PROCEEDINGS

OF THE THIRD ANNUAL

Institute on Accounting

Held At

THE OHIO STATE UNIVERSITY

MAY 17 AND 18, 1940

Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

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THE BUREAU OF BUSINESS RESEARCH
COLLEGE OF COMMERCE AND ADMINISTRATION

PREFACE

On May 17 and 18, 1940, the members of the staff of the Department of Accounting had the pleasure of welcoming members of the accounting profession to the Annual Institute on Accounting at the Ohio State University.

An analysis of the registration statistics discloses that 398 people were registered. Many others were in attendance, but did not register. A summary of the registration statistics follows:

Professional Connection		*Number*
Public accountants		no
Industrial accountants		104
Corporate officials, public officials and others		33
University officials and instructors:		
Ohio State University	27	
Other universities and colleges	30	
	—	5 ? y ' W "
Students:		
Ohio State University	90	
Other universities and colleges	4	
	—	94
Total registrations		398

The registrants came from eight different states: Ohio, West Virginia, Pennsylvania, Indiana, Michigan, New York, Illinois and Kentucky.

Membership held in Professional Accounting Societies by registrants:

Membershif in Professional Societies		*Number*
State societies of certified public accountants:		
Ohio	72	
Others	16	
	—	88
American Institute of Accountants		52
National Association of Cost Accountants		103
American Accounting Association		40

The Department wishes to acknowledge the assistance of the many persons whose efforts contributed so much to the success of the institute.

The Department of Accounting

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FIRST SESSION

FRIDAY, MAY 17, 1940 — 10:00 A. M.

Commerce Auditorium

Chairman:

GEORGE A. MACFARLAND, *President) The American Accounting Association $ Professor of Accounting, University of Pennsylvania, Philadelfhia*

Address of Welcome:

DR. JAMES L. MORRILL, *Vice-President, The Ohio State University, Columbus*

Topic: "Accounting Reports"

Paper:

DR. WILLIAM A. PATON, *C.P.A,, Professor of Accounting, The University of Michigan, Ann Arbor*

OPENING REMARKS

By GEORGE A. MACFARLAND
President, The American Accounting Association;
Professor of Accountings University of Pennsylvania, Philadelfhia

Members of the faculty of The Ohio State University, senior students, members of the Ohio State Society of Certified Public Accountants, guests from the American Institute, and all others who are friends of accounting: It is pleasant to start this Institute at Ohio State University.

We are fortunate this morning *in* that we have the Vice-President of the University here to welcome this Institute. He has a difficult assignment, because he is understudy for President Bevis, who has been called out of town. It is a pleasure to present James L. MorrilL

ADDRESS OF WELCOME

By JAMES L. MORRILL
Vice-President, The Ohio State University

Mr. Chairman, members of the Institute, and friends: It is pleasant always to greet old friends and to welcome new ones. It was my privilege three years ago to participate in our first Accounting Institute to the extent of a few remarks, and I feel, therefore, all the proprietary pride of a "founding father" in this distinguished and successful enterprise of our College of Commerce and Administration.

Let me convey to you first of all the sincere regret of President Bevis that he could not be here to welcome you, having been called to Washington. Speaking of this coming Institute, when we were at luncheon a few days ago, President Bevis remarked that he felt that the accounting profession had done a great deal to improve public understanding and attitude about the business of accounting. It was his observation at the Graduate School of Business Administration at Harvard University, he said, that the accountants have gone a long way in making more intelligible to the public their concepts, and in relieving themselves of a false public impression of infallibility. People have come to understand, he felt, that accountants are indispensable—not infallible. They have impressed the public with a high sense of fiduciary responsibility.

My own interest in this Institute is not so much in its subject matter, of which professionally I know nothing, as in its significance as another aspect of the growing enterprise of adult education or post-collegiate education. No nation is so thoroughly committed to the ideal of educational opportunity for all as our own. We have come pretty close to realizing what the historian James Truslow Adams characterized as the "American Dream." We have made practical the historical mandate of the Ordinance of 1787 to the effect that "schools and the means of education shall be forever encouraged."

Moreover, we seem to have expanded the meaning of that mandate to an acceptance of the idea that adult opportunity, even at the college level, is a national necessity.

More of our young people are *in* college than *in any* other country in the world—one for every 120 of our population, as compared to one for each 455 of the population *in* Great Britain, which ranks next.

The rise of state universities like our own is specially significant. In a recent study covering the 208 leading institutions of higher education in this country, public and private, 547,000 students were listed—approximately half of the nation's total. Fourteen per cent were in the private colleges, 38 per cent in the private universities, and 48 per cent in the state universities. But in the ten-year period ending in 1938 and covered by the study, private colleges and universities had grown 4 per cent in enrollment as compared with an increase of 25 per cent in the state universities.

It is not surprising, therefore, that President Conant of Harvard should have said not long ago that "during the next century of academic history, university education in this republic will be largely in the hands of the tax-supported institutions; and as they fare so will fare the cultural and intellectural life of the American people."

We in America are committed not only to educational opportunity at the college level, but we are engaged increasingly in "keeping on learning."

Statistics compiled by the American Association for Adult Education show that in 1924 something over 14,000,000 men and women were engaged in some recognizable and identifiable type of adult education. By 1938, the number had grown to nearly 28,000,000.

Here again the state universities, democratic in philosophy and responsive to the needs of the people, are pre-eminent. On this very campus last year there were some 67 institutes, conferences, and adult-education meetings of one kind or another, which brought more than 100,000 men and women to this campus, by actual count, to learn or to teach us something* Doctors and dentists, engineers, journalists, farmers, business men and industrialists, policemen and firemen, trade association executives—these were some of the types of those who came to the University to keep on learning and to keep abreast of the latest knowledge in the field of their professions and vocations. The Ohio State University has sensed this social challenge of adult education. We are still groping in our attempt to discover how best to meet it. My own interest in this Institute I ask you to share in the sense that your meeting is another contribution to this developing American enterprise of adult education. We welcome you as partners and as pioneers. We are anxious to deserve your cooperation.

Mr. Charles F. Kettering, noted automotive engineer and a graduate of this University, spoke on our campus last week. "The trouble with this country," he said, "is not, as many people suppose, an over-production of goods—but rather an under-production of ideas." It is the task of this University, as an agency of learning, to produce ideas. In attempting to meet this challenge, you share with us, and we welcome you gladly to this campus.

CHAIRMAN MACFARLAND: Way back in the stage-coach days, a man had to take an extended trip, and he wanted comfort. So he went to the stage ticket office and asked for a first-class ticket. After he had been on the stage coach a few hours, he happened to think that everyone seemed to be having the same comforts as he. He called up to the driver and asked, "What's the difference between a first, second and third-class ticket?" The driver called back, "Don't you know?" "No!" "Then wait and see." Soon they came to a steep hill, and the driver called through the window, "Second-class passengers get out and walk I Third-class passengers get out and push!"

In accounting circles, if anyone got a first-class ticket, it would not be our speaker. He would get a third-class ticket, so he could get out and push. I am not going to try to tell you what he has done. It is not all easily read, but it is all very sound business. Perhaps he is best known for his books and for his editorship of accounting handbooks—constantly producing in the interests of better accounting. With another distinguished teacher, he has just written a monograph which is a grand addition to the literature of accounting. Dr. William A. Paton.

ACCOUNTING REPORTS

By WILLIAM A. PATON, *C.P.A.*
Professor of Accounting, The University of Michigan,
Ann Arbor, Michigan

This is a very broad subject. I am assuming that it is my function to do a bit of browsing over the general field this morning, as an introduction for the heavy artillery of intensive discussion to come up later in the day.

I shall confine my comments to the staple periodic statements of income and financial position. These are the primary products of the accounting process, and the effectiveness of the process is to be judged largely by the adequacy of this final product. It is not suprising, therefore, that much of the discussion of accounting principles and procedures in recent years has centered in the subject of financial statements.

The first question is, for whom are financial statements intended? Whose interests are we trying to serve? It has become fashionable to rattle off a long list—management, stockholders, creditors, employees, customers, government employees, general public. This breadth of view is all to the good. However, it is well to remember that there are two major interests: (i) Management—those who run the enterprise; (2) investors—those who put up the money. I am pleased to notice that the program lined up for this Institute gives quite a bit of attention to the use of reports by executives. With all this noise about investors, government, and public, we have been, at times, a little in danger of forgetting management. First and foremost, accounting reports should be an aid to those who are directing the business; operating management is right at the top of the list of those we should serve. If our statements are not useful to management, they will not be much good to anybody.

