

1-1926

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Recommended Citation

Reckitt, Ernest (1926) "Trend of Modern Accountancy," *Journal of Accountancy*. Vol. 41 : Iss. 1 , Article 1.
Available at: <https://egrove.olemiss.edu/jofa/vol41/iss1/1>

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 41

JANUARY, 1926

No. 1

Trend of Modern Accountancy*

BY ERNEST RECKITT

I believe it may be taken as axiomatic that no business can meet with the highest measure of success unless those who are responsible for its management not only at regular intervals of time study the reports of their immediate past activities, but take the necessary time to give careful thought to the trend of the industry in which they are engaged, and from the sum of such factors adjust their policies to future needs. What is true of the individual concern is equally true of the group, and for this reason it would seem that the topic chosen for discussion at this regional meeting is especially timely, and that we owe a debt of gratitude to Mr. McKinsey for so ably introducing the subject of *The Trend of Modern Accountancy* in the April, 1925, number of THE JOURNAL OF ACCOUNTANCY.

I have stated that this subject is a timely one—and I say so advisedly—for we are entering upon an era in our professional work which is bringing with it new difficulties and problems to combat. The large volume of accountancy work due to the enactment of the 1917 and 1918 income-tax laws is becoming a thing of the past, while the problems associated with depreciation and depletion, which have been equally effective in the later tax laws as in the earlier, have been largely adjusted and standard rates agreed upon by the government and the taxpayer.

As a result, the volume of the fees of many public accountants, as also their profits, show decreases as compared with prior periods, this condition in turn creating dangers which should receive our special attention at this time if they are to be avoided. The first danger I have in mind is that under stress some accountants may be tempted to secure new clients by practices which would not be in harmony with the rules of professional conduct of the American Institute of Accountants. I am not, however, going to

* An address before a regional meeting of the American Institute of Accountants, Chicago, Illinois, November 17, 1925.

dwell upon this subject, but rather upon another danger which has a more intimate relationship with the topic arranged for discussion at this meeting. I refer to the danger that in order to make up for the decrease in fees from income-tax investigations some members of our profession may undertake work which neither their education nor experience would enable them to conduct with any personal guarantee of its accuracy, and which is therefore outside the province of our activities as public accountants.

Mr. McKinsey touches briefly on this subject when he says:

"We are all familiar with the unknown accountant who over night has blossomed out as a well known industrial engineer."

Later in the same paragraph Mr. McKinsey very properly states:

"I think that we are all willing to admit that no one can be an expert in all fields of business activity. The professional lives of all of us are too short for us to become competent to advise our clients on all matters."

In relation with the foregoing expression of opinion I propose in the brief space of time allotted me to refer to a new—and I consider a dangerous—trend in our professional work which should receive our careful study. This particular trend is especially insidious for the reason that some of the important bankers of this country are attempting, largely through ignorance of the conditions, to force this new activity upon members of our profession. I refer to the growing demand on the part of some bankers that public accountants guarantee the accuracy of the quantities and valuations of the items listed in the inventories of their clients, in the same manner that the accuracy of the cash in banks or the receivables are certified.

Let us meet the issue squarely and ask ourselves whether or not we would be attempting the impossible in trying to conform with what such bankers now appear to demand. I am thoroughly aware that this subject is a debatable one; that there are "pros and cons," and that there are many reputable firms of accountants which, after making many tests of different kinds, will give an unqualified certificate, including the valuation of inventories, but without having any representative present at the stock-taking. I think we shall all have to plead guilty—if "guilty" we be—of having done this very thing. But the bankers, as I understand it, say that this is not enough. They want us to be responsible for the actual physical count, and while of course not going so far as to state that every man engaged in the count must be an employee of the accounting firm, yet that the firm should

have a sufficient number of its employees present at the stock-taking so that a very comprehensive test of the accuracy of the physical count should be made, at least sufficient to enable the auditor to believe he could accept the accuracy of the whole. I am very strongly of the opinion that it is high time that the bankers and public accountants meet and thrash over this whole subject most fully and secure a "meeting of minds," so that the banker will understand our limitations and not expect us to be supermen or mind-readers. A clear line of demarcation as to where our responsibility begins and ends should be determined, as also the character of our certificates to be given, depending upon the responsibility undertaken. I wish to emphasize this point, for I believe it is one of the most important matters now confronting our profession.

We have two questions before us: First, can the auditor ever give an unqualified certificate as to inventories? Second, can the auditor undertake, at the time of stock-taking, a thorough test of the accuracy of the quantities and the valuations of the items contained in an inventory, including necessarily obsolete or slow-moving parts and finished merchandise?

