CORRESPONDENCE

Auditing Procedure in America

Editor, The Journal of Accountancy:

Dear Sir: The reprint from *The Accountant* (London) and "Econacon's" letter comprising pages 101 to 104 of your August issue raise points of considerable interest to professional accountants everywhere. Frankly to one who, like the writer, has been privileged to engage extensively in professional work along both British and American lines, the views expressed in *The Accountant* are astonishing. On the other hand, the tribute paid by "Econacon" to the excellence of certain American methods provides much ground for believing that ever-improving methods of auditing will be gained by combination of all that is best in British and American practice.

Regarding *The Accountant's* objection to carrying verification of inventories beyond "every possible test of inventory schedules within the sphere of accounting," one may well ask why so narrow a limitation should be imposed, and why valuable assets comprising inventories should be exempted from any of the verification processes applied for checking of relatively insignificant funds of "cash on hand."

In its recent report upon audit procedure, the American Institute of Accountants seems to take special care to protect auditors and the public against the dangers of any unwarranted assumption that physical tests of inventories for audit purposes imply any guarantee by auditors as to description, quality, or value of all such assets. If any danger remains of the public's not understanding that such tests are merely reasonable precautions to detect presentation by clients of inventory schedules that are inaccurate, surely it can be removed better by some judicious publicity rather than by any timidity in carrying out these essential physical tests? Regarding highly specialized inventories such for instance as chemicals, liquors, precious stones and minerals, physical verification obviously would not be attempted by a sensible auditor and no difficulty should arise in making it known why such lines cannot be tested physically.

Notwithstanding all the unavoidable limitations which lack of expert knowledge imposes upon auditors in regard to verification of certain classes of specialized inventories, very many lines of merchandise and other assets are by their nature so very simple as to enable their physical verification by anyone blessed with average intelligence. Does *The Accountant* seriously suggest that grave dangers, or unsupportable responsibilities lurk in dark recesses when physical tests are made of items such as catalogued machinery and tools held for sale, of automobile spare parts, and automobile tires; manufactured bottles, containers, and any of a thousand and one items that can be described at random as quite easy to count, weigh, or measure without any particular technical knowledge? In suggesting that such dangers and responsibilities warrant the confining of all inventory work to the checking of accounting schedules, *The Accountant* implies that the scope for auditors' usefulness in regard to inventories has long been filled in Great Britain, and that in America it is being overrun. Fortunately, however, physical tests of inventories form part of normal auditing procedure of certain leading professional firms in Great Britain as well as in America, and so far as can be gathered, no serious consequences have attended such inspections.

Seeing that your contemporary appears to fear especially the consequences of undue reliance by the general public upon what is being recommended for proper auditing procedure it will be well to consider what the public expects at present from the profession. There seems to be little doubt that regardless of whatever limitations auditors may consider desirable in regard to their duties, the public expects them to verify from every available source—outside as well as within the accounting records—all accounts included in statements certified by them, or to qualify their remarks in regard to such items that cannot be satisfactorily verified. This expectation which amounts to implicit reliance applies especially to current assets such as cash and accounts receivable, and also to inventories. Considerable dissatisfaction and very much adverse comment would probably be expressed should it become broadcast that at the behest, or with the approval of any responsible accounting body, auditors' work on inventories was purposely restricted to the checking of inventory schedules, and all obligations to make physical tests of supporting items were officially disclaimed. In view of such probabilities, does it not seem that the real danger to be feared lies in what auditors may fail to do in regard to inventories rather than in any additional steps they may take in the execution of their duties?

Because the consequences of publicized frauds cannot be confined to any individual practitioner or professional firm, but rather because such consequences damage the whole profession it seems most desirable that leading professional bodies should appoint committees as the American Institute has done, to report upon important matters and make suitable recommendations. Desirable as it is to leave procedure so far as possible to the special circumstances affecting each practitioner, this means of guidance to each for the protection of all is an excellent example of good Institute leadership. Reverting to inventories, could any responsible professional body assume responsibility for advising the general public that because of difficulties preventing auditors determining the condition, nature, and worth of certain specialized lines of articles their members are advised to refrain from attempting, as part of their normal procedure, to test physically the existence of those articles that present no difficulty, no matter how simple the work may be? Could the accounting profession reasonably expect to progress to higher spheres of usefulness, or even to maintain present standards in face of such a declaration?

