects, in accordance with standard classifications. (See the Committee's publication *A Standard Classification of Municipal Accounts*.)

13. Cost accounting systems should be established wherever costs can be measured. Each cost accounting system should provide for the recording of all the elements of cost incurred to accomplish a purpose, to carry on an activity or operation, or to complete a unit of work or a specific job. Although depreciation on general municipal fixed assets may be omitted in the general accounts and reports, it should be considered in determining unit costs if a cost accounting system is used.

14. A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports.

### Standard Procedures

1. The accounts should be centralized under the direction of one officer. He should be responsible for keeping or supervising all accounts and for preparing and issuing all financial reports.

2. A budget should be prepared by every municipality even if not required by law because such budgets are essential to the proper management of its financial affairs.

A distinction between the different funds must be made in such budget.

3. As soon as purchase orders or contracts are signed, the resulting obligation should be recorded at once as encumbrances of the funds and appropriations affected.

4. Inventories of both consumable and permanent property should be kept in subsidiary records controlled by accounts in the general accounting system. Physical inventories of both consumable and permanent property should be taken at least annually and the accounts and records should be made to agree with such inventories.

5. The accounting for municipal business enterprises should follow the standard classifications employed by similar private enterprises. Each college, hospital, library, and other public institution should follow the standard classification for such institutions.

6. Financial reports should be prepared monthly or oftener, to show the current condition of the budgetary accounts and other information necessary to control operations. At least once each year a general financial report should be prepared and published.

7. There should be general uniformity in the financial reports of all municipalities of similar size and type.

8. A periodic audit by independent accountants is desirable.

These principles and standard procedures were the plans for the structure which the Committee built. This structure is subject to alterations as changing conditions demand. The Committee's work is not a finished product.

During the years, the Committee released thirteen bulletins, some of which are revisions or consolidations of earlier bulletins. Prior to the release of the present volume, the following bulletins contained all of the Committee's releases:

No. 5 Municipal Funds and Their Balance Sheets;

No. 8 Municipal Audit Procedure;



No. 9 A Standard Classification of Municipal Revenues and Expenditures;

No. 11 Municipal Accounting Terminology;

No. 12 Municipal Accounting Statements; and

No. 13 Governmental Accounting Bibliography.

The Municipal Finance Officers Association was the prime mover in distributing the bulletins of the National Committee and urging the adoptions of the recommendations. However, they were ably assisted by the membership of the advisory committees and their organizations.

### Results

The direct results were actually astounding. Large numbers of local governmental agencies voluntarily put the recommendations into effect, and were assisted in so doing by the Municipal Finance Officers Association booklet: *Standard Practice in Municipal Accounting and Financial Procedure*. Others were required to conform by the adoption of procedure manuals on a state-wide basis. These manuals were predicated upon the work of the National Committee; consequently, great improvement in accounting, budgeting, reporting, and auditing followed.

It was now possible for governmental officers to have at their command the data necessary to give a satisfactory accounting of their stewardship. Account titles had the same meaning in the different governmental agencies. Reports were on a more comparable basis, and provided a medium for checking or comparing, within limitations, the efficiency and economy of operation with other comparable units of government.

Independent audits by outside accountants became more beneficial and practical. Bulletin No. 8, "Municipal Audit Procedure," served to inform

governmental officials as to what they should expect from an audit, what the agreement with the auditor should be based upon, a detailed description of an audit procedure and how an audit report should be prepared. This bulletin was in no sense a textbook on municipal audit procedure; however, its greatest distribution was to independent accountants interested in governmental audits. It is now considered as indispensable in this field. It has had four printings within 10 years and is now included in the current volume *Municipal Accounting and Auditing*.

Universities, colleges, and correspondence schools include governmental accounting in the accounting curriculum. The American Institute of Accountants' examination for candidates for the CPA certificate now used by all of the state boards includes governmental accounting problems and questions.

### Reactivation of Committee

Sensing the need of a review of the National Committee's work, to the end that it might be modernized if found necessary, president Charles L. Beazley, of the Municipal Finance Officers Association, decided to reactivate the National Committee, and in 1948 he requested the presidents of the various participating organizations to appoint municipal accounting committees if they had not already done so. Several additional organizations were included in this invitation so that the present roster of organizations which have appointed the advisory committees is as follows:

1. American Accounting Association;
2. American Institute of Accountants;
3. American Municipal Association;
4. International City Managers' Association;

5. Municipal Finance Officers Association of the United States and Canada;

6. National Association of Cost Accountants;

7. National Association of State Auditors, Comptrollers, and Treasurers;

8. National Municipal League;

9. School Business Officials' Association;

10. Dominion Bureau of Statistics; and

11. U. S. Federal Bureau of Census.

The Executive Board, as presently constituted, is:

J. M. Lowery, Los Angeles County Auditor-Controller, Chairman;

Lloyd Morey, Comptroller and Professor of Accounting, University of Illinois, Vice-Chairman;

F. H. Elwell, Dean, School of Commerce, University of Wisconsin;

Joseph F. Clark, Executive Director, Municipal Finance Officers Association, Secretary; and

Irving Tenner, Certified Public Accountant, Consultant.

The work of the reactivated committee got under way when President Beazley of the Municipal Finance Officers Association appointed six members of his Association who are recognized experts in the field of governmental accounting and finance to act as special reviewers of the existing bulletins. Each advisory committee was also requested to review the bulletins and offer criticism and suggestions for their improvement. All reports were classified and coordinated by the National Committee's

staff consultant who is eminently qualified to do this work, as he has served in this capacity with the Committee since its studies began.

The product of the National Committee's revision work *Municipal Accounting and Auditing* is now off the press and is available to all of us through the Municipal Finance Officers Association. It combines into one volume, the following revised committee publications:

Municipal Accounting Principles and Procedures;

Municipal Accounting Statements;

Municipal Funds and Their Balance Sheets;

Municipal Accounting Terminology; and

Municipal Audit Procedure.

The volume *A Standard Classification of Municipal Revenues and Expenditures* is the subject of the National Committee's current study and we expect to release a revised publication in the not too far distant future.

Looking back over the last 18 years, we see the enormous strides taken in the field of governmental accounting, budgeting, auditing, and reporting. Government accounting and finance officers no longer have to bow their heads in shame when they compare municipal and private enterprise accounting. However, looking forward, we see the need for continued study and research, for there is room for improvement. If the same zeal is applied in the study of the problems as has been applied in the past, we may anticipate the same outstanding progress in the next 18 years.

## Modern Trends in Municipal Accounting

by Osa F. Alexander

Partner, Burleson and Alexander, Greenville, Texas; Member of the Institute's Committee on Governmental Accounting

I BELIEVE A MAJORITY OF our certified public accountants in Texas have little or no interest in municipal accounting and auditing. Some of these accountants seem to have very good reasons for their lack of interest. We might concede that in the past their objections to audits of small cities were well founded. It *is not* my intention to discuss these objections, but *it is* my intention to stress the modern trend in municipal accounting that may cause even the most skeptical to realize that municipal accounting can be, and is, an important part of our professional activities.

I believe it is our duty to keep informed of these new developments in municipal accounting. Some cities have been forced to modernize their accounting and financial reporting due to the adoption of a new modern city charter. These changes and voluntary improvements have been too few and too slow to benefit the thousands of small cities. Some states have attempted to resolve this situation by the passage of laws requiring the adoption of uniform classification of accounts and standardization of financial report-

ing. In fact one state has already passed a law requiring periodical audits by independent accountants.

Where better accounting and reporting has been accomplished it has been mainly through the efforts of outstanding finance officers. The Finance Officers Association of the United States and Canada has pioneered the field of financial reporting for many years. By reason of their efforts and the efforts of the National Committee on Governmental Accounting and other associations of the League of Municipalities, many cities today have excellent records, procedures, and financial reports.

The manuals and procedures published by the Municipal Finance Officers Association have been used extensively in these development programs. Manuals have been prepared for use in small towns and some of the large cities have produced their own procedure manuals. The latest publication of the Municipal Finance Officers Association can be used effectively for small towns as well as for large cities. I refer to the book entitled *Municipal Accounting and Auditing*, published in September, 1951, by the National Com-

mittee on Governmental Accounting. The book combines and revises four former publications.

The publications revised were:

1. *Municipal Accounting Statements*
2. *Municipal Funds and Their Balance Sheets*
3. *Municipal Accounting Terminology and*
4. *Municipal Audit Procedure*

I would like to give you my observations in a case study of what occurred when this manual was applied to the accounting procedure in a city with a population of less than 30,000.

#### Paris, Tex., an Example

It is with the permission of the Members of the City Council and the City Manager, Mr. R. B. Riddle, of the City of Paris, Texas, that I use their city's accounting problems to illustrate to you many of the recommendations of the National Committee on Governmental Accounting.

In November of 1948 the City of Paris adopted a new charter setting up a Council-Manager form of government. Although the city had a population of less than 30,000, the charter provisions were practically the same as those recommended for cities much larger than Paris. One of the most important provisions of the charter to the practicing accountant stated that "the classification of revenue and expenditure accounts shall conform, as nearly as local conditions will permit, to the uniform classification as promulgated by the National Committee on Municipal Accounting, or some other nationally accepted classification" (now the National Committee on Governmental Accounting).

It also provided for the preparation of a complete budget and upon its adoption by the Council the "several amounts stated therein as proposed expenditures shall be and become ap-

propriated to the several objects and purposes therein named." The new charter also brought into agreement the budget and the tax levy by stating that the amount to be raised by property tax as shown by the budget shall "constitute a determination of the amount of the tax levy."

In addition, the new charter stipulated that the Director of Finance was required to maintain proper and adequate records, such records to include separate accounts for the items of appropriations included in the city budget, each account to show the amount of the appropriation, the amount paid therefrom, the unpaid obligation against it, and the unencumbered balance. There are more than 250 of these accounts in the city budget. These accounts must reflect unencumbered balances by reason of another section of the charter placing the Director of Finance in the position whereby he must refuse to sign a purchase order unless he can "certify that there is an unencumbered balance of appropriation and available funds."

The above noted requirements made it necessary to adopt a modern method of municipal accounting. In this connection, I made use of a mimeograph copy of the tentative draft of the new manual *Municipal Accounting and Auditing* which was published in final form in September, 1951, by the Municipal Finance Officers Association of the United States and Canada. With the cooperation of the city officials we endeavored to apply each form and procedure recommended by the National Committee in their new accounting manual. We met with more success than we anticipated. The principles of controlled fund accounting, strict regard to the budget, and the use of time- and labor-saving machines produced better municipal accounting for the city.

As a result of the adoption of a mod-

ern accounting system the city manager has available at all times a comparison of the actual revenue with the revenue anticipated in his budget. He also can secure from the accounting department, daily if he so desires, the condition of any or all of the 250 appropriation accounts set up in the budget. The information indicates the amount allowed as an appropriation in the budget against which actual expenditures are applied and the outstanding purchase orders, if any. Finally it shows the unencumbered balance at the end of any particular day. As a result of the adoption of the above noted accounting procedure, the city manager receives complete monthly statement of all accounts on approximately the second day of the following month.

I have mentioned the need for a change in the system for the City of Paris and how it was accomplished by a vote of the citizens through the adoption of a modern charter for the City of Paris. I have also told you about the improvement in reporting to the Management which resulted from the adoption of the principles set out in the new manual, *Municipal Accounting and Auditing*, but I have not told you of the many instances where changes had to be made in the practices to which the employees had been accustomed for more than a quarter of a century. I shall endeavor to point out many of the recommendations which you will find in the new book by explaining the difficulties we encountered in the change-over period.

#### Tax Improvement Program

Before I comment on the problem of accounting and reporting, I would like to review the city's tax improvement program. The main source of revenue in small cities is derived from the *ad valorem* tax department. I would like, therefore, to spend a little time in

explaining what many people in Texas call the "Unit Tax Ledger." The City of Fort Worth was one of the first cities to use this procedure in Texas. The first or at least one of the first small towns to follow Fort Worth was Greenville, Texas.

The City of Greenville with a population of 15,000 had always prepared its tax rolls in the customary alphabetical books, one for each year. For example, a piece of real property might appear in one year under the name of Mr. Jones and the next year under the new owner, Mr. Brown. Therefore, in order to ascertain the taxes applicable to a specific parcel of real property it was often necessary to search through eight or nine large tax books for the tax paid or to be paid on any one piece of property. The new unit tax ledger system sets up the real property as the controlling factor, with a separate ledger sheet which indicates taxes assessed and records of payments for years from 1919 to 1965. The change in ownership was indicated on the sheet but inasmuch as the tax followed the property, all records of assessments and payments were posted to the individual unit tax ledger sheet. This subject has received considerable attention in Texas and several articles and papers have been devoted to the improvements in tax assessing and collecting. A manual was written on this subject by Mr. Walter S. Curlee and his experiences in the tax office of the City of Fort Worth have been a great help to other cities in Texas now using the unit tax ledger system.

The City of Paris installed the unit tax ledger system and accounted for all improvements in real property on appraisal cards. Attached to the cards were pictures of the house or other improvements. This method indicated immediately that many values were understated and in some cases the improvements had not been rendered at

all. By picking up the understated values and adding the unrendered real and personal property, Paris' tax roll valuation increased almost 17 per cent or from approximately \$12,000,000 to \$14,000,000 in the first year alone. The increased valuation produced almost \$42,000 in additional taxes for that year.

All assessing and collection records covering one piece of real property carry the same identification number. These numbers correspond with an address plate which indicates the name of the current owner of the property. When the tax roll is prepared, the address plate is used in conjunction with a tax calculating machine and a simultaneous operation produces the tax statement (with multiple copies), the proof sheet (or roll), and enters the information on the unit ledger card. This operation makes it possible for one operator to prepare the entire tax roll, post the ledgers and make the statements, notices, and other copies in less time than was formerly required for preparation of the old style roll by seven or more employees. This year the tax roll was prepared and the notices were available for mailing more than a month before the effective mailing date.