There is a common notion that management knows the real "dope" in any case, regardless of the kinds of reports we issue. I do not agree. In large, complex enterprises, managers are very much in need of sound statements. The pattern of management's thinking is definitely influenced by the pattern of the general reports issued (I am not forgetting the many minor and specialized statements needed). This means that there is a possibility of management being beguiled by questionable reports as well as a possibility of management being aided by significant, discriminating reports. Managers are just ordinary human beings like the rest of us, trying to do their jobs as best they can. And, just like the rest of us, they can develop lines of thought which are not in harmony with essential conditions and processes, if the reports they read persistently fail to reflect such conditions and processes, or, worse, draw red herrings across the trail.

I am in the mood to throw just a dash of cold water on the importance of reports to stockholders. For years, most of us have been urging the necessity for giving more attention in reporting to the stockholder's requirements—especially those of the transient stockholder. In all of our textbooks we have pointed out again and again that if accounting does not produce sound, realistic periodic reports, the rights of particular classes of stockholders, and stockholders who buy and sell, may be jeopardized. This, of course, is the S.E.C.'s angle. But no good can be served by working up great enthusiasm, great missionary zeal, which is out of line with the actual possibilities. Accounting reports have their limitations in solving the problems that beset the typical transient stockholder, especially in days such as these. I am in favor of improving accounting reports, but I question our ability to save the speculator's "hide" by this means.

For one thing, there is the serious difficulty of securing an understanding of reports, no matter how well prepared and complete they are. This is, in part, a problem of terminology. Accounting terms have a very commonplace flavor, and every Tom, Dick and Harry thinks he knows all about them. Actually, they are seldom understood. I once heard a sermon entitled, "How to Turn Your Liabilities Into Assets." That was the last time I went to church. The concepts of accounting are not altogether simple. Our own thinking is none too clear, and laymen are, of course, still more careless. The recent story about depreciation by Stuart Chase is an excellent example of half-baked conclusions drawn from careless handling of accounting terms and the lack of a clear-cut grasp of account concepts in their relation to financial processes.

One of my former students recently sent me the annual reports of his company, and I took time off to look them over. The income statement and balance sheet did not reconcile; the balance sheet surplus did not tie up with the surplus per income report. I took him to task and we had it back and forth by correspondence. Finally, he fell back on the point that the stockholders couldn't understand the statement anyway—couldn't get anything out of it no matter how it was prepared. Unfortunately, there is a great deal of truth in that position. On the other hand, another student (on whom I had evidently made more of an impression) has recently sent me reports of a small company in Detroit, in which he is making a great effort to tell the stockholders everything.

There is a real problem in equipping the ordinary individual investor so that he can understand accounting reports to an extent which permits the basing of intelligent action thereon. Of course, some stocks are in fairly strong hands. The advisers of many investment trusts are, no doubt, sufficiently acquainted with the accounting lingo, and the concepts and assumptions that go with it, to make something out of reports for the purpose of handling investment portfolios.

Another thing you have to remember is that, as a people, we are speculatively inclined. (I'm not sure that many of us would vote for stability if we could have it.) Given our temperament, and the machinery for speculation in securities, we are *going* to have people rushing into and out of the stock market without paying much attention to accounting reports.

One of the general questions concerning accounting reports that interests me greatly is the period of reckoning. What is a significant period? Business concerns are complex, continuing organizations, and when we segregate the data of a short-time section of such an organization we immediately sever many living threads of connection and find ourselves in debatable areas of determination. Professor Littleton and I tried to emphasize this in our recent monograph dealing with corporate accounting standards. Financial statements at the best must be taken with a grain of salt; they are based on past transactions, yet look to future events for their validation. We have not given enough attention to what is a proper period of reckoning. I suggest that the movement in the direction of short-term reports, which we have all been encouraging for years, has shown a tendency to carry too far. The shorter the period, the greater the difficulty of preparing significant conclusions regarding the business. Monthly and quarterly income reports have been very much in the limelight, and, as a result, we have been growing hypersensitive to minor fluctuations.

How, for example, can a significant report of profits to stockholders per *quarter* be made in the face of a tax on *undistributed annual* profits. (I realize that this type of tax is in abeyance at the moment.) Incidentally, the tax situation has become so complex that I no longer dare attempt to illustrate a realistic tax adjustment in my course in accounting principles.

Even under favorable circumstances the year is none too long a period in which to attempt a profit reckoning. Short-term reports of various phases of the stream of business activity are desirable; I have no objection to daily reports of such data as sales, receipts, and expenditures. With respect to net profits, however, interim reports can be nothing but rough estimates.

I wish it were possible to experiment with a longer period than the year—say, five years. We could do a much better job of reporting income *in* five-year stretches than we succeed in doing for the annual stretch. However, I suppose we are committed to yearly reports, and that it is idle to speculate on the possibility of extending the term. At the same time, we may find it possible to improve the means of showing annual reports in proper perspective.

I am pleased to see the increasing emphasis being placed on the income statement. For a good many years I have been arguing that measurement of income is the crux and dominant goal of accounting. The balance sheet is important, but perhaps accountants generally have been unduly preoccupied with the balance-sheet point of view. At an early meeting of the revised Committee on Accounting Procedure of the American Institute of Accountants, Mr. May brought the point out well when he proposed that we consider "the most important single purpose of corporate accounts to be the determination of periodic income."

Shifting to some matters that are somewhat more technical, I might suggest a few points that have interested me. One of the things that we have generally failed to do is to indicate clearly the basis of valuations in financial statements. Take "cost or market, whichever is lower," for example. Almost never in financial reports can you find the amount of write-down, if any, disclosed. It would be a distinct improvement from the point of view of the importance of the cost basis as an approach to accounting conclusions if any special write-down were definitely shown. Indeed, wherever there has been a sharp movement of prices, at least a parenthetical showing of "market" or "cost of replacement" valuation, whether up or down, would be very informing.

Similarly, in connection with plant appraisals, I feel that it is generally desirable to report the effect of the appraisal—if it must be reported at all—in such a manner as not to obscure the cost data. In the balance sheet, I like a set-up somewhat as follows:

PLANT		
Cost	xxx	
Accrued Depreciation on Cost	xxx	
	—	xxx
Adjustment to Replacement Cost	xxx	
Depreciation Adjustment	xxx	
	—	xxx
		xxx

In the income statement, likewise, I prefer a treatment under which, if depreciation charged to operation is adjusted to an appraisal basis, the net figure be modified by the amount of "realized appreciation," so-called, so that final net profit and earned surplus may be restored to the cost basis.

Some of you may have noticed that I am listed as a dissenter to the bulletin dealing with "depreciation on appreciation" recently issued by the Committee on Accounting Procedure of the American Institute of Accountants. My dissent is based on the point that I have just tried to make. In general, I would like to see the data of plant appraisals reduced to the status of supplementary, qualifying information as far as the principal reports are concerned. I see no objection to placing depreciation on an appraisal basis in the operating accounts, for internal administrative purposes, assuming the appraisal data are carefully compiled and can be assumed to be significant, but I do not like the idea of substituting the appraisal basis outright for the cost basis in the financial statements. At the same time, I agree that in the formal or quasi-reorganization, where the corporation by common consent is making a fresh start, substitution of the appraisal basis for cost, with full disclosure at the point of departure, may be justified.

Our old friend "deferred charges" remains a sore point in financial reporting. Deferred charges cover a multitude of sins. I recall a case of a report issued by an Ohio company in which the deferred charge item, upon analysis, was found to be composed of eight classes of debits—including stock discount, bond discount, organization costs, doubtful accounts, prepaid taxes, and cost of abandoned equipment. The "unadjusted debits" of the prescribed utility classifications years ago set a bad example which has been widely copied.

The striking of intermediate profit balances in the income statement is another questionable practice which is still with us. The showing of "NET PROFITS before depreciation" is likely to convey an unwarranted and dangerous impression. Depreciation is not an optional, take-it or leave-it charge, but an actual cost, based on genuine expenditures of the past, although it is true that there may be room for argument as to the amount which should be recognized in the particular period. I also dislike the showing of "gross profit" after the deduction of so-called "cost of sales." There is no profit, gross or otherwise, until all applicable charges have been deducted. No objection can be raised, of course, to adequate classification of costs in the income statement. I also grant the importance of gross-margin computations in internal departmental reckonings. I am protesting only against the habit of setting up an array of intermediate "nets" in the operating section—broadly interpreted—of the general income statement.

The movement towards the enlarged income statement, running from sales to surplus per balance sheet, deserves a word of commendation. The advantage of this development lies in the discouragement it places in the way of tucking losses and special gains out of sight through charges to surplus or reserve accounts, with no notice of their effect in the general income statement. I am glad to see that an increasing number of important companies are issuing income and surplus statements as a single integrated report.

Perhaps the most important general question facing the accountant *in* connection with the preparation of financial statements is that of the proper means of dealing with business fluctuations. I referred to this question earlier in speaking of the problem of the accounting period, and I would like to return to it for a few moments in closing. What should be the general position of the accountant in this connection? The root of much of the controversy regarding accounting reports is in this area. Among some business men, and a few accountants, there has long been a tendency to assume that accounting includes in its objects the minimizing of the jars and jolts of business operation. In other words, many seem to hold the view that accounting constitutes a kind of rose-colored glass which serves to soften the sharp outlines of business irregularity.