As regards accounts receivable, your contemporary appears again to fear unnecessarily. The general public is surely sufficiently intelligent to understand that while full verification by direct communication with debtors is best, the moral and often concrete effects of partial tests make those tests preferable to sole reliance upon the checking of accounting schedules. If in spite of such partial test some error or fraud should escape the examples chosen for confirmation the public would certainly be left with much less ground for criticism than it would were no such test attempted.

During many years of service to the accounting profession in Great Britain, *The Accountant* has built up an enviable reputation for everything that is good in professional journalism, and it remains in every respect a credit to the great profession it represents. This fact makes the editorial reprinted in your August issue so very difficult to understand. If there is any misunderstanding in Great Britain as to the purpose of the American Institute's recommendations, or by readers on this side regarding the strange comments in *The Accountant* very much can be gained by exchange of views on the important subjects involved. It is to be hoped therefore that some constructive discussion may have been provoked by your having printed the editorial in question and your having invited comments in regard to it.

In conclusion it seems appropriate to express the satisfaction that comes from perusal of the remarks of your correspondent, "Econacon." This refreshing tribute to American methods augurs well for a good understanding all round. Your readers may be interested to know that many British accountants are glad to avail themselves of the best features of American methods of auditing. Those who are fortunate enough to be able to round off their excellent British training by having practical experience with any of the great American firms having offices in Europe consider themselves especially privileged. While not considering themselves in a class superior to those who have not had such experience, and not belittling in any way the splendid training gained from their British offices, they enjoy seeing the effective, modern, and sometimes novel methods imported by American firms from this side. They feel they have learned something new and extremely valuable.

Yours truly,

Cecil A. Ellis

Montreal, Que.

(*Reprinted from* The Accountant, *London, August 5, 1939*)

Sir,—May I comment on your leading article of 24th June and on "Econacon's" letter of 1st July?

The American practitioner works in an

atmosphere which would prove singularly disturbing to his English cousin and the demand for codification of practice exemplified by the recent report of the American Institute's special committee on auditing procedure shows only part of these difficulties. At the risk of some generalization, I would attempt to describe some further aspects of a system which is taking the profession here still further from the British tradition.

You have referred to the limitation of the scope of the audit to the matters covered by the clients' instructions. In effect, the directors of corporations here decide to buy an audit as they would a new piece of office equipment and one is tempted to suggest that they expect similar results. The price paid for the audit will often be the subject of competitive bids, with the result that a change of auditors from year to year is not the unusual and sometimes suggestive event it would be at home. The protection given by section 132 (3) of the companies act, 1929, is not available to the American practitioner, nor does it follow that professional etiquette will operate to hinder the client from doing the best deal he can in the matter of prices.

The following case may be extreme, but it will serve to indicate the possibilities of this system. An American city desired an examination of its accounts by independent public accountants. Tenders were invited and the lowest bidder secured the appointment, little regard being paid, apparently, to his personal and professional history and standing. His original price was far below that of his rivals, but he has succeeded in taking from the city fees greatly in excess of his original contract amount, by the simple expedient of using the information coming to him in the course of his duties. Certain persons concerned both with his appointment and the results of his report find it convenient to extend his engagement as the price for silencing the report! The city is, of course, full of rumors and the effect on the profession generally is to introduce suspicion into the public mind, to say the least. With their present knowledge and in the light of recent publicity, they can hardly be blamed for jumping to conclusions.

The demand continues for the publication of certified accounts which will enable the investor to place a reliable valuation on issued stock or share capital. To this end, it may be agreed that "underdisclosure is as reprehensible as overdisclosure," but it can hardly be hoped that the profession will accede to the extreme demands formulated by Mr. Kenneth MacNeal in his *Truth in Accounting* (1938: Oxford University Press); he has probably put into words what the average investor in this country is demanding, that the purpose of published accounts should be ascertainment of *true present worth* of the business and its assets; to this end the annual accounts should contain a revaluation of all fixed assets so as to indicate their market values. One wonders how the accountant will respond to the demand that he certify the present worth of the land on which the factory stands! But it is in this direction that public pressure appears to be driving him.