The tax department revision was well on its way when the new charter was adopted and the officials directed their attention to the new classification of budget accounts and the encumbrance method of handling current transactions. The mechanical equipment used in the tax office was utilized to post current transactions in the revenue, appropriations, and general ledger accounts. This was a decided financial advantage since no new equipment nor additional employees were required.

#### Combined Balance Sheet

I would like to compare the balance

sheet they used in prior years with the type of balance sheets recommended by the National Committee. The old balance sheet was in the form of a consolidated statement. All of the assets and all of the liabilities of all the funds were combined. To me, one of the outstanding recommendations of the National Committee on Governmental Accounting is that a combined rather than a consolidated balance sheet be prepared for municipalities. The old balance sheet showed assets of \$3,300,000 but out of this amount the general fund had control over \$22,000 in cash and a portion of the \$263,000 delinquent taxes receivable. The cash on hand and in bank was stated at \$137,000 but the general fund could spend less than \$22,000 of this amount. It can readily be seen that this consolidated balance sheet could be very misleading, so the proper steps were taken to set up fund accounts as recommended by the committee.

To do this it was necessary to eliminate from the general fund ledger all bond funds, sinking funds, trust and agency funds, water and sewer utilities funds, general fixed assets, and general bonded debt and interest. This left the general fund with little more than cash in bank and its proportionate share of taxes receivable. But that is as it should be, because the accounts so eliminated were set up as independent entities which were wholly or in part restricted as to availability for use in the general operation of the city.

The general ledger in the City of Paris, which is posted daily, is now segregated by funds. Within each fund are listed all of the accounts applicable to that particular fund. The procedure and account description follow very much the pattern set by the City of Wichita, Kansas, in its *Accounting Procedure Manual*, published in January 1947. Many of the machine procedures were also taken from Wichita's

procedure manual. While it would be much better for the city to have its own procedure manual this is not possible in the City of Paris at the present time. Many small cities cannot afford the cost of municipal accountants capable of writing such a procedure manual; therefore, they must depend upon the books and manuals now available to them through their associations and the experiences of other cities. At this point in the program our CPAs should encourage and assist the management in every possible way in setting up their records and procedures for modern municipal accounting.

The prior reports of the City of Paris gave very little attention to the budget. The actual revenues for the year were not compared with the anticipated revenues shown by the budget. As a matter of fact the anticipated revenues were not mentioned in the report. There was a comparison of the actual expenditures with the budget appropriations which showed an overspent condition of \$25,000. It was interesting to note that although there was no provision in the budget for payment, the city had purchased two pieces of fire equipment for \$25,000.

In many small cities today we find conditions still existing where the auditor's report gives little consideration to the officials' adherence to their legally adopted budget.

The Governmental Accounting Committee is now working on a *Standard Classification of Municipal Accounts*, which will revise the former publication entitled *A Standard Classification of Municipal Revenues and Expenditures* and at the same time will include classifications and explanations for the balance sheet accounts as well as the revenues and expenditures. A tentative draft was sent the members of the committee in September 1951 and we are using it on a trial and error basis in the City of Paris. This new proposed

publication is designed for all municipalities irrespective of size, activities, structure, or system of accounting. It will be of the greatest value if it is studied and used in conjunction with the committee's publication *Municipal Accounting and Auditing*.

#### Further Budget Changes

Although the City of Paris now has about the best budget I know of in a town of its size, many of the new budget procedures are not incorporated at this time. Last year's budget carried the revenues and expenditures of the water and sewer utilities in the general fund. This is being changed now and the utility accounts are being set up as a separate fiscal entity. Only the annual contributions from the water and sewer department will be entered in the general fund budget. The accounting for a municipally owned utility should be similar to the accounting for a privately owned utility. Therefore the contributions to the general fund should be as much as taxes that would have been collected by the city from a privately owned utility, plus a portion of its remaining net profit. Since the utilities are engaged in a function that should develop a profit, we believe depreciation should be considered a cost of doing business. The provision for depreciation should be funded; that is, cash or securities should be set aside to replace the worn out or obsolete equipment without levying additional taxes. If worn out or obsolete plants must be replaced by the issue of general bonds, the so-called contributions from utilities were not operating profits at all but only return of capital.

In the City of Paris special attention is directed to these operating statements because of the issue of revenue bonds which require payments of bonds and interest from the profit of the utilities.

The city's current budget has been

prepared showing the totals for the entire fiscal year. These have been divided for comparative purposes into twelve equal monthly amounts. While this method of allocation gives a fair comparison for some revenue and appropriation accounts it can readily be seen that this method will not be of much assistance in preparing a forecast of future cash positions. *Ad valorem* tax collections and election expenses are fair examples of accounts that can not be allocated equally to the twelve monthly budget periods.

Another correction will be made in the budget as soon as warehouse facilities have been completed to such an extent that a working capital fund can be established for stores, garage operations, etc. In the past the assets of the general fund have included inventories of materials and supplies and stores. In the near future a working capital fund will be established for the warehouseman who will handle these accounts more or less on an imprest fund basis. This will eliminate much confusion in the general fund budget and the accounting will be simplified in that encumbrances and payments for materials and supplies will no longer go through the general fund records.

The information available for the preparation of the budget at the present time comes mainly from comparison with annual amounts spent in prior years and experiences of the officials in predicting the needs for the coming year. At some future date the city may use some form of cost accounting to determine the estimates or set up a performance budget. At the present time I think they are doing a fine job and as the city grows I am sure they will keep pace with the developments in budgeting as they have done in adopting the National Committee's recommendations in accounting.

It is the legal duty of the city officials to prepare a budget. I believe it

is a professional responsibility of the independent accountant to give the budget full consideration and report upon the officials' compliance with it. Many small cities have poor budgets. This condition should be corrected first. To have good accounting and reporting a city must have a good budget.

The City of Paris prepared an entirely new budget which followed the modern concepts of municipal accounting. The city's current budget shows estimated revenues of \$495,000. Of this amount the taxpayers will be required to contribute \$330,000. The balance of the money will come from other sources such as miscellaneous franchises, licenses, parking meters, and approximately \$62,000 from the municipally owned utilities. The appropriations have been allocated to the general fund for the operation and capital outlay amounting to \$500,000 and the remaining portion will go to the special fund for bonded debt service. All of the accounts shown in the budget are represented by individual ledger sheets in the accounting department. These carry balances showing the condition of the anticipated revenues and budget appropriations daily.

#### All-Fund Report

Under the present system of fund accounting the budget covers only the operations of the general fund and the receipts and disbursements for debt service. The annual report can now be prepared in almost exact conformity with statements shown in the *Municipal Accounting and Auditing Manual*. The balance sheets for the general and all other funds are shown as separate entities. After all individual balance sheets, with their related statements, have been presented a combined balance sheet of all funds is presented. This combined balance sheet does not eliminate any inter-fund accounts and



sets forth in columnar form all of the assets, liabilities, reserves, fund balances, and surplus shown by the individual balance sheets. This all-fund report might be said to serve as an index or a quick reference to the contents of the various fund balance sheets.

The National Committee on Governmental Accounting recommends that a combined, rather than a consolidated, balance sheet be prepared. Although this might seem elementary to the student of fund accounting, nevertheless far too many small cities and far too many audit reports still show all assets and liabilities under grand totals of assets and liabilities.

The Municipal Finance Officers Association has been very generous in its offer to help any city finance officer or auditor to improve the financial reports. The Association will review any reports to determine whether or not they comply with the recommendations of the National Committee on Governmental Accounting. If the report does not comply they will suggest ways to bring the report up to accepted standards. When these standards have been met the association will issue the city a Certificate of Conformance. I was glad to learn that the City of Dallas has recently received the certificate based upon their report of September 30, 1951. I understand that only twenty other cities in the United States and Canada have received this Certificate of Conformance. The typical audit report prepared by the independent accountant does not contain all of the information necessary to get a Certificate of Conformance, but if correctly prepared will meet the requirements of one section of the report. His approved report will meet the requirements of the financial section, but the finance officer must submit his letter of transmittal and a statistical section. I am

informed that the City of Paris will try to get its certificate next year.

While I have discussed only a few of the statements and procedures covered by this new book on municipal accounting, I know it to be a fine publication. Each and every CPA should have this book in his library, and I personally can recommend it as being applicable to small cities.

If our profession has an outstanding responsibility to municipalities, I believe that responsibility is to show interest in their welfare and give them encouragement in adopting good modern methods of accounting. We must first know their problems and consult with the officials and other associations in an effort to achieve a universal acceptance of good accounting and auditing for municipalities.

For several years I have had the pleasure of working with members of the Governmental Accounting Committee of the Texas Society of Certified Public Accountants. We have studied the publications and manuals on municipal accounting and auditing, read the laws passed in other states, but we have not been able to generate much enthusiasm on the part of our own members of CPAs or the officials in the small cities. The solution may lie in legislative action. Our committee has a current charge to "study legislative requirements in other states—and submit recommendations to the Society Board of Directors based upon this study."

#### Recent Legislation

There have been several articles in *The Journal of Accountancy* dealing with some recent legislation affecting municipal accounting and auditing. The law in Maryland requires that local units submit uniform financial reports. The adoption of a uniform system of accounts should help to solve the problems. The auditor of a municipi-

pality would then have some idea of what to expect when he entered the accounting department of a municipality.

The state of Mississippi adopted a manual of accounts for use of Mississippi municipalities in 1950 (HB-79) which will also be of interest to our committee. It has been stated (by George W. Laffety) that statutory requirements regarding accounting in municipalities compares very favorable with the procedure manual in commercial accounting.

Another law will be given careful attention this year. The new Illinois Municipal Audit Law is another subject of interest. The August *Journal of Accountancy* carried an article on this subject by Lloyd Morey, CPA, Comptroller and Professor of Accountancy, University of Illinois and Vice-Chairman of the National Committee on Governmental Accounting. He states that this law puts into effect the best current practice in municipal auditing. Briefly the law in Illinois requires independent audits, by accountants authorized to practice under the laws of the state, of all municipalities having a population of less than half a million. Very small units (under 2,500) shall be audited biannually, but others shall

have such audits annually. The act also provides that contracts for performance of the required audits may be entered into without competitive bidding.

It appears to me that a combination of the two laws, one requiring uniform system of accounts and reports, and the other requiring periodical audits by qualified independent accountants, might be the answer to the problems of the city officials as well as an incentive to the certified public accountant to consider municipal accounting as a worth-while part of his profession.

In closing let me remind you of the new manual *Municipal Accounting and Auditing*, published by the National Committee on Governmental Accounting. This is an up-to-date manual and one on which you can rely. Certified public accountants should equip themselves to deal with the problems of small municipalities and should encourage them to adopt modern accounting and auditing procedures. We should solicit the cooperation of the Municipal Finance Officers Association and other organizations, and I sincerely believe our efforts will receive just reward in better accounting and more efficient administration in our municipalities.

## A Federal Single Appropriations Bill

by **J. Heywood Bell, Jr.**

Assistant to U.S. Senator Harry F. Byrd

IT IS A CURIOUS thing but when people talk about the federal budget they are usually referring to federal expenditures. They seem to overlook the fact that the budget has a revenue side.

This is true also in the legislative processes with respect to fiscal legislation in Congress. The two sides of the budget are never in juxtaposition during consideration for enactment.

Even more curiously, once the President submits his budget recommendations, Congress breaks up the appropriation side into ten or more separate, unrelated bills and, without ever looking again at the whole during its deliberation, the legislative branch enacts the appropriation budget piecemeal over a period of six months or more.

These are not the only oddities which impede proper and adequate consideration of fiscal legislation. When we talk about appropriations we frequently confuse them with expenditures—that is checks issued or cash paid out by the government. Or it may be vice versa. In these days there may be a vast difference between annual appropriations and annual ex-

penditures. It is annual expenditures (not appropriations) against annual revenue which determines whether we are to conclude a given fiscal year with a deficit or surplus. Yet, legislation providing funds for the federal government deals exclusively with appropriations (not expenditures).

Appropriations enacted during the three fiscal years ending last June 30 totaled more than \$227 billion. Expenditures during these same years totaled approximately \$151 billion. A large part of the appropriation balance, totaling some \$76 billion, obligated or not, remains available for expenditure in the current and subsequent years. This, of course, is in addition to some \$80 billion appropriated during the session this year. But in its action on the new appropriations during the recent session, Congress was without means of effective control or limitation over expenditures against appropriations enacted in prior years.

The situation is demonstrated concretely in the figures presented in the President's Budget Document of January 21 this year (Table 2, page A6). These figures are subject to some revi-

sion to conform with Congressional action, but at that time the President estimated expenditures in the current fiscal year 1953 would be \$85.4 billion. Of these expenditures only \$43.6 billion, or little more than half, was subject to action by Congress on appropriations before it this year. That means nearly \$42 billion was to be spent during this fiscal year from appropriations enacted in prior years over which Congress, in its action on this year's appropriation bills, could effectively exercise neither control nor limitation.

Thus it is seen that appropriations enacted in a year when revenue is high may not actually be expended until some fiscal year when revenue is low; or the situation may be the other way around.

#### **Lack of Effective Annual Control**

These are some of the characteristics of legislative procedures with respect to fiscal legislation which lead to the contention that Congress does not have effective annual control over the federal purse. There is more, but these are a few samples of what makes fiscal legislation confusing not only to the public but also to many of those who work with it and to some of those who have the responsibility of voting on it.

Reserving other factors contributing to the confusion for subsequent reference, it may be said here that these are splotches of the fiscal legislation fog which Senator Harry F. Byrd, (Democrat—Virginia), has been trying to dispel in his advocacy of the so-called Single Appropriation Bill.

Senator Byrd's proposal has three principal purposes — consolidation, control, and clarification in federal fiscal legislation. It would:

1. Consolidate all regular appropriation bills into one bill (this is

as far as the omnibus bill of 1950 went);

2. Control expenditures in a degree through statutory limitations on obligations against current and prior multi-year appropriations;
3. Clarify the federal fiscal situation, as contemplated by the bill, through the requirement that expenditure estimates be set forth in committee reports accompanying the legislation.

Measured by any yardstick, the federal government of the United States is the biggest fiscal operation on earth.