We will consider very briefly the first of these propositions. My personal opinion in the light of past events is that every certificate requires qualification with respect to the inventories. I am of course aware, as stated before, that this is a debatable question and in fact my good friend Mr. Robert Montgomery (who certainly as a writer on accountancy matters stands as a high authority), says on page 88 of his 1916 edition of *Auditing Theory and Practice*:

"If these (instructions) are followed with care, the auditor need have no hesitancy in certifying to the accuracy of the inventory item in the balance-sheet."

Now I concede that the instructions referred to are excellent, and under ideal conditions most of the instructions can be carried out, but how often do we find such conditions and how many of our assistants possess the intuition and powers of mind-reading required so that we can give unqualified certificates? In order to make this point clear I quote a few extracts from these instructions (the italics are mine):

"The physical condition and salability of the stock must also be considered. . . . This is a most difficult fact for the auditor to determine, *but he must depend upon his own intuition* and inquiries to determine whether or not the stock is in good condition or merchantable." . . .

"If not certified to or initialed by the persons who took the stock, by the persons who made the calculations and the footings, and by those who fixed the prices, have this information supplied and see to it that the persons who made the certificates or who supply the information are dependable and take the matter seriously."

I will not take up more time discussing this particular question, except to state that in actual practice it is the exception rather than the rule to find that the records are in such shape that we can carry out all the instructions recommended and still give an absolutely "clean bill of health."

Mr. Montgomery himself says:

"Where a good cost system is not in force it is almost impossible for an auditor to verify the goods-in-process section of the inventory to his satisfaction."

My belief is that there are so many possibilities of error or fraud which the auditor may not and can not detect, that we should recognize this condition and in all cases qualify our certificates to the actual degree of our responsibility, and if, as I am inclined to believe, this may not always be sufficient for the purposes of the banker or investor, then the services of the industrial engineer qualified in that particular industry should be called in and a certificate secured from him.

This brings me to the second question: "Can the auditor undertake in any way a thorough test, at the time of the stock-taking, of the accuracy of the quantities and valuations of the items contained in an inventory, to the extent that he would accept the accuracy of the whole?" This is the work that some of our bankers would now ask us to perform.

Now, from the bankers' point of view I grant it would be a most convenient plan of operation, if it were humanly possible to secure reliable data, if they were able to go to the Universal Appraisal, Audit, Engineering and Legal Service Corporation and engage its services for a complete investigation and report upon a company whose bonds they hoped to market, and to secure from such service corporation one certificate, covering not only the same ground as do the certificates now usually given by the public accountants, but covering also an appraisal of all the company's plants, a valuation of its patents, a statement that its plant and machinery were up to date and well arranged, a legal opinion as to the title of its land and its market value, a guarantee of the accuracy of the quantities contained in the inventory, including a proper valuation of all obsolete

materials, and an expressed opinion of the ability of the officers of the company in its management.

As, however, we have not yet reached the millennium, and as when the millennium arrives, certificates will no longer be required, I do not think that the banker would care to be left to the tender mercies of any such hypothetical concern as that described. The banker goes to the lawyer for legal information, to the appraiser for plant valuations and to the public accountant for the financial statement. But the banker now appreciates better than before that there is a hole in his armor, inasmuch as inventory valuations in a number of instances have been found inaccurate, especially when intentional padding has been fraudulently resorted to, and he is apt to blame the public accountant. Perhaps we should be blamed and then again perhaps the banker should be blamed for not taking to heart what many of us have been telling him of our limitations. I think that most intelligent bankers have realized, when they saw the unqualified certificate of reputable firms of accountants, that in so far as the inventory valuations were concerned no liability for error would attach to the accountant *provided* he performed the methods of attempted verification which the best practice heretofore made incumbent upon a conscientious practitioner. The banker knew that neither the auditor nor his representatives were present at the stock-taking, and that except upon proof of negligence or lack of living up to standard practice, no liability could accrue to the auditor.

However that may be, the banker now desires to be more thoroughly satisfied about the inventory valuations, and I think we shall all agree that he is entitled to that satisfaction. But in order to remedy this situation he asks members of our profession to become absolutely responsible for the entire inventory. My fear is that some firms of accountants may undertake this responsibility, either in ignorance of their limitations or through the desire for increased earnings.

It seems to me that the answer to this problem—and it is a difficult problem—does not lie in the public accountant's attempting to do something for which he has no qualifications. With equal force, but for different reasons, an appraisal company would be also unqualified to take and value inventories, except perhaps in a very few cases where its officers had had the experience required in the particular industry which was to be the subject of investigation.

However, I do not wish you to understand that I am opposed to a public accountant *supervising* the taking of the inventory. The only pity is that the business public does not use our services in this regard to a greater extent. To organize and supervise the methods adopted for taking the inventory is one thing, while the work involved in the actual counting and valuations is a horse of a very different color.