The avoidance of the natural business year and the concentration of work around 31st December closing has one effect, the importance of which seems to be inadequately recognized by the profession here. I refer to the system of recruiting temporary assistance to supplement the permanent staff during the months of November to April. While there may be a tendency for the same men to come back to these temporary posts year by year, there is little concern shown for what happens to them during the remaining seven months of the year. There is no real inducement to these men to pursue a steady course of training (which would hardly fit them to dispense "sodas" during the slack period), while their inclusion in an ordinary audit force must necessarily increase the responsibilities of the senior in charge.

The ebb and flow of this nonspecialist, if not untrained assistance, must in large part account for the elaboration of working papers referred to by "Econacon." From a personal experience of the system, I can say that the time occupied in the preparation of the voluminous schedules of vouchers examined could be much more fruitfully applied to the extension of the scope and variety of the tests made. The employment of men whose reliability and integrity have been proved to the senior from long acquaintance, and, indeed, friendship, and the cultivation of the team spirit which is found in the well-run British office, would relieve the senior of the fear that the work can only be said to have been covered properly if "writ large" in schedules. Their absence from British working papers does not reduce the value of those papers as evidence of a "tangible basis" for the accountants' opinions, if he has done a thorough job and followed the dictates of his own judgment.

Following the events of the past winter, there has been some tendency to vest the appointment of auditors in the stockholders; one feels, however, that there is no deep-rooted appreciation of the merits of the system and that when the tumult and the shouting has died down, the new idea will be forgotten in the absence of some ruling by an executive agency like the Securities and Exchange Commission. A number of firms, too, have gone to the trouble of calling in independent trade appraisers to supervise inventory taking. From the point of view of mere cost, it seems unlikely that this practice will be generally extended and one feels that the report of the American Institute's special committee may indeed encourage increased reliance on the auditors in this respect, your warnings notwithstanding. I have already observed a case involving the application of some of the principles laid down by this committee. A former colleague was recently sent to supervise the inventory of one of the largest of this country's steel producers; accompanied by a raw recruit to the profession, he spent some three weeks learning the use of, and using, a theodolite, his tutors being company officials. I give my friend full marks for intelligence and common sense, but I am still unable to understand how he could conscientiously certify to the quantities (let alone the quality or grades) of the ore reserves which, *inter alia*, he was called upon to check.

The scope of the usual audit here is not necessarily adequate to detect fraud, which Spicer and Pegler (*Practical Auditing*, 5th ed., p. 5) set at the head of "Reasons for Audit." Some interesting figures were given, last week, to an institute of accountancy conducted by Columbia University, New York. In an examination of some 500 cases of defalcation, initiated by the New York State Society of Certified Public Accountants, it was found that the great majority of the disclosures took place fortuitously and not as the result of an annual audit. Much attention is paid to the system of internal control, but it seems that the American profession might do well to study the results obtained by the British practitioner from extensive study of the profit-and-loss statement, not only in the light that the different items therein affect the balance-sheet, but from the point of view of the authority for the various expenditures and their verification leading to the discovery not only of such manipulations as defraud the shareholder in the smaller ways but in the larger matters covered by the doctrine of *ultra vires*.

Education of the public in the understanding of the true functions of the auditor will help the American profession much more than the overelaboration of codes of procedure, of which, anyway, the various Government agencies are only too willing to provide a supply. Somehow the profession has to attain the standing in the national economy reached by its counterpart in England, where freedom to exercise judgment and give opinions is unrestricted by any serious misapprehension on the part of the public as to what the auditor is trying to do.

Yours faithfully,

EPISCOPUS

Connecticut, U. S. A., 18th July 1939

Extensions of Auditing Procedure

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Whose balance-sheet is it? In your August issue Mr. Glover defends at some length the report of his special committee which endeavored to settle the question for all time in the following words:

"It should be borne in mind that the financial statements with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon these representations that the independent certified public accountant renders his opinion."