The modern growth of the government, and its expenditures, has been largely in four stages. And at each of these stages the need for better budget information and the need for better accounting and auditing facilities has been demonstrated. And in most instances these needs have been recognized by action which has been at least in the right direction.

Before World War I tremendous federal programs, projects and expenditures as we know them today were not even within the realm of imagination. In the absence of bigness, the difference between federal appropriations and expenditures was small in those days and inconsequential. Legislative control over appropriations currently before Congress was virtually control over expenditures in the ensuing fiscal year.

The complexities of big government began to manifest themselves during World War I, and not long after that the need for better budget information and reorganization of the federal accounting and auditing systems was recognized by the enactment of the Budget and Accounting Act of 1921.

When the depression came the federal government in the early '30's got into really big civilian projects and programs designed for big government spending tied to long-term commit-

ments and extending over more than one appropriation year. When the free spenders of that period ran into difficulties, they made an unsuccessful effort to subjugate the independence of the federal audit. It was in the 1930's, too, that the government corporation device came into its own, distorting the fiscal control picture as it developed. It took ten years to get the legislation enacted, but it was during this period that the groundwork was laid for the (Byrd-Butler) Government Corporation Control Act of 1945. Also during this period studied efforts for more enlightening budget information were begun.

Then came World War II, and with it came appropriations inaugurating long-term programs and projects beyond any previous conception. This was followed by such innovations as those included in the Eberstadt Amendments, which were sponsored by Senator Byrd as Title 4 of the National Security Act Amendments of 1949. These provided a framework for improved budgeting and improved accounting, auditing, and reporting in the Defense Department.

In the postwar period, peacetime civilian spending topped all the peaks. It utilized all of the permanent, indefinite, multi-year, and other appropriating techniques, and exploited all of the long-term commitment devices evolved during and before the war, and it developed some new ones.

#### Improved Budget Information

Some of those advocating the single appropriation bill like to think their agitation for obligation control and expenditure information had something to do with it, but whatever the inspiration, postwar budget information on expenditure estimates has been greatly improved. The Budget and Accounting Procedures Act of 1950 has been passed. And the "Joint Accounting Program" has been inaugurated by the

Treasury, Bureau of the Budget and the General Accounting Office. The objectives of these measures include better accounting support for budget estimates and better accounting control of expenditures after Congress has enacted appropriations.

The purpose of this flash-back through some 35 years is to point up the fact that while the government has grown, accompanied by its bounding expenditures, pace has been partially kept by improvement in budget techniques and information and in accounting and audit methods, procedures, and facilities. But as to the legislative process and procedures with respect to fiscal legislation, they have not been changed substantially in a hundred years.<sup>1</sup>

The need for some modernization and reform in this field of federal legislative procedures was vaguely recognized by the 1946 Legislative Reorganization Act provision for the so-called legislative budget. It was to be a congressional budget of both appropriations and expenditures.

This provision quickly brought into sharp focus the fact that in its traditional fiscal legislative procedures Congress did not have the facilities for controlling or limiting vast sums of expenditures on an annual basis, and therefore it could not produce an intelligent expenditure budget. The provision is still on the statute books, but it is not being complied with. It was doomed from the start for many reasons. But not the least of them was the fact that Congress had neither the information nor the facilities for annual expenditure control.

Already huge postwar appropriations and expenditures have become larger, and already confusing legislative processes with respect to fiscal legislation have become more confusing.

<sup>1</sup> Senate Report 842, 82d Congress, 1st Session, September 28, 1951, page 1.

It is now virtually impossible for members of Congress to inform themselves sufficiently on all of the items and provisions in the numerous appropriation bills to vote intelligently upon them.

An ordinary citizen, whose taxes pay the bills, is hopelessly lost when he tries to get the heads and tails of fiscal legislation.

It was against this kind of background that Senator Byrd first introduced the so-called Single Appropriation Bill on February 14, 1947. He has introduced it in every session of Congress since that time. And there is authoritative assurance that he will reintroduce it again early in the coming session, beginning January, 1953.

#### **Nature of Byrd Proposal**

As in the past, the resolution will be in the nature of an amendment to the Joint Rule of the Senate and the House of Representatives relating to the Legislative Budget. (If the Rules of the two Houses were amended to require the proposed procedure, it could not be abandoned by mere committee action as it was last year. It could be repealed only by resolution approved by both Houses.)

The resolution would require the consolidation of all regular appropriations into a single general appropriation bill.

Under terms of the resolution the consolidated appropriation bill might be divided into any number of separate titles, and if desired each of these titles might correspond to one of the numerous appropriation bills enacted under present procedures.

It would permit consideration of the consolidated bill by titles, at the subcommittee stage, without interruption of the present subcommittee organization of the respective Appropriations Committees, if that is desired.

There would be nothing in the resolution to preclude necessary deficiency

and supplemental appropriation bills in addition to the consolidated bill, but a reduction in the number of such bills probably would result. Private act appropriation bills and appropriation rescission bills also would be allowed.

The resolution would require that Congress write into the consolidated bill limitations on the net amounts to be obligated during the ensuing year against all new multi-year appropriations. Likewise limitations would be fixed in the bill on the net obligations to be made during the year against appropriations enacted in prior years which were still available for obligation.

These limitations would not prohibit government agencies from entering into authorized contracts, but they would control the value of property delivered and the services rendered during the fiscal year.

In the interest of administrative efficiency and to preclude unnecessary bookkeeping, the provisions limiting obligations would not apply to: appropriations made specifically for payment of claims certified by the Comptroller General; appropriations for payment of judgments; amounts appropriated under private acts of Congress; appropriations for payment of interest on the public debt; or revolving funds or appropriations thereto.

Under the resolution, both committee reports and conference reports accompanying each consolidated appropriation bill would show in tabular form the amount of each appropriation, including estimates of amounts becoming available in each fiscal year under permanent appropriations; estimates of amounts to be transferred between appropriations; estimates of the net amount to be expended during the fiscal year from each appropriation and from the balances of prior appropriations; and estimates of the amount remaining in the appropriation for ex-

penditure in a subsequent fiscal year.

Committee and conference reports accompanying deficiency and supplemental bills and appropriation recision bills would be required to include cumulative revisions of this table.

With respect to government corporations and other agencies authorized to receive and expend receipts without covering them into the Treasury, committee reports on the consolidated bill would show an estimate of expenditures out of their checking accounts (except those to retire borrowing) and estimates of their receipts (except from borrowing), to be deposited in checking accounts.

The House and Senate Appropriations Committees would be authorized to hold simultaneous or joint hearings on general appropriation bills in order to expedite their consideration.

And finally, to assure that expenditure authorizations were being considered in the light of the latest possible revenue estimates, the Chairmen of the House and Senate Appropriations Committees would be authorized to request the Secretary of the Treasury, from time to time during consideration of the bill, to transmit current estimates of federal receipts for the ensuing year.

This analysis of the resolution indicates clearly the care with which its provisions have been worked out and drafted. For obvious reasons officials of the General Accounting Office, Treasury Department, and Bureau of the Budget would not endorse or oppose a proposal amending legislative branch rules, but they have testified that the resolution is technically perfected, and that it is administratively practicable in terms of accounting and auditing practices and fiscal and budgetary requirements.

#### **Congressional Action on Bill**

Substantially as described, the reso-

lution has been introduced in the Senate in each of the past three Congresses.

It was first introduced in 1947 by Senator Byrd, with Senator Butler of Nebraska as a co-sponsor. The Senate Rules and Administration Committee of the Republican 80th Congress held exhaustive hearings and gave the resolution its approval without a dissenting vote; but it died on the calendar when the session expired before action was taken by the Senate as a whole.

It was reintroduced by Senator Byrd again in 1949, this time with Senators Bridges of New Hampshire, Butler of Nebraska, Ferguson of Michigan, Gillette of Iowa, Knowland of California, O'Connor of Maryland and the late Senator Wherry of Nebraska as co-sponsors. The Senate Rules and Administration Committee of the Democratic 81st Congress held exhaustive hearings and gave the resolution its approval without a dissenting vote. This time the Senate passed it as a whole without a dissenting vote. But the House of Representatives failed to act before the session expired, and the resolution died again.

Once more the resolution was introduced in 1951 at the opening of the 82nd Congress. This time more than half the membership of the Senate joined in its sponsorship. Once more the Senate Rules and Administration Committee held exhaustive hearings, and this time the committee reported the bill favorably, but with one dissenting vote cast by the chairman, Senator Hayden of Arizona. Senator Hayden's individual report in opposition was largely the publication of objections by the chairman of the Senate Appropriations Committee, and others solicited from subcommittee chairmen of that committee. The report was delayed until the Spring of 1952. It suffices to say that in an election year,

with Congress pushing for an early adjournment and with most appropriation bills still pending until the last moment, there was no action on the resolution in the Senate in the face of opposition by the chairman and subcommittee chairmen of the Senate Appropriations Committee.

Contrary to the general impression that has gotten abroad, this proposal as specified in the terms of the Byrd Resolution has not been tried. The House Appropriations Committee in 1950 originated an omnibus bill which was tried. But it embraced only one of the Byrd resolution features. After the Senate passed the resolution in 1949, Chairman Cannon of the House Appropriations Committee announced that in the following year, 1951 fiscal year appropriations would be considered in an omnibus bill, and the House Committee—before Easter of 1950—had reported such a bill for House action. Before the Senate passed this omnibus bill the Korean war broke out in June, necessitating vast new supplemental appropriations in addition to those included in the original bill.

Most of the opposition expressed by the Senate Appropriations Committee chairman and subcommittee chairmen in the Hayden Minority Report was based on what they said was their experience with this omnibus bill trial. They said it overworked the membership of the committee and it slowed down passage of appropriations.

In these days fiscal legislation is the most vitally important question before the Congress of the United States, and if necessary members of the fiscal committees of Congress could and should be relieved of some of their other duties. As a matter of record kept by the sponsor of the resolution, more members of both Houses of Congress participated in the debate on the omnibus appropriation bill than took part in the debates on the numerous ap-

propriation bills passed in the years immediately before and immediately after the omnibus bill trial, and the actual working time on the floors of the two Houses was shown to be less by the same record. Moreover, in the Senate the omnibus bill was reduced by a half-billion dollars in one of the most carefully worked out appropriation reduction amendments in recent years. There was nothing meat-ax about it. Unfortunately, the Senate amendment was compromised in the House-Senate conference on the bill. But despite this, it may be seen by the record that even this limited version demonstrated some advantages.

Besides the opposition in the Senate, which has just been described, Representative Taber of New York, the ranking Republican member of the House Appropriations Committee, and Speaker Rayburn of Texas have led the opposition in the House of Representatives to the single appropriation bill idea. Their reasons are not clear to the sponsors of the Byrd Resolution.

Neither is it clear whether the opposition in either the Senate or the House is based on an omnibus bill such as the one tried two years ago, or whether it is to a bill such as that contemplated under the Byrd proposal. There is a vast difference between the two.

The omnibus bill as it was drafted by the House Committee in 1950 merely dumped all of the regular appropriations into one bill. There was no provision for either the control or limitation of annual obligations, which are fundamental to the Byrd resolution. There was no provision for expenditure estimates. There was no authorization for requesting latest revenue estimates during consideration of the bill.

The House Appropriations Committee version of the bill was abandoned by the committee, over the protest of its chairman, after a trial of only one year. This trial was inade-



quate for numerous reasons, including the fact that it was limited to a year in which huge supplemental appropriations were required incident to the sudden outbreak of unexpected war. The action by the committee was final since the House had failed to pass the Byrd Resolution which would have amended the rules.

### **Criticisms of Byrd Proposal**

There are legitimate criticisms of the Byrd proposal. But they can be answered, and the sponsors believe they are outweighed and outnumbered by the advantages.

The three major criticisms of the proposal which have been considered by both the sponsors and the Senate Committee on Rules and Administration on three different occasions over a period of nearly six years are:

1. Length of time required by the Appropriations Committees and the respective Houses in consideration of a consolidated bill;
2. Necessity for the President to veto a bill containing all appropriations in the event he disapproved one or more items;
3. Tendency to increase log-rolling.

With respect to the first point:

Both the majority of the committee and the sponsors have taken the position that with proper cooperation between the two Houses and their respective committees, the time requirement should be met. This might very well contemplate joint hearings, prior to passage of the bill in the House of Representatives, for detailed information purposes and justifications.

With respect to the second point:

The majority of the committee and the sponsors have taken the position that the difference in the desirability of the item veto for use in connection with a consolidated bill and for its use in connection with twelve bills is a matter of degree; that in view of con-

troversial viewpoints on the constitutionality of the item veto, the subject should not be introduced in a resolution merely amending the rules of Congress. The item veto is a matter for separate consideration, perhaps as a constitutional amendment. Fewer vetoes should be expected since Congress has tightened up the rules prohibiting substantive legislation in appropriation bills.

With respect to the third point:

The majority of the committee and the sponsors have taken the position that log-rolling would be no greater than at present. Now, members interested in an appropriation item protest reductions in one bill because reductions were not made in the other bills previously passed. Those interested in subsequent bills are reluctant to vote reductions in the early bills. With a consolidated bill, the tendency to log-roll should be reduced because the total appropriation may be calculated at one time and seen in view of estimated revenue.

### **Advantages of Bill**

Offsetting whatever legitimate criticism there may be, there are many advantages. Among them are:

1. It would bring together in one place at one time the expenditures and appropriation program of the federal government so that all items can be considered in their relative importance to the others. This is impossible under the present system wherein appropriation and spending legislation is considered in numerous almost unrelated appropriation bills brought in over a period of six months or so.
2. It would extend legislative control over annual obligations for expenditure.
3. It would give Congress and the country a chance to see the whole

spending program of the federal government at one time, and it would give the Appropriations Committees a chance to see and study the same thing.

4. It would give the Appropriations Committees, the revenue committees and the country a chance to see how the spending program compares with the tax program.
5. It would give a clear indication as to the extent to which the government is committed to long-range spending programs which can be changed only by amendment or repeal of basic law.