My feeling is that business does have sharp fluctuations and also has more long-run patterns. Like the ocean, it may appear rough or comparatively smooth, depending on one's location and point of view. To the man on the boat, the waves are very large; to a passenger in the air clipper, the surface is fairly calm. It seems to me that it is not the business of the accountant to try to obscure genuine fluctuations. Significant movements should be disclosed to managers and others interested. On the other hand, movements should not be exaggerated; they should be reported in proper perspective.

There are those who believe that covering up the bumps may be justified on the ground that, if affairs are given an appearance of stability, all concerned will react more reasonably, and in the actual situation instability will be reduced. An example of this type of opinion is found *in* the person who argues that even if an insurance company or bank has suffered terrible losses it isn't wise to disclose the condition, as it may arouse *in* many minds such a fear of disaster as will induce action tending towards disaster. This position is not without appeal, but I hardly see how we can build sound accounting on such points of view.

There are a number of common accounting policies in which serious dangers lurk in this connection. One is the deferred charge habit, *to* which I paid my respects earlier. A second is the use of operating reserves. Not long ago, in Detroit, an interesting case came to light in which the monthly reports of a business showed an amazing stability in net profits, at around the figure of $17,000. The explanation was to be found *in* a "reserve for alterations," which showed great fluctuations, and swung back and forth between a debit and credit balance. The manager finally admitted that the business was not really as stable as his income reports showed, but insisted that "things looked much better" presented that way. Even ordinary reserves for insurance may be objectionable in this connection. If a company is so situated that it can afford to forego insurance, carry its own risk, it may be argued that actual casualties, if any, are the only charge which should be recognized. That is, if a concern carries the risk of loss, it has deliberately decided to operate in a setting which is different from that which would be in effect if certain risks were removed through insurance, and in this new setting, it may be contended, irregularly occurring losses take the place of the regular insurance premiums. Is it, then, proper accounting to make the two situations appear the same through the accruing of a reserve? I haven't time to elaborate the argument, but I suggest you ask yourselves this question: Can a possible fire loss, which may never occur, be said actually to accrue? Are particular assets placed in an increasing jeopardy simply because no fire has occurred for a few years? If not, then the credit balance in the insurance reserve is earned surplus which has not been passed through the income account. I doubt if any owner selling a business would be willing to deduct an insurance reserve balance from the value of the existing assets because the buyer contended that such assets had, in effect, been absorbed by an accruing statistical loss.

Another practice which should be appraised rather critically from the point of view I am suggesting is the last-in, first-out inventory policy. However, this is a subject in itself and I haven't time to discuss it here.

The points I would like to leave with you are these: First, there is nothing imaginary about business fluctuations; second, such fluctuations are more sharp in some lines of activity than others; third, accounting reports should disclose, not obscure, on the theory that management and others interested can react more effectively on the basis of realities than on the basis of fairy tales; fourth, annual reports should be supplemented with comparative, average, and cumulative income statements so that the movements of particular periods may be viewed in proper perspective against the background of the long-range pattern of activity.

CHAIRMAN MACFARLAND: Thank you, Dr. Paton, for that splendid talk. I am sure we are all delighted that you talked out loud with us, as though you were in class. As Dr. Paton talked, I thought of this Institute—of how we are gathered here, young and old, to hear a great teacher give a class, and of what that means to us.

A week ago I heard the report of an industrialist who had just returned from Europe. "If the Allies lose the war/' he said, "they can blame it on their failure to adopt American Industrial methods." And I was interested to see an article in *Harfers,* "The War Behind the War," in which the reporter voiced substantially the same opinion as the industrialist. France he let out, and put the blame on England. As he pointed out, one of the several reasons why England is behind us is because they have failed to exchange ideas through association and through conferences. It was particularly interesting to me because he mentioned that they lagged far behind us in cost accounting, in pursuing costs as we have been doing. Certainly that writer was not an accountant; certainly he would commend such assemblies as we have here.

SECOND SESSION

FRIDAY, MAY 17, 1940 — 12:30 P. M.

Faculty Club (Luncheon Session)

Brief entertainment

THIRD SESSION

FRIDAY, MAY 17, 1940 — 2:00 P. M.

Commerce Auditorium

Chairman:

HARRY W. CUTHBERTSON, *C.P.A., President\ Ohio Society of Certified Public Accountants; Partner, Wall, Casset and Eberly, Dayton*

Topic: Accounting Reports for Operating Executives

(a) Production Reports

(b) Distribution Reports

Papers:

C. HOWARD KNAPP, *President, National Association of Cost Accountants; President and General Manager, Clyffside Brewing Company, Cincinnati.*

HOWARD C. GREER, *C.P.A., Vice President and General Manager', Kingan and Company, Indianapolis.* (Paper not available for publication in the Proceedings).

INTRODUCTORY REMARKS

By HARRY W. CUTHBERTSON, *C.P.A.*
President, Ohio Society of Certified Public Accountants;
Partner, Wall, Cassel and Eberly, Dayton

Members of the Third Annual Institute on Accounting: It is a privilege and an honor to be here this afternoon. On behalf of the Society of Certified Public Accountants, I wish to express our gratitude to the Ohio State University and to the College of Commerce for this opportunity. The Certified Public Accountants in Ohio are particularly fortunate to have these opportunities each year.

The first speaker on the program this afternoon is Mr. C. Howard Knapp, Vice President of the Clyffside Brewing Company, and President of the National Association of Cost Accountants. Mr. Knapp's subject is "Production Reports for Operating Executives." It is my pleasure now to present to you Mr. Knapp.

MR. KNAPP: Mr. Chairman. The subject assigned for this afternoon is "Operating Reports for Executives." Mr. Howard Greer, well known to most of you, is to discuss the subject as it relates to distribution, whereas my task is to comment upon such reports with respect to production activities. I desire to take this occasion to express my appreciation and pride on two counts—first, because of being invited once more to appear on the program of this Institute on Accounting, planned and conducted so ably by The Ohio State University; and second, because of the fact that my colleague in the discussion of this subject is an individual as interesting and capable as my good friend, Mr. Greer. I cannot help but feel that your speaker-assignment committee had in mind the matter of balancing the quality of all your sessions, and, for that reason, I was fortunate enough to draw my present "running mate."

OPERATING REPORTS FOR EXECUTIVES

By C. HOWARD KNAPP, *C.P.A.*
President, National Association of Cost Accountants;
President and General Monager> Clyffside Brewing Comfany> Cincinnati

Nearly all of us gathered here are interested in accounting, and I, for one, am proud indeed to be a member of that fraternity. I can think of no greater opportunity for men today than that which awaits them in the field of accounting. During the last thirty years, there have been, of course, tremendous changes in all kinds of business and professional activities. Professional men have always been highly regarded in their communities. If a man were a doctor or a lawyer, he was, and is, considered an outstanding citizen, and, by the very nature of his profession, he must have had a great deal more than an average education in order to obtain the right to practice in his calling. On the other hand, a generation ago, most people who were in accounting, outside of the public field, were called bookkeepers, and, in many instances, if a man were asked as to the kind of work in which he was engaged, and replied that he was an accountant, the chances were that his interrogator would be apt to think that he was putting on the "high hat" in calling his bookkeeper's job by a more high-sounding term than it deserved. All that is quite different today.

There has never been a time when it was so necessary for the chief executive of a business to consult with the controller or chief accounting officer. A generation ago, the head accountant of the company was considered as simply part of the overhead—a sort of mild-mannered, necessary nuisance—whereas today he has a very important role to play in assisting in the planning of the affairs of his company. We have travelled a long distance from the counting houses described so ably by Dickens in his literary masterpieces. The modern office of today more nearly resembles the machine shop of a factory, because of the use of so much mechanical equipment as an aid in the creation and maintenance of records.

We are living in an age in which change is taking place more rapidly, perhaps, than at any other time *in* history. The nature of business, learning, even living itself, is such today that we must be constantly on the alert to take advantage of every new thought and every new idea, in order that our business, or our profession, will not be handicapped through our failure to keep abreast of the times.

To a greater degree than ever before, we live *in* a competitive world. Business management must be provided with more detailed accounting information about the costs of products, the results that will be obtained through different methods of marketing, the speed with which capital turnover may be accomplished, and so forth, if it is to retain for its business its place in a particular field of endeavor. Today, the relationship between the Chief Executive and the Chief Accounting Officer *in* a large or medium sized business is, necessarily, a very close one. The Chief Executive is reliant upon the Accounting Department to provide ways and means of forecasting expenditures, calculating capacity, and showing causes of variations from standard expectations. The basis for management control is accounting information, properly gathered and correctly interpreted. The accounting information must be of the highest type if management is to know the effectiveness of policies. Accounting is, therefore, the foundation upon which the Controller plans the historical record of the business that he is to interpret to management; through accounting, he operates the mechanism of the business.