Please observe that even the footnotes, written by the auditor himself, are to be palmed off on the public as representations of the client.

In his defense of this attitude, Mr. Glover starts out with a premise which is only a half-truth. He asks, "Where do the figures entering into the financial statement come from?" and he answers himself, "From the books of the client."

He absolutely ignores the possibility of any unrecorded liabilities, or other adjustments which a conscientious accountant might deem it necessary to make before issuing in connection with his signature a balance-sheet purporting to represent the financial position of the concern under audit.

There may be some corporations with accounting departments so well organized that the services of an outside auditor are well-nigh unnecessary, especially one who takes the position that he is not under obligation to disclose internal irregularities. But my experience has been different. I recall very few instances in the last twenty years of active practice in which the tabulations in my reports did not reflect the result of adjustments that were not on the books at date of audit.

I would like to know how Mr. Glover would have handled the following two cases taken at random from a long experience: The firm with which I was at one time connected was directed by the State Securities Commission to report on the financial position and operations of a certain manufacturing company which was selling its stock on a large scale to the public. The company had capitalized as "organization expense" certain items which in our opinion belonged in the operations. The entire board of directors, their chief accountant, and three prominent attorneys argued from two o'clock in the afternoon until midnight trying to convince the auditor that he was wrong, for these items made the difference between profit and loss.

(Please note that the accountant was not trying to convince the corporation executives, as Mr. Glover suggests. It was the other way round, although the client was paying for the audit.)

The accountant stood pat, issued his report, with the balance-sheet made up as he believed it ought to be. In the end, the state commission ordered the company to adjust its records in accordance with the accountant's report.

The second case which I cite was that of a tire company, engaged in selling not only its tires, but also its stock to the public. To enhance its tire sales, it had been giving away coupons good for discounts on future purchases, but without setting up any reserve therefor on its books. On the contrary, it positively objected to doing so. Their books showed a nice surplus. The accountant's balance-sheet showed a decided deficit.

What would Mr. Glover have done in cases like these? Would he have issued balance-sheets in accordance with the books and then explained that they were all right, with the exception of certain things which were all wrong? Or would he have issued a balance-sheet in each case as he believed it ought to be, and then insisted that it was the representation of the client?

It seems to me that this principle which the committee is seeking to establish is a very revolutionary departure, in spite of the fact that it appears to have been an accepted theory among certain classes of accountants in recent years. I question the necessity for establishing such an alibi.

Many times in negotiating with corporation officials I have been asked why I could not take their bookkeepers' statements, check them over and certify to them. The request is usually made in the hopes of reducing the cost of the audit. My reply has invariably been that I do not make audits that way. It is very easy to overlook things in checking that show up when a proper analysis is made. I think other accountants have had similar experiences. We have been holding out for a principle, and now comes along this special committee of our highly respected Institute and tries to break it down. No wonder "so many prominent accountants have expressed a contrary point of view."

Elsewhere in its report the committee admits that the so-called standard form may not be applicable in all cases:

"There may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined."

I suppose that ought to satisfy everybody, but I cannot help believing that the public has a right to expect the certified public accountant to accept responsibility for the financial statements issued over his name, without attempting to hide behind theoretical subterfuges. For that reason I voted against the acceptance of the special committee's report when it came up for discussion in our state society.

In this connection I recommend a careful re-reading of the following sentence by William W. Werntz, chief accountant of the Securities and Exchange Commission, quoted in your August leading editorial:

"If financial statements are amended to give effect to accounting principles for which there is substantial authoritative support instead of following the practice of basing the statements on dubious principles and making so-called 'full disclosure' footnotes, then we will be on the road toward clearer and more intelligible financial statements."

Yours truly,
EARLE GOODRICH LEE
Saint Paul, Minn.

Suggested Standards of Practice

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: The report of the special committee on auditing procedure presents a comprehensive statement of suggested standards of practice for the future with respect to the subjects discussed. The members of the committee deserve the most unstinted praise of all practising accountants for giving so generously of their time and energy in these busy days. The writer presents the following thoughts with some hesitancy, considering that so much time has been spent on the subject by such an illustrious group. Many of these thoughts are not original but were suggested to some of my associates at recent meetings of accountants.