The advantages of enactment of a single federal appropriations bill were recognized by the late Harold Smith, former Director of the Budget. They have been recognized by a Democratic chairman of the House Appropriations Committee, Representative Cannon, and a Republican former chairman of the Senate Appropriations Committee, Senator Bridges. They have been recognized by numerous authorities on political science and public fiscal and budgetary practices. In addition to these eminent authorities, the advantages of such a consolidated appropriation bill are recognized in testimonials from governors of a majority of the 48 States which are a part of the official record which has been made on the Byrd Resolution.

In September, 1951, the Joint Committee on Nonessential Federal Expenditures held a series of hearings on "Annual Control of the Federal Budget." At that time, Mr. Elmer Staats, Assistant Director of the Bureau of the Budget, contended that the place to make reductions in federal expenditures is in the basic legislation provisions which establish the requirement. Others make the same contention, and it is not to be denied. But sponsors of the Single Appropriation Bill contend that beyond this there are nonessen-

tials which can be trimmed out of federal appropriations and expenditures which are more easily overlooked when the whole picture is not available.

Even more fundamental is the desirability of legislative control over annual expenditures to the extent that it can be maintained through limitations on annual obligations. The Honorable Lindsay C. Warren, Comptroller General of the United States, testifying in the same hearing succinctly stated this fundamental when he said: ". . . Legislative power of the purse is a basic fiscal policy of our constitutional system of checks and balances. . . ." And he added: "There is no denying the power has been weakened. . . ."

Appearing in the same hearings, to discuss long-term commitments, and other factors pertinent to annual control of the federal budget, the Honorable Roswell P. Magill, President of the Tax Foundation and former Under Secretary of the Treasury, testified that: ". . . Expenditures have gotten out of control of Congress, so that the volume of expenditures which are really subject to annual review by the Appropriations Committee is, and the annual reductions are, relatively small."

It is a matter of record that, in connection with other proposals, Senator Byrd has urged a continuing search of the statutes for places to amend or repeal basic law to eliminate nonessential expenditures, and it may be assumed that other sponsors of the Single Appropriation Resolution would not be averse to such constructive studies. Likewise it can be assumed that in general they would favor adequate committee facilities for thorough consideration of fiscal legislation. The Joint Committee on Internal Revenue Taxation is an excellent example of staff facilities at their best.

These are other subjects which may

be related to the subject assigned for this discussion but they are not necessarily part of it. Emphasis here is on the fact that the single federal appropriation bill, as proposed in the Byrd Resolution, is desirable with or without consideration of such related proposals. In this connection, it may be well to conclude with a statement on the subject by the man who has sponsored the Federal Single Appropriation Bill Resolution since 1947.

In a recent memorandum on the subject, Senator Byrd said:

Our federal programs, through which federal taxes are spent, influence policies determined in world capitals around the globe as well as in county seats at home. They influence the course of bus-

iness and the lives of individuals. No single thing on earth is as economically important to as many people as is the fiscal situation of this government. Yet, we finance these programs under legislative processes in which it is impossible to know whether income and outgo are in balance until after the budget is enacted.

If the American Congress and public had an opportunity to analyze federal fiscal legislation—along with its cause and effect—during the course of its enactment, I believe the results would be wholesome, and that there would be a measurable reduction in nonessential federal expenditures. Such an opportunity could be provided by this simple change in the system under which federal fiscal legislation is considered.

**Tax  
Session**

## **Tax Administration as It Looks to the Taxpayer**

by *Thomas J. Green*

Partner, Peat, Marwick, Mitchell and Co., of  
New York, and Chairman of the Institute's Com-  
mittee on Federal Taxation

**M**ANY TAXPAYERS AND even a larger percentage of practitioners are inclined to think of tax practice more in terms of technical rules and regulations and technical performance than in terms of administration, but actually there are two basic sides to tax practice, the technical tax practice and administrative tax practice; and, as a matter of fact, while technical taxation is one of the most difficult of all subjects to master, administrative taxation has gotten to a point where a man really needs to be a specialist in that field if he is to be successful.

In view of the growing interest and growing size of this special segment of taxation, it has been suggested that I discuss briefly this morning just what makes tax administration function, just what makes it tick, and to see how such functioning operates not only from the viewpoint of certified public accountants as practitioners, but how tax administration looks to the individual and to the corporate taxpayer.

Indeed, the subject of tax administration is one of such importance to our Committee on Federal Taxation that we have for the past three years had a special subcommittee on tax administration, and I might say that it has functioned as one of our busiest subcommittees.

A perfect revenue law (if ever such existed) improperly administered or resisted by a hostile public will soon become a practical failure. On the other hand, a moderately perfect or even an imperfect law, if wisely administered with reasonable cooperation by the public, will produce generally satisfactory results. That is to say, the maximum efficiency in revenue administration can be attained only through the cooperation of Congress, the Joint Committee on Taxation, the Bureau of Internal Revenue, and the public.

Although aware of this situation, the taxpayer has not always enthusiastically joined in this cooperative effort, partly perhaps by reason of the natural

personal resistance to taxation itself.

Over the years there has been a continuous effort on the part of Congress and the Bureau to strengthen the enforcement provisions of the income tax law. Nevertheless, complete popular acceptance through legislation or Bureau policy appear to remain as a somewhat unobtainable goal. With human nature such as it is, this phase of administration will continue to be one of the major difficulties of tax administration.

### The King Bill

Within the last year there has been an important attempt to improve the enforcement and administration of the income tax law. On May 16, Congressman King introduced a bill known as H.R. 7893, cited as the Revenue Enforcement and Administration Act of 1952. I am sure you are all familiar with that bill. As you know, it was not passed by Congress before adjournment, but it is quite likely to be revived as a measure in the forthcoming Congress.

No honest taxpayer can quarrel with the purpose of this proposed legislation; yet there are some questions in the mind of the taxpayer about the possible interpretation and effect of certain sections of the bill. Perhaps of the most concern is the proposed section dealing with the disallowance of unsubstantiated deductions. In effect, this proposal provides that no deduction shall be allowed unless it is substantiated in accordance with regulations prescribed by the Secretary. Certainly there can be no objection to the requirement of keeping records which will adequately substantiate the amount of deductions claimed. At the same time taxpayers should not be required to keep records in such complete detail that each and every expenditure, even of a minor nature, must be supported by a voucher. I

think taxpayers generally would resist that type of administration.

As certified public accountants we are particularly concerned that the proposed requirement for substantiation of deductions will not be construed to nullify the use of generally accepted auditing standards and techniques such as the "test check" approach which has been developed over a period of years.

To establish the reasonableness of financial data, there is no need for a complete and detailed audit and check of every transaction. The principle of accepting certain deductions as appropriate and proper because of the nature of the business involved without requiring detailed proof is long established.

It is, of course, recognized that it is impossible to spell out in complete detail, either in the Code or the regulations, what records should be required in connection with every type of deduction. The Bureau and the taxpayer must be given reasonable discretion in the allowance of deductions. To prevent abuse of this discretion, all that is required is the use of intelligent and recognized auditing procedures under the framework of the existing law. Anything which adds substantially to the burden of paper work already required of the average taxpayer would tend to break down rather than to improve tax administration.

Such rigidity as has been proposed would negate the rule laid down in the Cohan decision under which an approximate amount must be allowed as a deduction where it is reasonable to suppose that *some* expenses were incurred even though the amount claimed is unsupported by records. Most taxpayers felt that this was a workable and fair rule and that the Bureau had ample authority to deal with any abuse in this area.

Another section of the bill had to do

with granting blanket authority to examine taxpayers' books, papers and records. The Commissioner already has the authority to subpoena any records which he may need to examine in connection with a tax case. It does not appear to be in the public interest to give the Bureau such broad authority to require any taxpayer or taxpayer's agent to appear and produce records without limitation.

Unless discretion were exercised, there would be a tendency toward fishing expeditions which might greatly inconvenience and harass taxpayers and taxpayers' agents without accomplishing any good in respect to revenue. There seems to be no evidence that the present authority of the Bureau to obtain and examine records is insufficient. Accordingly, it would appear from the viewpoint of the average taxpayer that this provision of the bill is undesirable and should be eliminated.

### Reorganization Plan

Recent efforts to improve tax administration have not been confined to proposals dealing with taxpayers. The Bureau itself has been the latest center of attention in this area. I do not intend to discuss the reorganization plan which is currently being put into effect throughout the country. Doctor Atkeson is going to cover that subject I am sure in great detail and to your eminent satisfaction. I would like, however, to review briefly the stand taken by the Institute before the Senate Committee handling the reorganization proposal, and speaking for the Institute, we felt that we are interpreting the viewpoint of the average taxpayer.

I give you a quotation from our testimony which briefly summarizes the Institute's position.

However, while we approve the general purpose of the plan, including the removal of the Collectors of

Internal Revenue from political control, it is no automatic cure-all and we should like to call your attention to some possible effects of the plan on taxpayers, both corporate and individual. We recognize, of course, that the plan proposed by the President must either be accepted or rejected as it stands by the Congress. We do not recommend rejection of the plan despite having many reservations with respect to it. At this stage, reorganization plan No. 1 is better than no plan at all.

As you know, there was a great deal of indecision toward the end of the Senate's debate on this reorganization plan, and we felt that our testimony there carried considerable weight as an endorsement of the plan and in bringing that plan to fulfillment.

The two major points stressed by the Institute in its testimony were the status of legal counsel assigned to the Commissioner and the opportunity for appeal in cases of controversy with the Bureau of Internal Revenue. The working out of the reorganization plan leaves much to be desired on these two points.

Under the reorganization plan the method of appointing the Chief Counsel was changed but he continues to be both Chief Counsel of the Bureau and Assistant General Counsel of the Treasury Department. This situation is undesirable. It is believed that a more efficient and workable organization would exist within the Bureau if the Chief Counsel should serve solely in the advisory legal capacity to the Commissioner, with his authority flowing from the Commissioner instead of from the Treasury Department. Considerable delay and annoyance is caused the taxpayer under the present system of multiple and conflicting opinions and rulings, particularly those within the jurisdiction of the interpretative division of the Chief Counsel's office.

One of the functions exercised by

the interpretative division is to review rulings involving contemplated reorganizations, stock dividends, and similar questions of interpretation which have been initially processed in one or another of the branches of what was the old income tax division prior to the reorganization. Usually a ruling on a prospective transaction is written promptly in one of the divisions under the jurisdiction of the Assistant Commissioner (Technical) only to be delayed, frequently without sound cause, while it is reviewed by the interpretative division. Although it might be argued that advance rulings on transactions involving clear-cut issues are unnecessary, the complexity of the tax laws and their administration together with the heavy burden of present tax rates usually makes it imprudent for a taxpayer to proceed to the consummation of a transaction without definite assurance as to the tax consequences.

Further, in addition to unjustifiable delays, the views of the interpretative division are sometimes considerably at odds with those of the office of the Assistant Commissioner (Technical), with the result that an impasse is reached and the taxpayer is denied the certainty emanating from an advance ruling. Such a deadlock frequently prevents the consummation of what otherwise would be a sound business transaction. A merger of the Chief Counsel's interpretative function into the office of the Assistant Commissioner (Technical) would result, probably, in prompt and consistent rulings to taxpayers, and certainly the average taxpayer is entitled to that type of definiteness.

In addition, there is considerable waste motion, inconvenience, and hardship to the taxpayer because of the substantial duplication of functions of the operations and technical offices by the review division of the office of

Chief Counsel. The present practice in the review division in largely duplicating the audit functions performed initially in the field and to a modified degree in Washington results in considerable delay in the allowance of overassessments. The elimination of this duplication could probably be most effectively accomplished by having the review functions performed within the framework of the operations office in Washington.

### Avenues of Appeal

Before complete details of the appeal procedure under the reorganization were made available, it appeared that the decentralization of the operations of the Bureau might be likely to curtail the avenues of appeal. Bureau announcements, however—especially since the organization plan has been put into effect—have disclosed that there will be no curtailment in the number of the avenues of appeals. Under the prior procedure, a taxpayer who was in disagreement with the revenue agent had no absolute right of appeal until after the receipt of the 30-day letter. He did, however, have two separate avenues of appeal after the 30-day letter, that is, to a conferee who occupied a separate position in the office of the revenue agent in charge and then to the technical staff.

Under the new procedure, the taxpayer is entitled to an informal conference with the examining agents' group chief prior to the preparation of the examining officer's final report and without the issuance of the 30-day letter. After the issuance of the 30-day letter the taxpayer's next administrative separate avenue of appeal is to the appellate division. This compares to the former technical staff except that the appellate division reports to the Assistant District Commissioner (Appellate) rather than direct to Washington.

Thus, under the reorganization there has been eliminated the appeal to the revenue agent's office conferee after issuance of the 30-day letter, but there has been added an appeal to the group chief before the issuance of the 30-day letter.

Most taxpayers feel that the establishment of an appeal before the issuance of the 30-day letter has much merit. They are in agreement with the idea of an informal conference. However, it is felt that the appeal should be to a conferee occupying a position independent of the examining agent. Under the procedure as established, the group chief is informed of the proposed adjustments of his examining agent prior to the conference.

Taxpayers, as a class, generally feel concerned that in actual practice there will be a tendency for the group chief to be influenced in his decision by his preconference discussions with the examining agent.

I will not discuss the detailed procedure to be followed by the taxpayer after the case moves to the appellate division. However, it might be appropriate to repeat a suggestion that has previously been made regarding settlement of tax controversies after the 30-day letter stage. As a substitute for the appellate division procedure at the 90-day letter stage, it has been recommended that an independent agency be created. This agency would take the form of an independent tax settlement board with jurisdiction to settle tax controversies informally on the basis of factual representations by the taxpayer and by the Bureau of Internal Revenue.

It is felt that this proposal would restore the confidence of taxpayers in the fairness and honesty of the Government in its collection of revenues. Long experience has shown that the overwhelming majority of the personnel of the Bureau of Internal Revenue

are good, law-abiding citizens and are honest and fair in their dealings with taxpayers. Nevertheless, having the settlement machinery separate and apart from the Bureau would eliminate the feeling of many taxpayers that the same agency is acting as both prosecutor and judge in tax controversies.