In making reports for executives, what, then, are the various factors to consider? First, and foremost, the accountant must attempt to look at the problem from the standpoint of the executive. He must visualize himself in that position, and must plan his reports in such a way that the busy executive will be presented with only those facts which show the results of operation, and those which will help to reveal the causes for results that are not in line with normal expectations. It is not enough for the executive to be informed of the results of his company's operations; it is even more important that reasons for those results be reported to him at the same time. In other words, the accountant must anticipate the obvious questions that will come to management's mind, and record the answers to such questions at the time the operating report is made. In a great many ways, the accountant is in a better position than the management to understand the various factors involved in producing a given result. Certainly, the accountant is in a position to know the increase in business necessary to warrant an additional advertising campaign, or the effect on both factory and distribution expense of a partial abandonment of current territory* The point I wish to make is that the accountant, to be worthy of the name, must do something more than merely record financial history. He must know what the results will be if this course, or that course, is pursued. More important still, he should report these anticipated results to management before management is confronted with the results itself. The able accountant is able many times to prophesy to the executive in just what round the "knock out" will occur if "he leads with his chin."

The science of modern business has been helped greatly in recent years through advance ideas in accounting. I desire to comment particularly on two phases of this improvement in accounting technique: (i) Increase in the number of cost factors; (2) budgeting and forecasting procedures.

INCREASE IN NUMBER OF COST FACTORS

A generation ago, it was thought that a fairly good cost job had been done if a product was costed as to: (1) Material; (2) direct labor; (3) burden. In too many instances, even today, such an outline is considered satisfactory. Obviously, no pattern can be laid down for all types of business, as conditions will vary to a marked degree, not only because of the nature of the business or industry, but, ofttimes, because of the differences within the same industry. I have no intention of making a discourse on cost accounting, but I believe that it is impossible to comment satisfactorily upon reports for executives without touching upon the desirability of having as many cost factors as practicable. If we are to make it possible for the executive to put his finger on a weak spot in the results of operation, the task is much easier if the cost factors are broken down. For that reason, overhead is pretty generally considered departmentally, or by cost centers, whereas, a generation ago, the determination of one-factory overhead was, perhaps, the usual rather than the unusual practice. Each item of cost that can be applied practicably to the product, or process, as a distinct item, should be so applied. Only by such a practice is it possible to report to the executive in such a way that intelligent action may be taken quickly.

Materials—Under the general heading of Materials, there may be such subdivisions as are discussed briefly below.

1. Raw Materials
2. Findings, or Direct Supplies

In industries such as the shoe business, important supplies are used that are definitely much more equitably applied direct to the article. In fact, in all packaging industries this is a most important factor.

3. By-Products, as a Credit Item to Cost

In many industries, the by-product recovery from the raw material is a substantial item, and an equitable cost is obtainable only when it is considered as a deduction from the specific material from which it came. Sometimes, the nature of the product will have a bearing on the amount of by-product that results, so that it should be credited to the product cost, rather than as a percentage credit of the material.

4. Inward Transportation, Warehousing and Carrying Charges on Raw Materials

In industries such as cigar manufacturing, tobaccos will be imported, entailing heavy transportation charges, and all tobaccos will be stored for a period of years, undergoing large rental, storage, insurance and tax charges. It is confusing many times for such charges to be included as part of the raw material cost, and entirely fallacious to consider them as part of overhead. The best results are obtainable when such items are classified as a separate element of cost, and applied to the product on the basis of the usage of the material to which they apply.

5. Interest on Investment in Raw Material

In some industries, when materials are owned for a long period of timej because of the necessity of a seasoning process before they are ready for use, such as in the lumber and tobacco industries, it is proper to consider interest on the investment in the raw material as a separate element of cost. Certainly, no equitable comparison of cost is possible if, in one case, a material being carried for seasoning purposes for a period of two or three years is considered at only its raw material cost per unit, whereas, in another case, because of different buying conditions, the material is purchased ready for use, having been seasoned by the vendor with the carrying charges included *in* the material price.

Operating reports to executives will be more valuable if material-consumption records are broken down into some of the subdivisions just enumerated. A report may show that a loss from standard on material has occurred, and yet the purchase price and consumption per unit may be at standard. However, the unit sales price of by-products may have decreased, transportation rates increased, or incoming shipments may have been made by express instead of freight. A breakdown of cost factors will make it easier to discover the cause of variations from standard.

One important division of material cost that must be made under all conditions, however, is the separation of *frice* variation from *usage* variation. Results may indicate that material consumption was at standard, and yet operations may have been anything but satisfactory. A substantial saving in purchase price as compared to standard may have occurred, but faulty usage, not in any manner due to inferior quality of the material, may have offset the price advantage. If the separation of *frice* and *usage* is not made, the executive is entitled to believe from the report that "all is well," whereas criticism of operating results, and even drastic operation changes, may be necessary to increase the profits because of purchase-price advantages. Also, it is most unfair to criticize factory operations if a loss *on* standard in value of material consumption takes place, when usage is at standard, because faulty buying or market conditions, beyond purchasing control, have resulted in payments in excess of standard for materials purchased. On some occasions, it may be that a loss on usage due to a somewhat unsound condition of material will be more than offset by the price-saving made in purchasing the slightly imperfect material. In any event, the report to the executive must indicate the loss on the one and the gain on the other. It will be seen, therefore, that the breaking down of material cost, by factors, to whatever degree may be practical, and certainly by price and usage, is necessary, if the executive is to be supplied with the information that will make possible the most efficient operation of the business.

Direct Labor—Under Direct Labor, whether payment is made on a piecework basis, day work, or incentive plan, it is desirable, also, where practical, to have a division of variation from standard or budgeted figure. Loss or gain from standard may be due to the work having been performed by employees at a higher or lower rate than the standard, or to a greater or lesser number of hours having been used than were called for by standards set by time studies. An operator who takes twice as much time to perform a certain task as another operator causes a higher cost for the product, even though both may be paid at the same piecework rate. He has caused the time elements of overhead, such as rent, taxes, depreciation, foremanship and supervision, to reach a higher cost with him than with the more efficient worker. Therefore, whenever practical, reports to executives should show, not only the comparison of actual direct labor costs with standard and budgeted figures, but actual hours with standard and budgeted hours, as well.

Burden, or Overhead—In my opinion, there is more reason to subdivide burden, or overhead, than either material or direct labor. In fact, I believe that, even for general terminology, the elements of manufacturing cost should be broken down into at least the following:

1I) material
(2) direct labor
(3) fluctuating, or variable overhead
(4) fixed overhead

In order that this discussion may not become too complicated, let us assume that manufacturing expense is either variable or fixed. It is true that we do have some semi-variable items, and, for budgeting purposes, the use of a flexible budget will assign the expected expenditure at various major changes in production rate. The use of the first two items, material and direct labor, will follow almost exactly the trend of manufacturing activity, and, the third, fluctuating overhead, will follow it very closely. The last item, fixed overhead, however, has almost nothing to do with the volume of production. I believe that one of the most important advances made in manufacturing accounting during the last twenty years has been the adoption, fairly generally, of the practice of separating factory overhead into fluctuating, or variable and fixed overhead. Suffice it to say at this point, that production reports to executives that do not recognize this distinction are weak in their most important spot. Fixed overhead, as its name implies, is almost completely uncontrollable as far as a factory department head is concerned, and, usually, is quite uncontrollable as far as management, itself, is concerned. Therefore, there is less occasion for management to check up the factory personnel with respect to such expenditures. On the other hand, it is perhaps the most important item of expense to study from the standpoint of management, as additional volume obtained after a careful study of idle-capacity cost has turned the results of many a company from a deep red to at least a pale black figure on the final P. and L. This point will be alluded to later on in this discussion.

BUDGETING AND FORECASTING EFFECT ON OPERATING REPORTS

Operating reports for executives have undergone a terrific change in recent years. The change has made it possible for business to be conducted along scientific lines instead of by "rule-of-thumb" methods. The most important device used in this transition has been the adaptation of the budget and its connecting links to business. The words "forecasting," "budgeting" and "cost accounting" are closely related. It is impossible to think of the budget without, at the same time, thinking of the forecast, as the basis of all budgeting is the sales forecast upon which the production and most other forecasts are predicated. The compilation of all budgets necessitates, or results in, cost accounting. The origin of the budget dates back to the 18th Century in England, when the Chancellor of the Exchequer's report to Parliament was termed "The Budget," and included a statement of the past year's expenditures, an estimate of the expenditures to be made in the year to come, and a schedule of taxes, together with recommendations for the method of levying such taxes. However, it was not until after 1900 that governmental and institutional budgets found favor in the United States, and the acceptance of budgeting in business did not become a factor until after the publication, in 1922, of the late Mr. McKinsey's book—*Budgetary Control.* It will be seen, then, that reports for executives, comparing facts with forecasted expectations, are of relatively recent vintage.