The committee has recommended substitution of the term "report" for what heretofore has been generally termed the "accountant's certificate." Undoubtedly, in the great majority of examinations which our profession undertakes, other than for the companies which have their securities listed on exchanges, a detailed report containing information not made public is submitted to the client. Surely in those cases the accountant should not again use the word "report" for his opinion on statements submitted by the company to its stockholders, etc. If there is more than one report they could be distinguished by using a term such as "condensed report" for the short form.

The questionnaire sent out by the committee under date of February 15, 1939, did not request suggestions for changing the form of certificate which has been widely used since 1936 and the writer is of the opinion that the profession will proceed slowly with general adoption of the short form of report as recommended by the committee.

No provision is made for including the purpose or purposes for which the examination was undertaken. May it properly be assumed that absence of statement of purpose indicates that the examination was made for all general purposes, including the detection of fraud? As the usual examination is undertaken for the purpose of enabling the accountant to form and express an opinion as to the accuracy of the presentation of the results of operation and financial condition set forth on the statements, should the first paragraph of the report so state, or should the purpose of the examination be stated only where there is limitation of scope?

The first paragraph of the proposed report consists of one very long sentence and long, complex sentences are often criticized when prepared for the perusal of the general public. The contention that statements made therein will lose their equality of weight unless all are contained in one sentence might also be applied to the order in which they appear in the sentence. It is suggested that a new sentence start with: "We have reviewed the system of internal control and the accounting procedures of the company and have examined, . . . "

The word "appropriate" suggests indefiniteness, dependent upon all the circumstances, and in the opinion of the writer it will not convey to the stockholder, investor, or credit man the same impression as either of the words "adequate" or "necessary." Accountants will use one of the words "appropriate" or "adequate" or "necessary" for the purposes of the examination but such purposes are not stated!

The committee recommends that all exceptions by the accountant be included in a separate paragraph, including exceptions affecting the scope of the work. If exceptions affecting the scope of the work are expressed, does not the phrase "by methods and to the extent we deemed appropriate" require modification? It is to be assumed that the financial statements are in substantial agreement with the books. Any substantial variation between financial statements and books should be fully disclosed.

If all exceptions are to be contained in a separate paragraph it would seem advisable to endeavor to standardize the order in which the types of exceptions are to be stated, such as:

(1) Special or specific purpose of examination.
(2) General limitations of examination.
(3) Limitations of specific verifications.
(4) Lack of substantial agreement between financial statements and books.
(5) Inadequacy of accounting procedure.
(6) Inadequacy of system or extent of internal control.

(7) Lack of consistency.
(8) Exceptions respecting specific items in the financial statements.

The report of the special committee states that the methods and extent of the verifications and tests are to be dependent upon the accountant's judgment of the adequacy of the internal control and the accounting procedures of the company. No provision is made in the suggested form of report for an opinion as to the effectiveness of these procedures. Unless such provision is made in the "opinion" paragraph it might be advisable to amend the first paragraph of the report so as to read somewhat as follows: "We have examined or tested the accounting records of the company and other supporting evidence by methods (at times) and to the extent we deemed adequate, taking into consideration the extent of internal control and the accounting procedures of the company."

The last paragraph is quite condensed as compared with that which has been in general use for several years. However, the writer believes the accountant would be indicating his intent more clearly to the reader if he used the word "practices" instead of "principles," so that the last phrase would read: "And conform to generally accepted accounting practices, maintained on a basis consistent with the preceding year." The witnesses for the Institute, in answering questions as to accepted accounting principles, as shown on pages 358–59–60 of the June, 1939, JOURNAL OF ACCOUNTANCY, were far from consistent and uniform in using the term "principles" because the words "practices," "conventions," and "procedure" were employed apparently for the same meaning. If it might be generally understood that the phrase "generally accepted accounting practices" includes all those accounting "principles" which are generally accepted and used the situation would be considerably clarified.

Yours truly,

CHARLES S. ROCKEY

Philadelphia, Pa.