### Protecting the Taxpayer

Perhaps one of the most common complaints of many taxpayers is what they deem to be the one-way street attitude of carrying out the administration of the tax law. What the average taxpayer thinks *should be* an exemplary attitude was evidenced by a report, now four years old, on the investigation of the Bureau of Internal Revenue by the advisory group to the joint committee of the Congress. This report stated in part:

Although primary emphasis seems usually to have been placed on the correction of errors that understate tax obligations, equitable administration requires that equal emphasis be placed on inaccuracies that overstate the taxpayer's liability. It is the function of the administrative agency to assist taxpayers in the determination of their correct tax liability. For those who are uninformed, or misinformed, the Bureau should serve both the interest of the taxpayer and the Government.

The Bureau is not the Government's advocate; its responsibility is to provide uniformity in the application of the immediate financial consideration. To no small degree the environment in which the Bureau appears as an advocate has been created by the zeal of representatives of interests who can afford specialized attention to their tax problems. The vast majority of taxpayers, however, are without competent tax counsel and neither know nor can inform themselves of the unavoidable intricacies of the Revenue Code. For this large group the Bureau must scrupulously maintain a policy of equal regard to the interests of the Government and



taxpayer. The same policy should apply in dealings with the clients of the tax bar and the tax accountants, although it is reasonable to assume that audit activity to ascertain over payments of tax by the group will be sterile.

Actually most taxpayers have found that this enunciated philosophy has not been followed in practice. The common cry is that too much emphasis is placed on protecting the revenue and too little on protecting the taxpayer. For example, in situations where some taxpayers take one side and some the other, the Bureau, pending final settlement of the question, will take both sides in order to be assured of collecting eventually its proper tax on the theory which finally prevails.

In such a situation the Bureau is certainly acting as the Government's advocate without proper regard to establishing uniformity in the administration of the tax law. Even if in particular instances the Government sustains a revenue loss, that loss is not nearly as important as the boost to a taxpayer's morale based on a feeling that he can get consistent treatment as against another taxpayer.

A source of considerable confusion and annoyance to the taxpayer as well as waste motion with relatively little compensating increase in revenue to the government lies in the fairly universal practice among revenue agents of proposing shifts of income and/or expense items between years. Such "nuisance adjustments," except as between years in which there has been a sharp change in rates of taxation, will usually result only in an interest adjustment. Sometimes the adjustment favors the government and sometimes in favors the taxpayer. But most taxpayers feel that where a return is prepared in accordance with accepted accounting principles consistently maintained and the item or items in question would, under the regular

methods of accounting, be taxed in the normal course of events as reported, nuisance adjustments of this type should be discouraged. Standardized supervision of revenue agents' reports to insure consistent treatment of like items by revenue agents, similar to the type of review and supervision exercised in public accounting firms, would certainly be helpful toward a solution of this problem.

### Handling Rulings

The Bureau's method of handling rulings has been a constant source of vexation to the taxpayer. It is believed that settlements of tax disputes would be facilitated and the entire tax administration machinery would run more smoothly if the Bureau should adopt a clearly defined policy with respect to publication of Bureau rulings and to announcement of action on decisions of the Tax Court of the United States.

Frequently in the course of negotiation of a settlement with an Internal Revenue agent, the taxpayer or his representative is confronted with official rulings on one or more of the issues in controversy, which rulings have not been made available outside the Bureau organization and the existence of which had been unknown to the taxpayer or his representative. Whether or not the taxpayer agrees with such a ruling, considerable time on both sides could have been saved had he had knowledge of its existence when the return was prepared and, armed with the knowledge of the Bureau's position, might have had an opportunity to distinguish the facts in his particular case and to weigh the possible necessity for court action to sustain a position in opposition to that of the Bureau.

To correct this situation, taxpayers would like to see that consideration be given by the Bureau to:

(1) Publication of all rulings which are regarded to be of sufficient general application to be circulated within the Bureau organization.

(2) Announcement of acquiescence or nonacquiescence on all regular decisions of the Tax Court of the United States on which a timely appeal is not taken.

#### **Multiple Issues**

Another source of frustration to the taxpayer pertains to field settlements involving multiple issues. A majority of cases going into conference in the field following issuance of the 30-day letter and filing of the protest involve two or more independent issues.

In conference it is usually possible for the representatives of the Bureau and of the taxpayer to reach tentative agreement on many, frequently a substantial majority, of the issues. However, almost as a general practice the Bureau representatives adhere to the position that unless the remaining issue can be settled, no agreement on any of the issues can be reached, and that the entire case must be appealed *de novo* by the taxpayer. This necessitates further conferences and possibly petition to the Tax Court solely for the purpose of reestablishing the same atmosphere of settlement which could have prevailed at the earlier conference level. In the final outcome the results are usually no more favorable to the government than if the tentatively agreed issues had been settled at the

earlier conference level. It is recommended that the appellate procedures be specifically revised to permit of partial settlements of cases of this type.

I have touched only on some of the highlights of tax administration. There are many other problems in this field which concern the taxpayer, and which I will simply enumerate:

Delay in promulgation of regulations after enactment of a new ruling or Supreme Court decision.

Legislating by means of regulations.

Relitigation of issues settled by court decisions, even the Supreme Court of the United States.

Bureau's handling of depreciation allowance.

Enforcement of Section 102.

Refusal to amend a regulation or ruling after acquiescing to a Tax Court decision which has decided an issue contrary to the position taken in the regulation or ruling.

That gives us in a nutshell some of the phases of tax administration in which the taxpayer is intensely interested.

In conclusion, I wish to again point out that to be successfully administered, a tax law needs to be sound and needs to be respected as such by taxpayers generally. To gain such respect both Congress and the tax enforcement authorities must aim at all times at simplicity in the laws and regulations and display an attitude that assumes that the great body of taxpayers are decent and honest.

# Reorganization of the Bureau of Internal Revenue

by T. C. Atkeson

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**T**HE GROWTH IN SCOPE, nature, and complexity of the Federal tax system during the first half of the twentieth century was tackled by an administrative mechanism largely designed during and for use in the nineteenth century.

Spill-overs and seam burstings were inevitable. These spill-overs were piecemeal and sporadic, but all tended in the same direction, namely, to push, although on a spotty basis, the ultimate work and decisions involved in tax administration closer to the taxpayer's location.

More and more duties and responsibilities were assigned to the man in the field in respect to both audit and settlement authority.

Individual income tax returns of certain types were subject to audit by Collectors of Internal Revenue and other types by Internal Revenue Agents in Charge. The Collector was under the supervision of the Washington Deputy Commissioner in charge of the Accounts and Collections Division, while the Internal Revenue Agent in Charge was under the supervision of the Washington Deputy Commissioner

of the Income Tax Division. The fraud work incident to the individual income tax returns was under Special Agents in Charge who reported to still another Washington headquarters official. The appellate work incident to the individual income tax returns was under the Appellate Staff Field Divisions administratively accountable to the Washington Appellate Staff Head.

Thus, there were four separate and distinct field jurisdictions concerned with problems of auditing individual income tax returns. Moreover, the geographical areas covered by each jurisdiction varied considerably.

This scattered distribution of assignments was the natural outcome of the extension of duties occasioned by workload increases under the nineteenth century theory of organization.

The primary faults were unnecessary difficulty in designing and managing a nation-wide audit program for individual income tax returns, and frequent taxpayer bewilderment as to who had jurisdiction over his case.

The piecemeal structure also perpetuated another basic fault, namely, that of looking on the taxpayer as

separate and distinct persons whenever he filed more than one class of tax return. Certain types of excise tax returns were audited by Collectors, others by excise tax agents under the Internal Revenue Agents in Charge; all withholding and social security returns were under the audit jurisdiction of the Collectors; corporation income and profits tax returns were under the sole jurisdiction of the Revenue Agents in Charge; and we have already noted how the individual income tax returns were divided. This type of assignment tended to subject the taxpayer to a number of separate examinations by different revenue representatives at varying intervals. The faults of this approach are obvious.

The need for reorganization can also be demonstrated by other serious defects in the old system, among which were political appointment of Collectors, Assistant Commissioners, and the Chief Counsel; scattered ruling and policy-making authority; lack of adequate response to centralized control; and no integrated Inspection Service.

### Steps Toward Reorganization

Despite the need for reorganization to meet the added duties imposed during World War II, neither time nor manpower permitted a large-scale overhauling.

With the wartime strains over, but with the postwar strains still ahead, the new Secretary of the Treasury, John W. Snyder, launched a concerted program to overhaul, streamline, and modernize the whole tax collection system. The program was started in October 1946, when the Secretary called to Washington all the key revenue officials to plan and initiate this transformation of a near-century-old organization.

The October meeting was the first of a continuing series of moves and actions through the ensuing months

and years that began to take form in major changes and innumerable lesser improvements in the Bureau's methods and organization.

Officially this was labelled the "Management Improvement Program." In everyday terms it meant: cutting red tape; speeding up operations; cutting down overhead; streamlining administration; replacing obsolete methods with modern ones; getting more done with the same manpower and money; and making tax payment and tax collection simpler.

It was not just an overnight job. The unremitting job of catching up and keeping up with the heavy workload of tax collections had to go on, as incomes and the volume of tax returns increased. The plant could not be closed down for repairs, or for new models, or for retooling and replanning the assembly lines.

At the executive levels of the Bureau, major changes were shaped on the basis of recommendations of key officials, and as a result of top-level studies.

A Special Committee on Administration was set up by the Commissioner, and later, at the Secretary's direction, a Management Staff was established as part of the Commissioner's office.

A Management Committee also was established by the Secretary in the Treasury Department to serve as a consulting group for improved management throughout the Department, including the Bureau of Internal Revenue. Later the Secretary created a Special Committee to Direct the Management Studies of the Bureau of Internal Revenue, composed of well qualified people from both inside and outside the government and headed by an experienced business man and former Under Secretary of the Treasury, A. L. M. Wiggins.

The Congress also took an active

interest in the improvement of the Bureau's operations. The House Committee on Appropriations made a number of recommendations, and the Advisory Group to the Joint Committee on Internal Revenue Taxation also submitted a series of recommendations. Virtually all of these recommendations were adopted.

One of the outstanding management firms in the country, Cresap, McCormick and Paget, was engaged in September 1948 to make a comprehensive analysis of organization and procedures in the Collectors' offices with recommendations for improvement. When this study was completed, the firm was engaged to do a similar study on the organization of the Bureau itself.

The cumulative result of these management improvement projects was the presentation to the Congress on January 8, 1952, of Reorganization Plan No. 1 of 1952, which became law on March 14, 1952.

### **Provisions of the Plan**

Although the plan itself, as approved by the Congress, is fairly simple in scope, it is extremely important as a legal foundation for the reorganized structure.

It abolished the appointive offices of Assistant Commissioner, Special Deputy Commissioner, Assistant General Counsel for the Bureau of Internal Revenue, Collector, and Deputy Collector.

It established new offices, namely, an Assistant General Counsel, three Assistant Commissioners, not to exceed 25 District Commissioners of Internal Revenue, and not to exceed 70 other offices with such title or titles as the Secretary may determine, all of which are to be appointed under the classified civil service.

It authorized the transfer to the Secretary of the Treasury of all func-

tions vested by statute in officers, agencies, or employees of the Bureau of Internal Revenue since the effective date of Reorganization Plan No. 26 of 1950.

It permitted the Civil Service Commission to classify the new positions for purposes of compensation without regard to the existing numerical limitations on positions.

And, finally, it provided an effective date of not later than December 1, 1952.

At the top is the Commissioner of Internal Revenue who will, under the direction of the Secretary, have general superintendence of the assessment and collection of all taxes. He will be appointed by the President subject to confirmation by the Senate. He will be the only officer in the revenue service so appointed—all others being subject strictly to civil service rules.

The Commissioner will carry out his responsibility of superintending the assessment and collection of the revenue through three immediate Assistant Commissioners.

One Assistant Commissioner, designated Assistant Commissioner (Technical) will superintend the drafting of all ruling and other interpretative material which is needed by the taxpayers to comply with their obligations under the law, and superintend the formation of Commissioner's policy in respect to all so-called technical responsibilities in tax administration, such as proposed legislation, tax treaties, and appellate procedures and practices.

One Assistant Commissioner, designated Assistant Commissioner (Operations), will superintend the actual assessment and collection of taxes, the audit and investigation of returns, and all operational functions incident to such responsibilities.

One Assistant Commissioner, designated Assistant Commissioner (In-

spection), will be charged with the responsibility for attainment and subsequent maintenance of two major over-all objectives which are (1) the coordination and intensification of internal inspection and investigative effort throughout the Internal Revenue Service to assure scrupulous adherence to proper ethics and standards of conduct by all personnel, and (2) the continuing appraisal of applied management improvements, operating techniques, and administrative procedures to facilitate realistic evaluation from the standpoint of economy and efficiency as a means of keeping the Commissioner currently informed concerning these matters.

The Assistant Commissioner (Technical) will carry out his duties with aid of a staff of tax technicians at the Washington headquarters office who are specialists in the various classes of taxes. He will not exercise any line-officer control over any field offices.

The Assistant Commissioner (Operations) will carry out his duties through direct line-officer control of each of the District Commissioners strategically located throughout the United States.

The District Commissioners under the direction of the Assistant Commissioner (Operations) will have complete jurisdiction within their respective areas of the following duties incident to the assessment and collection of taxes: (a) distribution of all tax forms and notices; (b) receipt, audit, and investigation of all classes of tax returns; (c) tax fraud work; (d) canvass for delinquent returns; (e) assessment and collection of taxes; (f) inspection of the production of distilled spirits and tobacco; (g) the hearing of all appeals from proposed assessments.

In effect, the District Commissioner will supervise the presently widely

scattered functions currently performed by the Collector, the revenue agents, the special agents, the alcohol tax inspectors and investigators, and members of Appellate Staff, plus certain functions of the Chief Counsel. It represents a complete coordination of all tax collection functions at the local level.