Prior to the use, in business, of the budget and predetermined cost, operating reports for executives consisted principally of historical records. Management was informed as to what the results for the period had been, *the* comparison usually being with the corresponding period of the preceding year. The budget presents a perfect yardstick by which to measure performances. Operating reports for executives, to be of real value today, must show "what was performed" or "has happened" compared with what "ought to have been done." There must be:

1. Standards for every element of cost
2. Master budgets
3. Flexible labor and expense budgets
4. Frequent presentation of actual performance compared with planned performance

It is impossible to place too much emphasis on the fact that operating reports must be made in such a manner that they will indicate the results attained as compared with what it was thought should have been attained, rather than with operating results of the preceding year. Because of the importance of the budget *in* this plan of presentation, it must be made flexible. In that respect, it will differ from standard costs. The latter will indicate the cost that should result at the expected volume of production, and with prices and rates, as well as efficiency and usage, at a stated basis. In most instances, it is not practical to change standards with each minor change in conditions, and, with the so-called basic standard costs, they may remain at the same figure for long periods. Budgets, however, should be flexible. Particularly is this statement true with respect to operating reports for executives. They should be flexible in at least two ways:

1. With respect to the expense to be incurred at various levels of production;
2. With respect to changes in conditions that may occur during the period for which the budget was set. (This type of flexibility may be called extra or reduced budgetary allowance.)

If operating reports to executives are to be useful, those reports having to do with departmental or cost-center activities must make allowances for all conditions over which the individual responsible for each cost-center activity has no control. Much of the sting of criticism is ineffective if the cost-center head is able to alibi results with such excuses as "you didn't provide me with enough production," or "it's not my fault that labor rates were increased," or "the supplies and machine parts were purchased at a higher rate than the budget rate." The function of the executive is to criticize and correct faulty performance, and to commend and reward a meritorious effort. The function of the accountant is to thoroughly understand this condition, and supply the executive with operating reports that are boiled down to the point where the executive may see, at a glance, the operating results. Also, the executive should be informed *in* such reports of the reasons for departure from predetermined expected performance.

Standards must be set, both for price and usage, on all subdivisions of material and direct labor, and variable overhead and fixed overhead; in other words, for all individual cost factors. As previously stated, greater difficulty is encountered *in* setting standards for fixed overhead than for any of the other major cost classifications. Should fixed overhead be computed on the basis of forecasted production, or on the normal (easily attainable) full capacity of the plant? The solution to this problem may vary, depending upon the nature of the business, whether or not the plant capacity is well in excess of expected production, or whether or not the industry is in a state of depression. It is certain that very little of the available business would be secured if selling prices were based on costs computed on the basis of fixed overhead being applied on forecasted production, when depression conditions indicate that less than half of plant capacity will be utilized. Also, it is true that a new plant, constructed with the idea in mind of a greatly increased production, is at a distinct disadvantage if the entire fixed overhead is computed on the basis of the forecasted production, rather than the easily attainable full capacity. Under such conditions, it is imperative that fixed-overhead standards be computed on normal capacity, with that part of fixed overhead which actual production has failed to earn at standard rates being charged directly to profit and loss as idle capacity.

In my opinion, the ideal method of solving the idle-capacity problem is to compute fixed-overhead standards on the basis of normal (easily attainable) full capacity, and also to compute, for the purpose of auxiliary information, the cost of expected and actual idle capacity. In a great many instances, this may be done with very little additional effort, as illustrated in the hypothetical case shown in Exhibit A.

EXHIBIT "A"

IDLE CAPACITY COSTS—APPLIED TO PRODUCT—1940

JANUARY

	TOBACCO PROCESSING DEPARTMENTS Nos. *20j 30, 45*	MAKING DEPARTMENTS NO. *10 -Large Cigars* Nos. *70-72-SmaZl Cigars*		PACKING DEPARTMENTS Nos. *50, 55, 58*	IDLE CAPACITY COST
Idle Capacity Cost	$1,525	No. 10	$4^94	$1,445	
		Nos. 70-72...	562		Total $8,226
Direct Labor @ Standard	$7>295				
Per Cent of Idle Capacity to Direct Labor	20.9				
Cigar Production					
Department No. 10			IOJ030M		
Department No. 72			3J470M		
Total				i3,5ooM	

Idle Capacity Cost per M

Cigar	PROCESSING *Direct Labor @ Stand, per M*				*PerM*
Blackstone Londres	.678 @ 20.9%	.142	.468	**.107**	.717
Perfecto	814 "	**.170**	.468	**.107**	•745
Cabinet	702 "	.147	.468	**.107**	.722
Junior	600 "	.125	.162	**.107**	•394
Totem	914 "	**.191**	.162	**.107**	.460
Hoffmanella	480 "	**.100**	.468	**.107**	.675

Such a treatment of idle-capacity cost is a good illustration of what I meant earlier when I said that the accountant should attempt to anticipate the various facts upon which the executive will desire information. Under such a plan, there will be reported to the executive, monthly, the cost of idle capacity, broken down by principal products, if need be, and thereby he is supplied with information which may be of value in determining selling policies.

Recently, I have used a refinement of this idle-capacity plan, which I believe is new, and which I believe has a great deal of merit. When standard overhead rates first came into more-or-less general use, a rate was established, applied to direct-labor dollars, or machine hours of production, and the difference between the actual overhead expense and the amount applied *to* production through use of the standard, charged or credited to under- or over-absorbed overhead, on the theory that the month of low production would be offset during the year by months of heavy production, so that the under- or over-absorbed overhead account would be liquidated at the end of the year. Trouble develops from such a plan when actual production does not come up to the figure upon which standard overhead rates were set. There is nothing more disconcerting than to find one's company going into the last quarter of the year with the knowledge that a large under-absorded overhead balance must be liquidated in that crucial quarter because of the fact that actual production is not going to approximate the amount forecasted. Under such circumstances, management may be looking for a "goat," and the accountant is elected, as management very likely may say, "You reported that earnings for nine months were X dollars, and now you find a substantial amount that resulted from our failure to meet anticipated sales during that period, and, therefore, this item, not yet charged off, should have been applied against the profit of that period." On the other hand, there are many reasons why the failure of production to earn actual fixed overhead for some certain months does not justify a charge to P. and L. for the fixed overhead unearned by production in that month. The business may be a highly seasonal one, and some months of the year will be certain to have a comparatively small production, or, the nature of the business may be such that the equipment must be shut down and completely overhauled once a year. In such instances, the production year is the important cycle, and a truer picture is portrayed if allowance is made for those periods of the year when it is expected that production will be at a minimum. The problem is to record the cost of idle capacity in such a way that it will be correctly stated for the year without unfairly penalizing those months when it is expected and planned that production will be curtailed because of repair work and overhauling that must be done if the equipment is to serve in the best possible manner, and, at the same time, using a plan other than the old over- and under-absorbed account, so as to avoid a charge-off at the end of the year of an accumulated under-absorbed balance. Exhibit "B" illustrates such a plan under two conditions of fixed-overhead application; the upper half, when fixed overhead is applied against normal (easily attainable) full capacity, and the lower half, when applied against forecasted production.

EXHIBIT "B"

DEPARTMENT NO. 80

When af plied against 'Normal (easily attainable) Full Capacity

Forecasted For Year 1940			ACTUAL *February*	
		January		*July*
Normal Capacity	*i8o;ooo bbls.*			
Forecasted Production	*150,000 bhls.*			
Fixed Overhead	*$180,000*	$14,800	$14,600	$i5j$oo
Fixed Overhead cost per bbl	*$1.00*			
Idle Capacity forecasted for year	*$30,000*			
Forecasted Sales	*150,000 bbls.*	9,000	8,250	16,500
Actual Sales		8,250	8,250	17,000
Actual Production		6,000	6,000	16,000
Fixed Overhead cost of excess capacity		2,500	2,500	2,500
Fixed Overhead cost of failure to meet sales forecast		750	....	* 500
Total charge to Profit and Loss for Idle Capacity		$3,2^0	$ 2,500	$ 2,000
Fixed Overhead earned by Production		$ 6,000	$ 6,000	$16,000
Over- or Under-absorbed Fixed Overhead...		Dr. $ 5,<I5o	Dr. $ 6,100	Cr. $ 2,500