Cash Discounts

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: In the June, 1939, issue of THE JOURNAL Charles L. Richardson asks several questions relating to the handling of cash discounts in retail-store accounting.

In retail-store accounting, where cash discounts are taken regularly, it is customary to reduce the closing inventories to cost or market as determined by the retail inventory method, less cash discount, and to reduce accounts payable to the amount of unpaid invoices, less the amount of cash discount which will be earned thereon. These adjustments are made through the cash-discount-earned account.

The following simple procedure briefly illustrates the way that cash discounts are handled in actual practice:

(1) Purchases (gross)....	$20,000	
Accounts payable (net)...........		$19,000
Cash discount.....		1,000
(2) Purchases (gross)....	20,000	
Accounts payable (gross).........		20,000

The purchases have been charged with the gross amount in the foregoing entries; therefore, a reserve for cash discount on merchandise in stock at the end of an accounting period is necessary. This may be computed by determining the ratio of the annual amount of cash discount to the annual merchandise purchases paid for each department. The percentage result thus obtained is applied to the physical inventory at cost. The computation may be made by departments whenever variations exist in the cash discount rates.

Mr. Richardson also asks "whether or not (cash) discount should be deducted from accounts payable at the end of the year." This depends on how the purchase entries were recorded on the books. If the entries were like (1), then cash discount should not be deducted from the accounts payable because the invoices have been entered net. On the other hand, if the entries were like (2), then cash discount should be deducted from accounts payable. This may be computed by applying the ratio of annual discount earned to the annual merchandise purchases. The percentage result thus obtained is applied to the outstanding accounts payable.

Yours truly,

MELVIN KESTLER

Los Angeles, Calif.

The Valuation of Compensation Stock

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Reference is made to the article by John Kunkel in the July, 1939, issue of THE JOURNAL, entitled "The Valuation of Compensation Stock," and to the hope expressed in the last paragraph of the article that more might be said on the subject.

Mr. Kunkel arrives at the interesting conclusion that the board of directors should declare a definite value for all services furnished by employees and, accordingly, when an employee subsequently receives stock for such services, he should account for the difference in value as gain or loss on the stock.

Mr. Kunkel does not comment on one interesting feature of gain or loss; namely, that it is usually associated with ownership of property over which the holder has sufficient control that he may elect either to hold or to sell. This characteristic is usually absent in undelivered compensation stock. The employee has deliberately taken as part of his compensation the right to receive stock at a future date. Usually such a right is not assignable. All this is understood by the employee, and he is aware of the fact that part of his compensation is *not* measured by a definite sum of money. His position is similar to an employee who contracts to take as part of his compensation a percentage of the profits to be determined after the close of the year. In both cases, the employee has been placed on an incentive basis and the attempt is made to measure his services, in part, by the results produced.

If "the reasonable value to the corporation of the services to be hired" is ascertained, as suggested by Mr. Kunkel, then the employee should be paid that amount in money or money's worth. If the money's worth is to be stock of the employer, it should be covered by a specific stock purchase contract.

In any event, I believe that the rules of accountants should reconcile as closely as possible with the rules formulated by the courts in cases where both are free from statutory definitions and permitted to form opinions by the use of logic. The income-tax statutes (except for special cases under section 165) have contained no stipulations as to how compensation stock is to be accounted for; hence, the courts have been free to formulate a logical conclusion, and it seems to me that their conclusion is quite logical when they say that compensation stock should be valued at the date received by the employee. That is the first time that he comes into possession of an asset which may either be sold or retained.

This does not mean that there should not be interim valuation (1) by the corporation in respect of its future liability to deliver the stock and (2) by the employee in respect of his future right to receive the stock. These valuations might change at the end of each accounting period. The corporation, however, could close its accounting by acquiring or creating the stock and appropriating it irrevocably to the fulfilment of the contract. The value of the stock at the date so appropriated should control the final entry by the corporation on its books.

In an arrangement of this nature it should be remembered that while the value of the compensation offered may be indefinite it usually is not any more so than the value of the services rendered.

Yours truly,

EDWIN S. RENO

Pittsburgh, Pa.