The District Commissioners will carry out their responsibilities through direct line-officer control over Directors of Internal Revenue, with at least one such officer for each state, and in the more populous states more than one. Actually there will be a Director of Internal Revenue located in each city in which a Collector was formerly located.

The Assistant Commissioner (Inspection) will carry out his responsibilities through line-officer control over Chief Inspectors numbering not more than 25. Each Chief Inspector will have assigned a small staff of top-flight investigators.

### **Method of Installation**

A Selection Board was established by the Commissioner, with the approval of the Secretary, for the purpose of systematically reviewing the qualifications of all persons within the Revenue Service, as well as those not in the Revenue Service but who had appropriate civil service status and who were interested in any of the positions falling under the jurisdiction of the Selection Board.

The Board's jurisdiction extended to the offices of District Commissioner, Assistant District Commissioner, and Director of Internal Revenue. Among the instructions issued to the Board was the following:

As members of the Selection Board, you have the responsibility for making recommendations for key personnel in the Bureau's field organization under the Reorganiza-

tion Plan. The character and level of Federal tax administration for years to come is dependent upon the caliber of the men and women chosen by you. No consideration, other than that of finding those persons best qualified to provide the highest type leadership, should enter into your deliberations.

In those geographical areas in which qualified candidates for the position of Director of Internal Revenue could not be found by the Selection Board, the Civil Service Commission was asked to hold an open competitive examination which, of course, extended to persons without civil service status as well as those with status.

The candidates selected by the Board for nominations were named by the Secretary to the Civil Service Commission as nominees. Upon receipt of the names of the nominees, the Civil Service Commission made an independent character and qualifications check and conducted oral interviews with each nominee. The Civil Service Commission has satisfied itself in each and every case that the nominee was fitted for the job to be appointed or else declined to authorize appointment.

In those cases in which civil service examinations have been held for the post of Director of Internal Revenue, the usual selection and appointment procedures regarding candidates selected have been followed.

Therefore, one of the primary purposes of the reorganization, namely, that of making all appointments strictly in accordance with civil service rules, has been definitely accomplished.

One of the next steps taken in respect to the installation of the reorganization plan was the development of a number of task forces to which were assigned the duties of working out the numerous details incident to

the conversion of the old to new organization. The general nature of the details is indicated by the titles assigned to each task force, namely, Civil Service, Legal, Washington Headquarters Office, Functional Description Charts, Operating Manuals, Housing, Revenue and Disbursement Accounting, District and Subdistrict Boundaries, Budget and Fiscal Allotments, and Statistical and Other Control Reporting.

The terrific amount of work devoted to each of these subjects has permitted orderly installations of each office. Among the more important functions of the Task Force on Legal Matters revolved around the matter of delegation orders which were issued coincident with the establishment of each new office under the plan. Much care has been taken in the drafting of these orders to make certain that every action taken incident to revenue administration by the new offices was such that it could not be contested from the standpoint of lack of authority.

In view of the numerous technicalities and details, the system was adopted of installing one district at a time for the purpose of making certain that headquarters men were available to aid in the launching of each district as established.

Four districts have been established, involving 11 Directors of Internal Revenue. These districts are Chicago, which was reorganized on May 20; New York City on June 30; Baltimore on September 8; and Buffalo on September 22. The Directors' offices are located in the same cities in which the former Collectors of Internal Revenue were located, and the geographical area covered by each Director coincides precisely with that of the collection district under the former Collector of Internal Revenue.

On August 11 the headquarters of-

office was brought under the reorganization plan.

The remaining districts will be brought in as provided by the Plan on or before December 1.

### **Filing Returns**

All returns and tax payments will be made to the Director of Internal Revenue within the collection district in which the taxpayer resides. The boundaries of the collection districts are precisely the same as heretofore. The information concerning the location of the Director of Internal Revenue according to geographical boundaries is shown on page 2 in the instruction sheet accompanying the individual income tax return, Form 1040, for 1952. The change in title from "Collector" to "Director" is more than merely a matter of words because the Director has the authority and responsibility to direct all revenue functions in his district.

In general, all requests for information or advice will be obtained from the Director of Internal Revenue. There will remain, however, some matters on which taxpayers will request advice that will continue to be given only from Washington, because they involve questions of over-all Bureau policy or of a ruling requiring national uniformity in its application. In such cases, taxpayers will direct their requests for rulings, as in the past, to the Commissioner of Internal Revenue in Washington.

### **Examination and Audit**

After the returns are filed and the tax is paid, the next matter of interest to the taxpayer is the examination or audit of his return. This is another point of contact at which taxpayers will begin to notice an improvement in the operations of the Bureau when reorganization is fully effective.

Heretofore, the function of auditing tax returns has been divided between

the Collector's office and the office of the Internal Revenue Agent in Charge, and in some years a taxpayer might have his return audited by one office and in other years by the other office depending upon the income or tax group in which he happened to fall. Under the reorganization all audit functions will be brought together in the Audit Division in the Director's office. This will make possible better planning of audit work.

The Audit Division of the Director's office will examine all types and classes of tax returns, except a few specialized types such as alcohol and tobacco, firearms, narcotics, and wagering taxes. Because there will be brought together in the Audit Division the great bulk of the audit work under the jurisdiction of the Director's office, it is planned that where feasible, a "one shot" audit of income, excise, and other types of returns of a business concern may be accomplished by a team from the revenue office making the complete audit at one time. It is hoped by this means to reduce the inconvenience to taxpayers incident to the verification of returns by substituting one visit by representatives of the Director's office for the old system of several visits.

There will be in the Audit Division an Office Audit Branch which will conduct the correspondence audits, those entirely carried on by letter, and the office audits, those made by having the taxpayer appear at the local Revenue Service office with his pertinent records. The Field Audit Branch will continue to make those examinations where it is necessary for an examining officer to go to the taxpayer's home or place of business to audit or check the books and records. In each instance the examining officers will be organized in groups which will be under the immediate supervision of a group chief who will be the administrator and technical advisor for the examiners assigned to him.



### Informal Conferences

A perfect tax system would be one in which all returns filed are correct under the law and the examining officers would have nothing to do but verify this happy state of affairs. The next thing to such a perfect tax system would be one in which the examining officers occasionally found questionable items on returns but were able to reach prompt agreement with the taxpayers as to proper tax result.

Of course we all know that the actual state of affairs is that while prompt agreement with taxpayers is the general rule, there are many complicated factual and legal issues which require conferences and extended consideration. The reorganization has among its purposes the preservation of the taxpayer's privilege to confer with appropriate authority where the taxpayer is unable to agree with the revenue agent's findings as to a possible deficiency or overassessment. Under the reorganization, emphasis is being placed upon informal conferences at the group chief's level. This will provide an early opportunity to reach an agreement with the minimum of formality in procedure.

Under the new procedure the examining officer is required to inform the taxpayer of his right to an informal conference if the taxpayer is not in agreement with the changes proposed by the examining officer, or if the taxpayer does not wish to execute an agreement form. The examining officer will furnish the taxpayer a brief statement identifying the proposed adjustments and containing instructions for the arrangement of an informal conference. The examining officer will then promptly furnish his group chief a copy of this statement so that the group chief may be prepared to arrange a conference when the taxpayer's request is received.

Ordinarily the group chief will con-

duct the conference but, at the Director's discretion, a specialist may be brought in or another qualified employee of the Audit Division may conduct the conference. The examining officer will be present at the informal conference and the taxpayer may appear with or without representation as he chooses and may bring witnesses for the purpose of assisting in establishing the facts.

The objective of the informal conference is to provide an opportunity to resolve issues at the earliest possible time and to resolve them in an atmosphere of informality in order that the case may be disposed of as simply as possible under the law. It is for this reason that these conferences are held prior to the preparation of the examining officer's final report, without the issuance of any 30-day letter by the Director, and without requiring the filing of any written protest or brief by the taxpayer.

If agreement with the taxpayer is reached at the informal conference, the appropriate agreement form is executed and the examining officer prepares a report giving effect to the conference conclusions. The entire file is then submitted to the Review Group in the Audit Division through the Group Chief. Upon approval by the Review Group the case will then be made ready for closing and a copy of the examination report mailed to the taxpayer. If agreement is not reached with the taxpayer at the informal conference, then the usual procedure is followed for completion of the examining officer's report and issuance of a 30-day letter to the taxpayer, together with a copy of the examining officer's report.

The 30-day letter will afford the taxpayer a period of 30 days in which he can choose one of three courses of action. First, the taxpayer may file a formal protest, under oath, with the

Director and request that the case be transferred to the Appellate Division of the district. Second, the taxpayer by request—or by simply failing to respond within the 30-day period—can secure issuance of the statutory notice from which an appeal may be taken to the Tax Court. Third, the taxpayer can execute the agreement form enclosed with the 30-day letter and thereby close the case by accepting the proposed determination.

You will note that if the taxpayer files a protest and request for a hearing, such protest and request will be filed with the Director of Internal Revenue. Where a hearing is necessary, however, the case will be transferred to the Appellate Division of the District Commissioner's office as the next highest and final administrative authority to hear the taxpayer's protest against the Director's determination.

Before discussing the procedure in the Appellate Division, I wish to explain briefly why no reference has been made to consideration of the case by the Conference Section which heretofore existed in the revenue agent's office. As previously stated, the privilege of a conference where agreement is not reached with the examining officer is maintained but such conference is now placed at the group chief level.

Personnel of the present Conference Sections of the revenue agents' offices are being detailed to the Appellate Division. It is believed that the informal conference, augmented by more group chiefs, will provide greater opportunity for settlement of cases in the first instance. At the same time a more efficient use of revenue personnel can be provided by concentrating all appellate functions in the one organization. Adding to the Appellate Division the force of revenue agent conferees will be of considerable as-

sistance in reducing the backlog of appellate cases.

Cases in the Conference Section of the revenue agent's office are being transferred to the Appellate Division automatically upon the establishment of new offices in the district. However, there will be a few cases which will remain under the Director's jurisdiction primarily because the conferences have already been held and only the final paper work remains.

### Appellate Division

The course of our taxpayer's contacts with the Internal Revenue Service have now reached the stage of the Appellate Division. The Appellate Division of the district functions at the District Commissioner's level only. This does not mean that its services are not available in the local area served by the Director, but rather that the Appellate Division is not a part of the Director's office since its basic function is to hear appeals from decisions made by the Director's office. The Appellate Division is headed by the Assistant District Commissioner, Appellate, who has the full authority of the Commissioner to make final agreements on behalf of the Bureau with taxpayers in the settlement of cases. The only limitations on the settlement authority of the Assistant District Commissioner, Appellate, are the following:

- (1) He must secure the concurrence of the Appellate Counsel before he can settle any case docketed in the Tax Court;

- (2) He must secure the concurrence of Appellate Counsel before he can eliminate the *ad valorem* fraud or negligence penalty in any nondocketed case;

- (3) In any case in which criminal prosecution has been recommended, he must wait until final disposition has

been made of the criminal aspects of the case;

(4) In order to modify any decision of the Excess Profits Tax Council, he must secure the concurrence of the Council; and

(5) His decisions in cases involving overassessments or overpayments in excess of \$200,000 are subject to review by the Chief Counsel and by the Joint Committee on Internal Revenue Taxation.

Under the reorganization the headquarters of the Appellate Division for each district will be in the city in which the District Commissioner is located. The trial of tax cases in the Tax Court on behalf of the government will be the responsibility of the attorneys in the Chief Counsel's office assigned to the Appellate Counsel who will operate under the general supervision of the District Counsel, whose headquarters will also coincide with the office of each District Commissioner.

Under the reorganization the Appellate Division of each district will continue to maintain offices in all important cities. Each of the branch offices will be under the immediate supervision of an Associate Head or Assistant Head of the Appellate Division.

Formerly, only the Head of the Appellate Division had final settlement authority. Under the reorganization the Assistant District Commissioner, Appellate, has this full authority. In addition, he is authorized to delegate all of his settlement powers to his immediate assistant known as the Associate Head of the Appellate Division of the district; and he has similar power to delegate final settlement authority to any Assistant Head or Special Assistant to the Head of the Appellate Division in any case where the net deficiency or net overassess-

ment determined by the Director does not exceed \$10,000 and the basis of settlement does not involve a net over-assessment in excess of \$10,000. The delegations of authority to reach final agreement will result in more prompt disposition of cases.

The procedure in cases before the Appellate Division, whether in a docketed or nondocketed status, is not basically changed under the reorganization, although continuing study is being given to methods which will provide for more expeditious service to taxpayers. Two steps which are now being taken and which may assist immediately in accomplishing this objective are the detail of additional personnel to the Appellate Division from the former Conference Section and the issuance of statutory notices directly from the Appellate Division in un-agreed cases (instead of returning the case to the office of the examining officer as was the prior procedure).

### Washington Review

In the discussion of our taxpayer's contacts with the Internal Revenue Service up to this point we have omitted any reference to Washington review of agreements which may be reached in the Director's office or in the Appellate Division of the District Commissioner's office. Only a word needs to be said on this subject because it is our desire and expectation that agreements reached in the field will, to an ever increasing extent, stand as final action, and the upsetting of an agreement in Washington will occur only under unusual circumstances.

It should be made clear at the outset that agreements reached in the Appellate Division are generally final. They will not be reopened in the absence of fraud, malfeasance, concealment, or misrepresentation of material

fact or an important mistake in mathematical calculation. There is a post review in Washington but this is a management device used to check the application of established policies to settled cases and to provide a basis for advisory service in the disposition of future cases.

Agreements reached at informal conferences in the Director's office will also generally reflect a final disposition of a case. Such agreements are subject to review by the Review Section in the Audit Division in the Director's office and also to a post review in Washington. However, it is not the policy of the Bureau to upset such agreements unless there is a clearly defined misapplication of law, misrepresentation of material facts, or an important mistake in mathematical calculation resulting in a substantial change in tax liability.

In this connection it is important to note a statement made by Secretary Snyder on the occasion of the installation of the Washington headquarters office on August 11, 1952. At that time he said, "Another important feature of great interest to the taxpayer, growing out of the reorganization plan, is that the headquarters offices of the Revenue Service in Washington will be freed of all tasks directly related to actual tax settlements, except for a minimum of supervisory functions required by statute. The headquarters function henceforth is that of policy making, executive direction and planning."