When applied against Forecasted Production

		January	February	July
Forecasted Production	*150,000 bbls.*			
Fixed Overhead	*$180,000*	$14,800	$14,600	$i5>5Oo
Fixed Overhead cost per bbl	*$1.20*			
Forecasted Sales	*150,000 bbls.*	9,000	8,250	16,500
Actual Sales		8,250	8,250	17,000
Actual Production		6,000	6,000	16,000
Fixed Overhead cost of failure to meet sales forecast (charged to P. and L.)		900	....	•* 600
Fixed Overhead earned by Production		7J2OO	7,200	19,200
Over- or Under-absorbed Fixed Overhead...		Dr. 6,700	Dr. 7,400	Cr. 3>*oo

* Denotes a credit

The Normal Capacity of 180,000 bbls. does not mean a capacity of 15,000 bbls. per month, because it allows for repairing, relining and overhauling of equipment. This work, of course, will be done during those months of the year when seasonal conditions call for a minimum of sales. Forecasted production, therefore, will be well under the average of 15,000 in some months, and well over in others. The calculations on the exhibit assume that the inventory at the beginning of the year is a normal one in quantity, and, therefore, forecasted production will be the same as forecasted sales. The charge to P. and L. is made on the basis of divergence of actual sales from forecasted sales, rather than actual production from forecasted production, because at the end of the year, ordinarily, it will be sales that will affect the actual production. The upper half of the exhibit, indicating fixed overhead applied *on* normal full capacity, shows an easily attainable capacity of 30,000 bbls. in excess of expected production. With a fixed-overhead cost of $1.00 per barrel, we know that excess capacity, based on expected sales, will cost $2,500 per month, and such a charge is made each month to P. and L. Such a charge is unnecessary *in* the example on the lower half of the exhibit, because overhead is applied on forecasted production. I am sure it is unnecessary to explain this exhibit in greater detail, I believe it to be an improvement over the usual methods of handling that part of fixed overhead which production has failed to earn in a certain month. *On* the one hand, it makes *it* unnecessary to face the "day of reckoning" toward the end of the year that must be met under the old "under- and over-absorbed" method when production fails to reach expectations, and, on the other hand, it is not nearly as drastic as the more modern method of charging to P. and L. each month that part of fixed overhead which production has failed to earn. It makes allowance for seasonal periods of business, as well as repair months of production planning without unduly penalizing specific months. It is a report that attempts to reach the executive's viewpoint, rather than the accountant's, and yet permits complete control of the accounting.

Operating reports for executives in a well-managed company, of course, will be numerous. I am indebted to my afternoon's colleague, Mr. Greer, for the following list of "Periodic Reports Reviewed by General Management" in the company of which he is General Manager. I am listing only those reports that have to do with the production end of their business. In addition to reports on live stock that are reviewed daily, the following are reviewed weekly:

Analysis of Departmental Proficiencies, Day Work, Delays, Overtime, etc.
Report of Product De-graded, Re-worked, and Tanked
Estimates of Construction and Maintenance Work Required
Reports on Construction and Maintenance Work in Progress
Report of Cars Loaded and Orders Filled
Analysis of Shortages on Orders Handled
Reports of Production, Shipments, and Stocks on Hand
Comparisons of Budgeted, Actual, and Previous Year's Performance
Reports of Costs, Selling Prices, and Profit Margins by Products
Comparison of Standard and Actual Yields by Products
Estimates of Net Results by Departments

A monthly review is made of the following:

Preliminary Report of Net Results by Plants
Preliminary Report of Main Plant Results by Departments

Final Summary of Net Results by Plants and Branches
Comparison of Budgeted, Actual, and Previous Year's Overhead Expenses
Details of Manufacturing Margins and Expenses by Departments
General Operating Statistics and Comparisons, including Industry Data

As you know, in most businesses, there will be the usual reports, and/or charts, and/or graphs, covering:

Operation Cost Reports
Departmental Performance compared with. Flexible Budgets
Departmental Performance compared with. Standards
Spoilage Reports
Idle Machine Time Reports

Machine Repair Cost Reports, and many others

As a result of careful preparation of such reports by the accounting department, and extensive study of them by executives, American industry, undoubtedly, has advanced to a much higher degree of effectiveness than otherwise would have been the case. Many talks have been made and scores of papers written illustrating reports covering the usual production activities. Most of you know a dozen books where you can obtain interesting information relating to executive reports, covering actual performance compared with a flexible budgeted figure, for instance. For that reason, it has occurred to me that my contribution to this program might be more helpful if, first, the subject were discussed along general lines, and secondly, if the exhibits used applied to something other than budgets and forecasts. I believe the two exhibits thus far discussed have somewhat of an original touch to them.

An experience of a year ago convinced me of the importance of an intelligent presentation of all the facts when reports are made to executives. A company, manufacturing a consumer product, found it necessary to establish its own sales branch in a certain city because it was impossible to find a suitable distributor for that territory. It was definitely a case of "have your own sales branch" or do practically no business there. A branch was established and treated as any other distributor in home office accounting. A loss resulted on the books of the sales branch, because its volume was naturally smaller than most of its competing distributors in the territory who carried a line of products of a number of manufacturers. On the othey hand, a more concentrated selling job was done, as the salesmen working from the sales branch had only on brand to sell. Operating loss of the sales branch was shown as such on the company's monthly P. and L. statement, and, after several months of fairly large losses, some of the directors were all for the discontinuance of the branch because of its operating loss. In order to present the true facts as to whether or not it was wisdom to discontinue sales effort in the particular territory, the loss on the sales branch was asterisked and a footnote made on the P. and L. statement. Exhibit "C" illustrates the footnote. It simply presented to the board of directors what the results would be if the territory were abandoned. A complete change of attitude took place on the part of the complaining directors, and they became enthusiastic as to the advantages to be gained through the aggressive operation of the sales branch.

I believe that the information to be gained from the footnote of Exhibit "C" is an excellent illustration of the "thinking for the executive" that the accountant must do, if he is to perform his function of presentation of executive reports in the most effective manner.

A prominent New York bank created a great deal of favorable publicity for itself, a number of years ago, by publishing its statement in

EXHIBIT "C"

Net Profit, before Profit and Loss Items	$ 10,000
Miscellaneous Profit and Loss Income	800
Interest Paid	* 600
Loss on Sales Branch	* 1,000
NET PROFIT	$ 9,200
Loss on Sales Branch	* $ 1,000
Factory Profit on Sales made by Sales Branch	1,800
Advertising in Sales Branch Territory not Charged to Sales Branch	* 500
Net Profit of Sales Branch, on Basis of Factory Cost	$ 300
Fixed Charges Absorbed in Sales Made by Sales Branch	2,000
Amount by which Company's Profits Have Been Increased Through Selling in Sales Branch Territory	$ 2,300

* Denotes loss

a way which it claimed could be understood by everyone. It simply showed what it owed to depositors, what it had to pay it with, with reference to the time it would take to liquidate the assets to be used in paying, and how much was left over after paying all depositors. It makes a very clear and concise statement, and it has continued to use this type of statement in its advertising for several decades. I was reminded of this bank statement by a form of executive report which was sent to me recently. It is Exhibit "D." It does seem to me that this narrative form of statement has a great deal of merit and will portray a clearer picture to many an executive of what has happened in the affairs of his company, during the past month, than will the usual "cold-figures" statement form. All variations from standard or budgeted expectations are indicated in a way which, I believe, even an executive can understand, and when that is done we can expect greater speed *in* the taking of action to correct weaknesses that may have filtered into operations.

Exhibit "E" is an example of a summary report of variation from

EXHIBIT "D"

....DAIRY COMPANY

Operating Profit and Loss Statement for the Month of ....

Value of Products Sold $286,500
These products, their preparation and their sales should have cost: 235,546
To leave a Gross Profit of .... 5O>954
— BUT —
These conditions changed the costs:
Purchase Prices .... — $948
Milk Losses .... — 361
Volume of Production .... + 584
Control of Labor .... — 860
and Expenses .... — 474
Total .... — 2,059
To leave an Actual Gross Profit of 4.8,895
Delivery Expenses should have been: .... 39>4*o
To leave a Net Profit of 9,485
— BUT —
These conditions changed:
Expenses: Losses on Bottles .... — $34*
Bad Debts .... — 118
Delivery Overhead .... —
Delivery Operating .... — 619
Total .... — 1,078
LEAVING AN ACTUAL OPERATING NET PROFIT OF: .... $ 8,407

EXHIBIT "E"

PRODUCTION COST AND VARIATION STATEMENT

Month — Months, to date

VARIATION	ACTUAL	[illegible] ALLOWANCE	EXTRA BUDGETARY ALLOWANCE	No.	ACCOUNT	ACTUAL	VARIATION
					Materials		
					Price		
					Materials Handling		
					By Product Cr.		
					Usage		
					TOTAL MATERIALS		
					Direct Labor Hours		
					Direct Labor Rates		
					TOTAL DIRECT LABOR		
					Indirect Labor		
					Indirect Mat. & Supplies		
					Miscel. Items		
					TOTAL FLUCTUATING OVERHEAD		
					TOTAL FIXED OVERHEAD		
					TOTAL PRODUCTION COST & VARIATIONS		

Comments

Reasons for Extra Budgetary Allowance

expectations to be made monthly to executives. More detailed reports for each cost center, covering direct labor, and full details of fluctuating overhead will have been made, separating controllable items from uncontrollable items, so that a proper basis for criticism of cost-center head is possible. The variation of fixed overhead will be volume variance to which other volume variances will be added coming from the flexible budget records, and from selling and administration. Reports for executives should be issued solely from the standpoint of presenting the salient points of departure from expected results that have occurred during the month's operations. They should not be issued from the standpoint of what the accountant must do to properly tie in the actual results with his accounts. The accountant should be clever enough to plan such a procedure *in* a manner that will not becloud or confuse the executive viewpoint.