“But,” I hear some public accountant saying, “I have an industrial engineer on my staff and he has under him a staff of junior engineers to assist him, and furthermore we can also use some of our junior accountants to assist in the testing of the accuracy of the quantities counted by our clients’ own employees.”

Gentlemen, this line of talk perhaps “listens fine” to an outsider, but to those of us who have been in the accounting profession for many years, does it sound practical as a general proposition? You will note I say “as a general proposition”, and I say it advisedly, for I am willing to grant there may be some few instances where an accountant’s practice may be largely made up of clients all engaged in the same industry and that under such ideal conditions he *might* have a staff of engineers having especial knowledge of the raw materials, goods in process and finished goods used in that industry. Even such an accountant will have very difficult problems to solve, for unless he succeeds in getting each of such clients to close the books at regular intervals of time throughout the year instead of closing at December 31st, as, unfortunately, is now the case, what is he going to do with all these engineers during the balance of the year? Naturally he would have to discharge them when the rush season was over and engage a new staff for the next year’s business; but it is hardly conceivable that they too would be experienced in the materials handled by the particular industry in question. But even assuming all of the conditions to be ideal, we are still faced with the fact that the public accountant engaging the man in charge of the engineering department can have little or no knowledge of his ability or the character of the service rendered by such department. The old proverb, “The cobbler should stick to his last” is as true today as when it was first coined.

I have attempted to demonstrate that even under special and ideal conditions there is much to be said against the practice of

public accountants holding themselves out as competent to take inventories and to certify to the accuracy of the quantities; but if this practice were to be adopted by any accountants it is quite clear that only very large firms could organize an industrial department. What about the hundreds of smaller firms of accountants? And I believe we can accept Mr. McKinsey's statement, that the modern trend of our profession is towards an increasing number of small firms of reputable experienced public accountants, especially in the smaller cities. It is, in my opinion, quite inconceivable that they could engage as a member of their staff any industrial engineer, however desirable it might be at certain times.

Among the clients of even a small organization, and much more so among the clients of a large firm of public accountants, it is quite conceivable that a great number of varying industries will be represented. Thus a single firm may number among its clients the following industries: machine shop, foundries, electric equipment, cabinets and furniture, dry-goods stores, milling, chemical products, lumber. In certain sections of the country other industries might be added, such as cotton, silk or wool spinning and manufacturers of yarn and cloths. All the above industries have sub-headings of infinite variety. Is it conceivable that one organization of industrial engineers as employed by one firm of accountants can intelligently undertake the stock-taking of even a small percentage of the businesses whose records they audit?

In the above paragraphs I believe I have demonstrated that the public accountant would not and could not undertake the verification of the quantities or the value of obsolete stock—even with the assistance of an industrial engineer on his staff. Are we to leave it at that? I do not think so. Surely we should attempt to suggest some constructive plan which may supply the banker the protection he is looking for and to secure to him the full value of a balance-sheet. The banker or investment banker or broker has seen the necessity of securing certificates from appraisers covering the plant values; certificates from lawyers covering titles to property and legality of corporation acts and resolutions; certificates from public accountants covering valuations of all assets and liabilities other than valuations of plants and the quantities in the inventories and valuations of obsolete stocks. Why should not there be filed with the banker

or published in the prospectus the certificate of a firm of industrial engineers familiar with the particular industry in which the prospective borrower is engaged? This practice would probably require some changes in the methods adopted by those concerns now practising as industrial engineers, and the desired results are not going to be evolved immediately, but surely it is better to work along the lines of least resistance and engage those who are better qualified for this particular work than to engage those who have had no experience and who can not secure such experience.

The adoption of the method suggested would undoubtedly result in firms of industrial engineers specializing in only a very few lines of industry, so that they could give the required service. In time we should find a great many small firms of industrial engineers springing up, each with specialized knowledge of a particular industry. On account of the present tendency of all members of an industry to coöperate with one another along lines of common interest and stabilization, it would be only natural to suppose that each and every member of an industry would find benefit in employing the same firm of industrial engineers who were familiar with their problems, and such engineers would be eminently qualified to become responsible for the quantities and valuations of the inventories of those engaged in that industry.

If I were to attempt to prophesy, I am inclined to believe that just as the modern trend is for a very large increase in the number of small but reputable firms of accountants, so in the profession of industrial engineers the trend will be in the direction of an increasing number of firms in this profession, each, however, specializing in but a few industries, but all thorough masters of the engineering problems met with and of the character of the raw materials, the goods in process and finished merchandise.

I believe it is within the power of the bankers and the public accountants of this country to speed the day when the profession of the industrial engineer, along the lines I have suggested, will become a valuable factor in the business world and that by an intelligent coördination of the work of the public accountant and the industrial engineer, the banker will be able to place reliance upon the valuation placed upon the inventory in a certified balance-sheet.