### Flexibility

The rules stated in respect to examinations, informal conferences, and appeals are those which appear to be most practical for both the taxpayer and the Government. In accordance, however, with the testimony given by the Commissioner in the Congressional

hearings on the reorganization plan, some experimenting will undoubtedly be necessary in certain areas to reach the best results. Consequently, it is to be anticipated that any rule or procedure demonstrated to be inferior to others which might be developed will be changed. It is, therefore, to the interest of all members of your organization and others practicing before the Treasury Department to aid in the program of continual improvement of the rules and practices in order that full advantage may be taken of the potential benefits opened up under the reorganization plan. These improvements will come to light only through experience with specific types of cases as affected by the specific rules which have been laid down.

Each District Commissioner will have administrative jurisdiction over all the Directors within his territory. For example, the District Commissioner at Chicago exercises supervision over two Directors; in New York City, three Directors; in Baltimore, three Directors; and in Buffalo, three Directors.

The District Commissioner is the line officer who ties together the work of the Directors under his control. The District Commissioner is responsible directly to the Assistant Commissioner in charge of Operations at the Washington office and is the officer who sees that the policies and programs developed at the Washington level are carried out.

The District Commissioner has six assistants, one each for Administration, Collections, Audit, Intelligence, Alcohol and Tobacco Tax, and Appellate.

None of the actual operations are carried on by these assistants except certain phases of alcohol and tobacco tax work and the appellate work. The jobs performed by them are largely planning and follow-through functions.

One of the management engineers

who aided in the development of the reorganization plan has described their relationship to the Directors in the following manner:

(a) *Program Planning*—That is, *what* is to be done and *when*. The District Commissioner must, within the framework of nation-wide objectives established by the Bureau, prescribe the scope, broad content, and direction of each aspect of the revenue operations within his geographic area. In the case of the collection function the definition of the program will tend to be rather constant from year to year, except as Congress adds to or subtracts from the taxing statutes. On the other hand, the audit enforcement programs will probably always require redefinition from year to year to secure the most timely attack upon sources of unpaid or uncollected revenue. In every function the establishment of the program plan is the initial and most fundamental responsibility of the District Commissioner and his Assistants.

(b) *Quality Control*—That is, *how effectively* is the program accomplished. Second in order of importance is the District Commissioner's responsibility for assuring adequate results—qualitatively. In the collection function this connotes accuracy in the recording of payments, in the preparation of delinquency notices, warrants, etc. In the enforcement function this connotes the skill and thoroughness in audit and investigation, the maintenance of proper technical standards, etc. In the appellate function this connotes the judgment and ingenuity applied in achieving fair settlements. The techniques of quality control are development of standards, and the evaluation of compliance with standards through inspection, post review, and similar devices.

(c) *Production Control*—That is, *how rapidly* and *how economically* is the work accomplished. In every function production control is concerned with quantitative output rate of work as well as the volume produced per payroll dollar. This is the segment of responsibility which is concerned with work measurement. Production control is perhaps most important in the collection function where a large vol-

ume of repetitive work is performed. It is probably of smallest importance (comparatively) in the appellate function where the judgment element predominates.

(d) *Organization and Procedures Planning*—That is, *how* the program is to be accomplished so as to meet established standards of quality and production. The "how" is the principal responsibility of all levels of line management (division heads and directors). The District Commissioner's staff, and the headquarter's organization, have a leadership role, however, in pioneering new techniques by research and experimentation. The answer to the question "how" specifies the form of organization, the staffing pattern and the basic system in terms of forms, records, equipment, and work flow. The planning of organization and procedures is dependent upon the (1) program plan, (2) quality standards, and (3) production standards established by higher management for a given period.

In these ways, the District Commissioner's office will provide us with the very essential tool of true management control.

### A Summary of the Plan's Noteworthy Features

(a) *Adapability to future changes in the tax laws*—The tax system can be expanded or contracted without affecting the framework of the new organization. Every class of tax will involve one or more of the several functions characterized by the organizational set-up, namely, collections, audit, intelligence, regulatory, and appellate. New classes of tax will be merely superimposed upon the existing classes within each of the functional breaks; or if various classes of tax are repealed they will be taken away from each of the functional breaks—but in neither case will it be necessary to increase or decrease the basic organizational groups.

(b) *Coordination of ruling work*—The integration of all tax ruling work under the Assistant Commissioner (Technical) permits a more uniform policy in respect to decisions affecting all classes of tax; makes possible a wider dissemination of rulings through the Internal Revenue Bulletin Service; and provides an

atmosphere of more objective consideration due to a separation of the operating functions from the official who considers the ruling.

(c) *Settlement powers*—The vesting of final settlement authority in the Assistant District Commissioner (Appellate) with redelegation powers to the Associate and Assistant Head of the Appellate Division accomplishes both independence from the examining function and wider decentralization of settlement authority at one and the same time.

(d) *Improved audit programming*—The centralization of all audit work under the Director will permit a clearer appraisal and direction of the total audit workload. The former organization scattered the various pieces of the total workload among several separate organizational groups.

(e) *Future expansion*—The plan provides for up to 25 District Commissioners and up to 70 other officers, now entitled Directors. The full number of offices allowed are not being established at this time. As population and business activity increases in the years ahead, additional offices may be established to render the necessary services without any further change in law.

(f) *Inspection Service*—Provision in the plan for an Assistant Commissioner (Inspection) enables the Commissioner to establish a truly independent inspection service which can at all times without fear or favor of any of the operating officials make a thorough examination of any and all offices in the Revenue Service. Full advantage is being taken of this and an Inspection Staff has been assigned for frequent examination work.

(g) *Line officer direction*—The chain of command which runs from the Assistant Commissioner (Operations) to each District Commissioner and from each District Commissioner to the Directors places all operational work in tax administration which includes about 55,000 of the total of 57,000 revenue employees in a direct line of control centering in the Assistant Commissioner for Operations.

### A Summary of the Plan's Advantages

The advantages which stem from the plan's features outlined above are as follows:

1. Requires all officials and employees (other than the Commissioner) to be selected according to civil service rules and regulations.

2. Permits taxpayers to transact all matters relating to Federal taxes in one office.

3. Reduces the number of separate field officers reporting directly to the Washington headquarters.

4. Consolidates the audit and investigation of all classes of tax returns under one head in each area, thereby resulting in more equal and uniform enforcement of each of the separate classes of taxes.

5. Provides a uniform appellate procedure for all classes of tax at points more conveniently situated for the taxpayer.

6. Provides central legal staff service in all offices.

7. Provides a more adequate supervisory structure to cope with a highly decentralized tax service.

8. Provides a more uniform personnel and administrative service policy in each of the separate offices.

9. Enables the top line and staff officers in Washington to concentrate more on executive direction, over-all program planning and research.

10. With the smaller number of field offices reporting direct to Washington, it becomes feasible to have more frequent general conference sessions with the Commissioner as well as between field offices, thereby insuring closer coordination with Washington and uniformity of tax administration as among geographical areas.

11. Better utilization of personnel is possible since transfers, reassignments, etc., can be made by the District Commissioners as among all classes of tax work within their area.

12. Numerous separate files now maintained by the Collector, revenue agents, special agents, appellate staff, etc., can be combined with savings in maintenance costs.

13. Some savings in rental and library costs can be realized by combining offices.

14. Better physical office layouts can be achieved by having the offices now under separate Deputy Commissioners combined at the local level under one head.

15. Taxpayer inconvenience, especially in respect to businesses, should be reduced as a result of one revenue ex-

aminer making the examination of all classes of taxes rather than having calls from separate examiners for various classes of taxes.

16. Travel time of examiners should be reduced by the combined examination policy.

17. Provides a more effective inspection device by having field inspectors independent of the operating offices subject to inspection.

18. Provides an organization more adaptable to the administration of a constantly changing tax system.

**Bibliography**

Since the presentation of the plan to the Congress, there have been a number of official documents and statements relating to it. For the convenience of those who wish to explore the subject in more detail, I have prepared a reference list of all the major items as of September 30, 1952. This list follows:

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Letter from District Commissioner Wright to employees of Chicago, Illinois district (Monthly Activity Report, May 1952, Exhibit A) . . . 5-20-52

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Bureau News Release (Appointment of Directors of Internal Revenue for the three collection districts in New York City) IR-003 . . . 6-27-52

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Remarks by Assistant Head of Management Staff, Assistant Commissioner Winkle and Head of Appellate Staff at Seminar on Plan at New York City. (Monthly Activity Report, June 1952, Exhibits C, D and E) . . . 6-30-52

Bureau News Release (installation of officers for New York City area) IR-004 . . . 6-30-52

Bureau News Release (Reorganization of Washington, D. C. Headquarters Office) IR-006 . . . 8-4-52

Bureau News Release (Reorganization of Washington, D. C. Headquarters office) IR-007 . . . 8-10-52

Program of installation of officers at Washington Headquarters (Monthly Activity Report, July 1952, p. 21) . . . 8-11-52

Address of Secretary Snyder at installation of officers at Washington Headquarters (Monthly Activity Report, July 1952, Exhibit B; Treasury Press Release S-3126) . . . 8-11-52

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#### Treasury Decisions and Orders and Reorganization Orders

T. D. 5900 Conforming references in 26 CFR to collectors, deputy collectors, district supervisors in reorganized offices to new nomenclature, approved May 13, 1952, 17 F.R. 4464, for May 15, 1952.

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Treasury Department Order No. 150-2, delegation to Commissioner of general authority over functions in Bureau of Internal Revenue, May 15, 1952, 17 FR 4590, for May 20, 1952.

Treasury Department Order No. 150-3, abolition of certain Illinois offices and establishment of new, May 15, 1952, 17 FR 4590, for May 20, 1952.

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Commissioner's Reorganization Order No. 6, May 15, 1952, Delegation of authority to District Commissioner, Director, and Internal Revenue Agent to examine books and witnesses, 17 FR 4587, for May 20, 1952.

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#### Chicago

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Commissioner's Reorganization Order No. Hdq-1 delegation of functions, with Exhibits A, B, C, D, July 29, 1952, 17 FR 7154, for August 6, 1952.

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#### Baltimore

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## Economic Aspects of Taxation

by *Price Daniel*

Attorney General of the State of Texas; Senator-Elect to the Eighty-Third Congress

**T**HE ACCOUNTING AND LEGAL professions work closely together, and there is every reason for cooperation. Each of our professions is vital to business, to government, and to the public interest. I am glad that you have come to Texas and honored us on this occasion and hope that you have enjoyed yourselves and will continue to enjoy your stay with us.

My subject is listed as "Economic Aspects of Taxation." That is a mighty broad subject. How would you like to have my assignment on this the last hour of a three-day program?

I am sure that any one of you could handle the subject better than I, and I am quite certain that it has been covered to some extent by your preceding speakers.

My only qualification as an expert on this subject is that I am a speaker away from home. Our distinguished Railroad Commissioner, Ernest O. Thompson, long ago defined an expert witness as just an ordinary witness away from home.

Today I am just an ordinary witness on the economic aspects of taxation.

I speak to you as one who has been

a tax law enforcer and a tax law maker on the state level, and also as one who will soon become a tax law maker in the United States Senate.

As Jay Phillips has told you, I have been nominated by both the Democratic and Republican Parties. If the Lord wills and if President Truman does not endorse me, I think I will win the election. Next year I will be worrying about the economic aspects of taxation in Washington.

### A Threat to Stability

With all that has been said on your splendid program up to now, I am tempted to cover my subject by simply saying that taxes are too darn high. They are being used for too many purposes other than the raising of necessary governmental revenues. They are destroying business and profit incentives in general and constitute a real threat not only to the economy of our people but also to the stability of our nation.

That would be a fair summary of what I will say in my prepared text.

A few decades ago, taxation was a relatively minor factor in business.

Perhaps the taxpayers didn't think so, but, viewed in retrospect, it was a much simpler matter then. From the national standpoint, the Administration would work up a budget—for a while it could be expressed in millions rather than billions. Generally, the budget was not too far out of line with the actual needs of the national government. The Congress would receive the budget, make a few speeches about it, and refer it to the proper committees. The committees, in turn, would take it apart and look at it, grumble a little and whittle a little, and send it on through for a vote on the floor. The public would grumble a little, write a few letters to Congressmen about public extravagance, pay its taxes and forget the whole thing.

Today it is quite different. This year the people of the United States will pay in taxes, so we are told, nearly one-third of the total national income. In the past seven years of the present national Administration, we are told that our federal government has collected more federal taxes than in the combined 156 previous years of previous Administrations of this country put together. Every person in every business feels the burden and cries out for a halt.

My emphasis is not necessarily on how high taxes have become, nor is it on the tremendous complication of our present tax structure; my chief interest and concern, thinking and speaking as a public official interested in taxation as a matter of public policy, is with the new ways in which taxation is being used today and the effect of those new uses.

A whole new science has been developed in the last 20 years, a science of discovering new ways in which the national wealth and income can be taxed, and discovering new uses of taxation other than the historic, simple, basic use of taxation as a means

of raising the necessary cost for necessary government.

#### Taxation's "New Look"

In other words, taxation today has a "new look," and I think we should take a close look at that "new look." In recent years taxation has been made to produce some strange and frightening results other than merely meeting the government payroll. We have seen the principle of taxation dedicated in some instances to the perpetuation of an Administration in power. There was no concealment of the philosophy of tax and tax, spend and spend, and elect and elect. Of all the cynical public expressions, this was the first declaration of a positive and declared intention to use the power to tax for the purpose of influencing the public in the continuation of a political administration.

We have seen the principle of exception used as an implement of power. Punitive taxation can be enacted, with permissive exception as a part of its enabling legislation. This negative principle can be used for political favors and further influence.