I have attempted to express my ideas on "Operating Reports, for Executives," from the standpoint of production. As previously stated, I have elected to make my presentation along general lines, around a few exhibits, most of which are somewhat off the beaten path. If I have been fortunate enough to develop any ideas that are new to you, or to have added anything to your fund of knowledge on this important subject, I am very happy, and, in any event, I consider it a real privilege to have had this opportunity of appearing once more on an Ohio State University Institute of Accounting program.

CHAIRMAN CUTHBERTSON: Thank you very much, Mr. Knapp. That was a very fine talk.

Our next speaker is Mr. Greer, who used to be Chairman of the Accounting Department here at Ohio State University, and who is now Vice-President of Kingan and Company, Indianapolis. He will speak on "Distribution Reports for Operating Executives."

FOURTH SESSION

FRIDAY, MAY 17, 1940 — 7:00 P. M.

The Faculty Club (Dinner Session)

Chairman:

WALTER C. WEIDLER, *Deem, College of Commerce and Administration, The Ohio State University, Columbus*

Toastmaster:

DR. STUART C. MCLEOD, *Secretary, National Association of Cost Accountants, New York*

Topic: "Published Financial Statements"

Paper:

VICTOR H. STEMPF, *C.P.A., President, New York State Society of Certified Public Accountants; Vice President, National Association of Cost Accountants; Partner, Touche, Nwen and Comfany, New York*

INTRODUCTORY REMARKS

By WALTER C. WEIDLER
Dean, College of Commerce and Administration,
The Ohio State University

This is a very happy occasion for the College of Commerce in general,, and for the Department of Accounting in particular. We look forward to these meetings, and we hope the programs may have a cordial reception. The attendance is so good that it gives us hope that the program is good enough to bring a large group back again another year.

I think I should be remiss if I did not speak for my colleagues in expressing our appreciation of the cooperation you gentlemen have shown. You have supported our ventures, *givtn* us the benefit of your advice, and contributed richly to our programs. I want to thank *in* particular the men who appeared on the program today, and who will appear on it tomorrow. I know how much time it takes to prepare for and take part in an institute of this kind, and I want to assure you that you have made a rich contribution to the life of the College of Commerce and Administration. I hope that all of you will come back to see us again.

Before presenting the toastmaster of the evening, we have a couple of guests whom I should like to present. First, Dr. Alpheus Smith, Dean of the Graduate School and distinguished physicist.

DR. SMITH: I am delighted to bring you the greetings of the Graduate School. We look with pride on the work of the accountants. Of course, physics may seem a far cry from accounting, but physics is connected with engineering, and engineering is connected with business, and business is certainly connected with accounting. And there you have it!

DEAN WEIDLER: The other guest whom I should like to present is Mr. H. D. Defenbacher. (Mr. Defenbacher acknowledged introduction.)

I feel that any introduction of our toastmaster for the evening would be superfluous. Dr. McLeod.

DR. STUART C. MCLEOD (Secretary, National Association of Cost Accountants, New York): Dean Weidler, ladies and gentlemen. Before I go into the gruesome realities of my responsibility tonight, may I take a moment to express to you and your Accounting Department the sincere appreciation of our Association for the courtesies you have extended to us.. It has been a pleasure to work with you in this contribution to accounting, and we shall be very proud to work with you in the future as we have in the past.

Now, I have to approach the realities. At noon today Mr. Miller informed me that my only responsibility this evening was to introduce my friend Mr. Stempf. But they sent me a list of the men whom I am to introduce, and I approach the task with diffidence.

Mr. McLeod introduced the following:

Mr. Robert L. Baughan, C.P.A., Huntington; President of West Virginia Society of Certified Public Accountants.

Mr. Clyde Benoy, Auditor, Motorists Mutual Insurance Co., Columbus; President of Columbus chapter of National Association of Cost Accountants.

Mr. Harry W. Cuthbertson, C.P.A., partner, Wall, Cassel and Eberly, Dayton; President of Ohio Society of Certified Public Accountants, member of jOhio State Board of Accountancy.

Mr. Homer Dalton, C.P.A., partner, Konopak, Hurst and Dalton, Toledo; Past President of the Ohio Society of Certified Public Accountants.

Mr. George W. Eckelberry, C.P.A., Professor of Accounting and Director of the Summer School, The Ohio State University.

Mr. Berl G. Graham, C.P.A., partner, Gano and Cherrington, Cincinnati; member of Council of the American Institute of Accountants.

Mr. Howard C. Greer, C.P.A., Vice-President and General Manager, Kingan and Company, Indianapolis; Past President of American Accounting Association; formerly chairman of Department of Accounting, The Ohio State University.

Mr. John Haskell, Vice President, New York Stock Exchange, New York.

Mr. C. Howard Knapp, President and General Manager, Clyffside Erewing Company, Cincinnati; President of the National Association of Cost Accountants.

Mr. Grant T. Lohnes, Treasurer, National Cash Register Co., Dayton; Past President of the National Association of Cost Accountants.

Mr. George A. MacFarland, Professor of Accounting, University of Pennsylvania, Philadelphia; President of the American Accounting Association.

Mr. H. H. Neel, President and Treasurer, Ewing-Von Allen Dairy Co., Louisville; Vice President of the National Association of Cost Accountants.

Dr. William A. Paton, C.P.A., Professor of Accounting, University of Michigan, Ann Arbor; Past President of the American Accounting Association.

Mr. Maurice E. Peloubet, C.P.A., partner, Pogson, Peloubet and Co., New York; member of Executive Committee of the American Institute of Accountants.

Mr. Abner Starr, C.P.A., Lybrand, Ross Bros, and Montgomery, Cincinnati; Secretary of the Ohio Society of Certified Public Accountants.

Mr. Jacob B. Taylor, C.P.A., Professor of Accounting and chairman of the Department of Accounting, The Ohio State University, Columbus; at present Director of the Department of Liquor Control, State of Ohio;, Past President of the American Accounting Association.

PUBLISHED FINANCIAL STATEMENTS

By VICTOR H. STEMPF, *C.P.A.*
President, New York State Society of Certified Public Accountants;
Vice-President, National Association of Cost Accountants;
Partner, Touche, Niven and Company, New York

WHOSE BALANCE SHEET IS IT?

The *Journal of Accountancy* for May, 1940, carried an editorial which strived again to answer that everlasting question: "Whose Balance Sheet is it?" Stripped of all ambiguity and irrelevance, the question seeks to fix the primary responsibility for the representations made in financial statements. The views of the Securities and Exchange Commission confirm those of accountants; i. e., "The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligation in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."

An appreciation of this principle is essential to understand the fundamental character of published financial statements and the distinct responsibilities of the issuer and the independent C. P. A. relative thereto.

FACT OR OPINION?

Of equal importance is a sound concept of the nature and limitations of accounting, underlying all financial reporting; viz., the simple fact that accounting is *not* an exact science which permits the statistical presentation of the indisputable facts. Although it deals with the mass of facts reflected in the divers transactions of business, accounting assays those facts by the application of judgment and opinion, in order to portray a practical interpretation of the financial position and result of operations of a going business.

For the latest provocative word on that subject, you should read the monograph by Paton and Littleton entitled *An Introduction to Corporate Accounting Standards,* issued under the auspices of the American Accounting Association. These gentlemen, who enjoy great respect in the profession, refer to financial statements as "provisional in character," saying that "impressions gained from them, and decisions resting upon them, may have to be changed in the light of future events, and should be tempered with a knowledge of this contingency." They advocate a stricter adherence to cost as the indispensable basis for stabilized accounting, supplementing such statements with others designed to trace the effects of general price movements upon the affairs of the enterprise. Others advocate the abandonment of cost, and insist that financial statements should be stated completely in terms of "value."

WHAT IS CUSTOMARY ACCOUNTING PRACTICE?