We have seen the principle of income taxation used as a deliberate means of attempting to control standards of living. The idea of defeating inflation by "siphoning off surplus spending power" has been publicly declared time and time again, and it is unsound, in my opinion. There is only one way to curb inflation and well we know it; that is to cut out extravagance and increase productivity so that there are enough goods available to satisfy the purchasing power represented by dollars in circulation. The idea of prostituting the sacred trust of the power to tax by deliberately curbing individual purchasing power to conceal inflation induced by wasteful practices must be abhorrent to this group above all others. The very keystone of the

profession of accountancy is the elimination of waste and the prudent administration of funds.

We should not overlook the psychological aspect of taxation, in our preoccupation with the economic aspects. We are told that in some European countries businessmen make no bones about keeping two or three sets of books—one for themselves, one for their partners, and one for the tax collector. This is the inevitable consequence of irresponsible taxation, where taxes have been piled upon taxes until it has become an obvious impossibility to pay all the taxes and still stay in business. Businessmen, and individual taxpayers, have been forced to become tax dodgers, and I say that this country is not too far from that dismal condition.

When the people of a nation become convinced that their tax makers are irresponsible, that their tax collectors are unreliable or dishonest, and that their tax spenders are capricious and corrupt, then they can't help becoming a nation of tax dodgers, and the groundwork will have been laid for far-reaching moral decay.

### Need for Incentive

Possibly the most significant direct economic aspects of taxation are concerned with the future—with the principle of incentive which has been and always will be the foundation of continued growth and greatness of this country.

We all know that we aren't going to work very hard unless we are able to keep what we make, or a substantial portion thereof. I am talking about an individual attitude, and it applies also to corporations, because, after all, corporations are manned by individuals. The lack of personal incentive which follows excessive taxation is one which cannot fail to pervade the cor-

porate field as well as the individual attitude toward personal income.

I sincerely believe that the invasion of taxation into the territory of opportunity and incentive is almost as serious a threat to our economy, our security, and our future, as an invasion of American territory by a belligerent power, and when we are thinking about that belligerent power, and our worst enemy being communism, and a Communist, we only have to look at their books, to the books of Stalin and Lenin, to see that their hope for the destruction of this country is that we will tax and spend ourselves to death.

Stalin put it in these words: "We will never have to conquer the United States by force of arms. We will make that country spend itself into destruction."

Our present trend of taxation is directly conducive of monopoly. It is shrinking the horizons of research, discovery, and expansion. It is destroying the incentive to start new ventures to make new goods and services. It is drying up the future source of tax revenue, by keeping small businesses small, and by preventing the successful launching of new businesses.

It seems to me that the present basic approach to taxation needs realignment. The current approach is to accept the stated budgetary requirements of the Administration and then to try to devise a tax bill which will extract that amount of money from the taxpayers without sufficient consideration of the economic feasibility of either the amount or the method. That is no more logical than for a wife to say to a husband, "John, I want \$60 this week. I know you only earn \$100 a week, and I know that you'll have \$20 held out in taxes, \$5 on the bank loan, \$10 due the grocery and \$15 on the furniture, leaving you only \$50, but you still bring home that \$60 or else."

That leaves John three choices: he

can skip some of his payments, thus losing his furniture or his line of credit at the grocery. Or he can borrow from the loan sharks, thus hastening his ultimate disaster. Or he can desert his wife, quit his job, and go fishing. Small business, and new business, have just about those same choices today.

Even the more enlightened prison camps in the Iron Curtain countries have discovered that they must give their prisoners a certain minimum number of calories in food daily; otherwise they won't be able to perform their daily stint of work. Yet our tax system is cutting lower and lower the capital diet on which business must feed to survive, without any regard to the irreducible minimum below which business cannot be productive.

All economic history tells the same story; there are only two sources of expansion, risk capital, or reinvested earnings. Obviously, there is a maximum of tax which any business can pay and continue to grow; the same is true of any economy. And growth is essential. Our population is growing steadily. Demands on our productivity are growing steadily.

Continued expansion of our economy requires not only expansion of businesses already in existence; it requires the constant entry of new businesses, not only in established fields of enterprise, but to pioneer new fields, develop and exploit new ideas and new products. We cannot keep a healthy economy without the constant introduction of new blood, any more than we can maintain an adequate standing army without the constant induction of new recruits. But if we inaugurate and sustain a tax policy which gives a new enterprise a chance of only about one in ten of surviving, how many recruits are we going to attract for our standing economic army? Where is the risk capital coming from, or the reinvested earnings? We

can't draft them. If we ever come to that point, we have complete socialism. There has still got to be incentive, which means a fair return on risk capital and a tax structure which will permit the retention of enough of earnings to reinvest to permit expansion to meet the requirements of competition.

### Case of Small Business

I am, of course, dealing in generalities, generalities of principle, but after all, we need to adopt a set of taxation principles before we get down to enacting specific taxes.

To get a little more specific in the area of new and expanding business, I can present to you a composite picture of the average small company's tax problems today. This summary was accumulated in a national survey by an organization called the Young American Business Conference, which concerns itself entirely with small business tax problems. This information was presented in a statement to the Senate Small Business Committee, and if it has been referred to previously on your program, I hope you will forgive the repetition.

Based on a study of 100 companies, all less than six years old, none employing more than 500 persons, none with assets of more than \$5,000,000, the average leveled out at approximately 100 employees per company, with average assets of around \$500,000. The survey covers principally the manufacturing industries, which is where we must look for broadening industrial horizons and increased employment and productivity.

The typical company in this category earned, in 1951, about \$90,000, before taxes, on assets of about \$500,000. That is a return of 18 per cent on invested capital and it sounds pretty good. But, wait. This same average company has no excess profits tax credit to speak of. The industry

average rate of return method, applied to invested capital, won't help him, because the industry average is based on a cross-section of all companies in his category, and this includes all the old, established companies with huge capital and assets, who accumulated them in periods of relatively low corporate taxation, and who can get along nicely on a relatively low percentage of return on their assets. Our small new company has assets too small to use in a formula involving the average earnings rate based on competitors many times his size and age.

Further, the base period earnings method will do him no good, in trying to compute a decent excess profits tax credit, for the chances are he either wasn't in business during the base period, or, if he was, he was operating at a loss. So the average new company depends on the statutory minimum excess profits tax credit of \$25,000. This means he faces a potential 82 per cent tax on more than two-thirds of his profit, which may be his first profitable year after two or three or four years of losses.

True, the amendments to the 1951 Revenue Act included a maximum limitation, after the company's first five years of existence, of 17 per cent of the total revenue as excess profits tax. So our average company, with an excess profits tax credit average of any small new enterprise just getting started, will pay a normal tax of \$27,000, a surtax of \$14,300, and an excess profits tax of \$15,300, or a total of \$56,600. This is an over-all effective rate of 63 per cent.

That isn't all. According to the survey, the average company by now owes about \$40,000 in bank loans or quick debentures. These obligations are never long-term or elastic; immediate substantial reduction is mandatory. So, out of the \$33,400, our average company has left, it will have

to pay from \$15,000 to \$25,000 right away to keep the sheriff out of the plant.

By this time, this company has been in business five or six years, and a lot of his equipment is either obsolete or worn out. Just to keep his present capacity going—mark that, not to expand and increase capacity, just to stand still—he needs to add or replace equipment to extents varying from \$15,000 to \$50,000. The survey figures an average of \$75,000 needed annually for expansion in order to keep up with the competition.

So, while needing \$25,000 for repair and replacement and \$75,000 for sound expansion, the John Doe Company has \$13,400 to do it with, after he has paid his taxes, paid the banker enough to keep him quiet for a while, not to mention anything like dividends to the stockholders.

#### Concern to CPA

I believe that this sore spot in the small and new business picture of our economy is one which should be of greatest concern to all of us. I think it particularly concerns you gentlemen. The greatest future of the independently practicing public accountant lies in the area of small independent business. When a company gets too large, they set up their own accounting and auditing department, and you hear from them only once a year for an outside annual audit. But the companies who fall into the category I have just described—they can't get along without you—and in the long haul, you won't prosper as you should without them, nor will the nation as a whole prosper without them.

Our country has prospered above all others in the past because we have had the liberty and freedom which gave opportunity and incentive for men to create and to build for individual profit, for new businesses, for

small business and large businesses.

That opportunity and incentive has been stifled in other countries, and it is being stifled in our own country by a burden of taxation brought on by waste, extravagance, and inefficiency in an overcentralized federal government.

Our government today needs the keystone of your profession—the elimination of waste and prudent administration of funds—more than any business which you may represent; in fact, our federal government has become the biggest business in the world today. It collects and spends more money than any other single institution. Its budget is still unbalanced. It owes the largest debt—a public debt now greater than the combined public debts of all the nations of the world. It is the largest employer and the biggest land owner in the western hemisphere.

Today our federal government owns 24 per cent of all the land in the

continental United States, and it is trying to take from the states and private individuals thousands of additional acres without compensation. I am sure you know what I am talking about there.

I understand the governor has already covered that subject. The tidelands grab is only one of the evidences of this trend toward more and more centralization of power at the expense of the states and of the individual citizens.

Our national government has grown too big and too far away from the people. It has used recent taxation policies to nourish and sustain that growth. Inefficiency, waste, extravagance, and corruption are the inevitable results of any government which has grown too big at the top. It will take the active interest of men of your training and ability to help restore the fiscal and financial principles which are necessary for the future of our economy and welfare of our nation.

# Separation of the Bureau of Internal Revenue from the Treasury Department

by **William A. Sutherland**

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**Y**OUR CHAIRMAN VERY kindly omitted to tell you why I am not on the printed list. I am a self-invited guest, and I understand that such guests are usually not placed on the list. I did ask to come here because I think this subject of the separation of the Bureau and the Treasury is a matter of very, very vital concern at this time, contrary to the opinions of some of the technical men in the Treasury—and, Doctor, I am not referring to the Bureau of Internal Revenue. The people in the Treasury think that it is a foolish idea and that nothing will come of it.

I personally believe that you are going to hear a great deal of discussion of the subject in the next few months, and, if sound arguments against it are not made, and up to date I have not heard any, I think it most likely that something will be done about it.

I know that a number of the important Republicans on the Ways and Means Committee have been very much interested in this proposal and have publicly stated their interest. I know some Democrats on that Committee who are interested in it but

who have not made any public statement. I believe that when the logic of the proposition is fully presented to the Ways and Means Committee and to the Finance Committee, you will find that this subject will cut completely across party lines and that the people who are interested in sound organization will realize that the time has come when this very important tax collecting agency, which has grown like Topsy, needs to be separated and given independence from the department of the Government whose primary concern is not administration but the determination of the proper fiscal policies.

People in the Bureau—some of the finest public servants that we have had and whom it has been my pleasure to know over a number of years—have told me for a long time that this reorganization is essential in order to have the best tax administration. I once thought that they were influenced by the fact that they disagreed with the economic and fiscal policies of the tax people in the Treasury, who, whether or not they were technically over the Bureau, were actually in a position to



direct the Bureau because they had the ear of the Secretary to the extent that nobody away from his office could have it.

I told these people in the Bureau that it was purely a matter of personnel, and if you appointed a bad man as Commissioner, one who had the same beliefs and policies concerning administration as people in the Treasury, you would have exactly the same situation; that is, I believed that it was purely a matter of men and not of organization, and I had no real interest in it.

### Importance of Organization

As I have studied the matter over the last ten years, and particularly very closely over the last five or six years, when I have been more active in the work of the American Bar Association, and in connection with legislation, I have come to feel that my view was completely wrong and that it is very much a matter of organization and, perhaps to a comparatively small extent, a matter of men.

The situation is this: We have two functions in connection with taxes. One is the high policy function of deciding what kind of taxes we are going to have, how high they are going to be, on what group of the population we are going to impose them, and how we are going to fit our tax policies in with our borrowing and spending policies. That is a vast, difficult subject which will always be with us. In that connection we are now going to have the added help of Senator Daniel, whose address impressed me tremendously.

The other function we have is collecting the taxes after these laws imposing those taxes are passed. This is an entirely different problem, one which requires an entirely different type of training and an entirely different approach.

Although I have frequently disagreed with some of their views, I think that the Secretary of the Treasury has been very wise in having at his elbow people who have gone deeply into the economic theories concerning taxation and who have studied the effects of tax policies upon the other fiscal problems of the Government. That is very necessary. Fortunately we have had in those positions some men who have been highly competent in dealing with these broad policy questions. But it would be by the merest chance if the people who were capable of doing the best job in that field were at the same time able to take a group of 60,000 people scattered over the country, collecting some \$60 billion dollars from 50 million people, and handle that vast administrative job as capably as it would be handled by persons chosen for their administrative ability.

### Need for Study

All I am asking you to do is to ask your Tax Committee immediately to begin a study of the pros and cons of this question of separating the Bureau from the Treasury and come forth with one of the excellent reports that it always gives to the public when it has studied a problem. It would not disturb me if there were a dissenting report. If your Committee undertakes to work on this problem and views it as a matter about which something is very likely to be done, and in connection with which you can have a great deal of influence, it will come out with a report that will be most helpful.

My sole purpose in asking to come before you was to be able to give that message to you. I should add that in many of the statements that will be made on the subject, an effort will be made to make it appear that the suggested change has a great many more political implications than it actually

has. It should have nothing to do with party politics; it is simply a matter of sound governmental organization needed to do a vitally important administrative job.

But the very fact that it will be argued that it is political will give it political angles. In view of that fact, it is most important that a distinguished group such as yours should not simply rely upon the report of your Committee to have the effect that you want it to have. Rather, you should each actively take an interest in the subject and give what advice you can to the Senators and Representatives from the various states. I can assure you that they are most delighted to hear from you when you are advising about matters of general public interest and not asking, as all of us fre-

quently have to do, for personal favors which some of us probably would not grant if we were in the position of the legislators.

The American Bar Association has appointed a committee to study this subject. I hope that the Controllers Institute will follow suit. I know that at least one of your distinguished members, Mr. Mark Richardson, is deeply interested in this subject. He testified before the Ways and Means Committee when it was holding hearings on the King Bill. I imagine he would have been here to address you today, rather than I, had it not been for his illness.

I hope you will all take an interest in this, and, Senator Daniel, I am delighted to have had the pleasure of saying these few words before you.