Business practice plies a traditional middle course which recognizes the fundamental concept of matching costs with revenue and, while it ignores market appreciation because it is *unrealized* gain, it does recognize market decline, in the principle commonly known as "cost or market, whichever is lower." This introduces a factor of "value" into certain classifications of the balance sheet, particularly inventories, and, in the views of some, distorts the statement of operations by the injection of this "value" factor into the matching of costs with revenue.

Many accountants favor the movement to segregate such market declines in the statement of operations, but one gathers the impression that Paton and Littleton would ignore them (other than by parenthetical reference), although they would give recognition to losses in respect of obsolete or damaged goods. In discussing this subject informally in the Committee on Accounting Procedure of the American Institute of Accountants, the thought was expressed that the deduction of these latter losses establishes a residual *useful* cost, and that the recognition of determinable market declines in inventory serves exactly that same purpose, the distinction being purely one of degree. In either case, the merchantable value of the inventory has been "damaged," and adjustment for the damage determines a *useful* cost as distinguished from purchase or production cost, without violating the fundamental standard of matching cost and revenue.

This somewhat complex digression serves to illustrate the strong influence which judgment and opinion bring to bear upon accounting and financial reporting.

FINANCIAL REPORTING

Financial statements serve a threefold purpose:

(1) For management: The control and interpretation of operations,
(2) For creditors: A sound basis for credit analysis,
(3) For investors: Adequate data from which to determine whether to buy, sell, or hold securities.

The management purpose was ably discussed by Messrs. Knapp and Greer this morning and we shall hear more on this subject tomorrow from Mr. Peloubet. As to the other two, it should be borne *in* mind constantly that all financial statements, passing into the hands of outsiders, are potentially credit-seeking or investment-seeking statements, and should be reviewed from the standpoint of the responsibilities attaching to such representations before issuance.

ACCOUNTING STANDARDS AND CONSISTENCY

Published financial statements should be prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Consistency of method is viewed, today, as the prime essential of respectable accounting. This does not preclude change, for revisions may be necessary or desirable sometimes, but change should not be capricious, and, when made, should be disclosed, with direct reference to the effect of the revision upon income.

The combination of these two factors does not imply uniformity in the sense of inflexible standards, but relates rather to broad basic rules. Typical of such standards is the recognition of the fact that fixed assets, in fact, are deferred charges to future operations, and that depreciation should, therefore, be provided as an ordinary and necessary element of operations. However, that principle finds many varied applications, each of which may be acceptable in its place, if consistently used.

For example, the prevailing practice in Great Britain is to provide for depreciation on the declining base, whereas in this country we prefer the straight-line method of proportional amortization of the capital sum (in excess of estimated scrap value) over the reasonable, economic life of the asset. The production-unit method is a modification of this practice, giving greater weight to the usage factor than to that of time. Depreciation may be provided on individual units, or on groups based upon average life, in many various ways, any one of which may be appropriate in a given case, if adhered to consistently.

On the other hand, there are unusual applications or, at times, distortions of principle which, if material, provoke criticism. Using simple examples, these may be errors of commission, such as capitalizing certain types of maintenance, or errors of omission, such as the failure to provide for doubtful accounts. The Securities and Exchange Commission has taken the position that disclosure of unusual methods will be accepted for registration purposes only if there be substantial authoritative support for such practices. The rule permits reasonable flexibility while restraining undue departure from the course of ordinary procedure.

Accounting is not static j it seeks to keep pace with the changing needs of industry. Some practices observed or condoned ten or twenty years ago have been found wanting and have been rejected; others have survived the test of time. Thus, the last-in, iirst-out and base-stock inventory methods are finding effective application slowly in pertinent industries, just as the retail method found appropriate acceptance gradually during the last twenty-five years.

Management's outlook is inherently optimistic and courageous. It must be so to get anywhere! On the other hand, those concerned with financial reporting should maintain a searching skepticism, lest they be led to see things not as they are but as they ought to be. Accountancy has always recognized the danger of over-optimism, and one of its elementary precepts has been conservatism, epitomized in the maxim, which seems to have fallen into some disrepute, "Anticipate no profit, and provide against maximum losses." The academic attitude, and that of others who do not bear the brunt of management, involves a peculiar paradox. On the one hand, it seeks greater candor in the disclosure of all material facts; and, on the other, looks askance upon too much conservatism, with the warning that "Understatement may be as bad as overstatement."

The vital question seems to rest on whether the conservatism is reasonable or unwarranted, and here we enter the sphere of judgment and opinion.

The argument that a rule of practice can not be right if it doesn't have a foundation in sound theory provokes the unsound assumption that what *is* good in theory *must* be good in practice. There has been too much emphasis on the importance of meticulous theoretical accuracy of annual profit and loss. The swing in that direction was induced, no doubt, by actual or implied failure to disclose fully all material facts in the past. One may appropriately repeat the acknowledged facts that actual results- of operations can be determined only by final realization and liquidation, that all intermediate endeavors are approximations, bearing in mind that there is a crucial distinction between an estimate prepared with flagrant disregard of pertinent facts, and one which is prepared conscientiously on the basis of deliberate and sound interpretation of facts and circumstances. The latter reflects the purpose and value of practical accountancy.

It is not argued, for one moment, that we should abandon the search for sound modification of accounting procedure which may more closely reconcile abstract theory and common practice, but let us remember that the determination of trends is probably more important to the investor, the true long-pull investor, than the determination of the bottom dollar of annual profit and loss. Nor should we lose sight of the fact that management is far more concerned about its long-range policy and objectives than it is in the opportunist extraction of the last dollar of profit in the current year.

GENERAL OR SINGLE-PURPOSE STATEMENTS

Dr. Paton dealt with many technical aspects of accounting reports in the first session of this morning. All of these have a vital bearing upon the soundness of representations made in "Published Financial Statements." The few underlying aspects which I have discussed are those concerning which the viewpoints of accountants are commonly misconstrued. Much of this confusion involves the wish to abandon the *cost* concepts which govern accounting and to substitute some form of *value.*

There has been much discussion, during the past year, concerning the need for single-purpose statements as distinguished from all-purpose statements. Messrs. Kaplan & Reough discussed the idea in an article in the *Yale Review* of April, 1939, and, *in* the April, 1940, *Journal of Accountancy*$_y$ Professor Brink of Dartmouth dealt with the matter again. In the same issue of the *Journal,* Mr. Charles Couchman presented a very practical and rather amusing discussion of "Realism in Accounting" which demonstrated the impracticability of many of these proposals.

As a matter of fact, the idea of special-purpose statements is not new. Every student of elementary accounting is familiar with the so-called "Statement of Affairs," which shows the balance sheet, stated in book amounts, *in* comparison with amounts "expected to be realized" or "expected to rank," with an added variance column, whereby a receiver may forecast the results of realization and liquidation. Certainly, in the application of standards and budgets for management purposes, such forms are used constantly *in* accounting for variances between bogey and actual. The same practical application of the theory finds expression in financial reports prepared incident to negotiations for the prospective purchase and sale of a business. What is wanted by those who advocate the idea in relation to published financial statements?

Whatever purpose might be served by the presentation of the accounts on a realization and liquidation basis, or any basis other than that of a going business under such circumstances, would be purely academic.

It should be emphasized that published statements normally deal with a going business, which hopes and intends to keep going. The interpretation of fact sought by the stockholders, prospective investors, or creditors of a going business is essentially the same. The needs of these groups differ only in the varying interest they may have in the several classifications shown in the statements; the matter is one of more detail, not one of basic differences in form. All of these groups want more elaboration of material fact. Certainly, those who have the patience and ability to digest the details may get what they want from the registration statements filed with the S. E. C. The basic summaries, balance sheets and statements of surplus and operations, filed with the Commission, do not differ in material fact from those appearing in annual reports to stockholders; the significant elaboration is to be found in the mass of supporting schedules and explanatory notes required by the Commission, and in the narrative section of the registration statement proper.

THE TRANSITION IN FINANCIAL REPORTING

In speaking of the change which has occurred in financial reporting during the past ten years, the afore-mentioned factor of elaboration of accounts is, perhaps, the most striking. The reluctance of management to disclose details (which may be called the "fetish of brevity") was inspired not only by a strong conviction that many financial details are "trade secrets," the disclosure of which would injure the competitive interests of the company, but also by the desire to present the salient features of the accounting in condensed form to simplify the process of digestion. One need hold no brief for either of these viewpoints; like all things, they also involve a question of degree.

The fact that the S. E. C. has recognized requests for confidential treatment supports the conclusion that there *are* cases in which disclosures would be detrimental from a competitive standpoint, and, therefore, opposed to the best interests of stockholders.

Likewise, one does not have to be a Ned Sparks to feel that the majority of stockholders "can't be bothered" to read the financial reports of their companies. I am reminded of a philosophical client in the Middle West, who said, "When I pay my annual visit to my investment banker in New York, the first question is, 'Did you make any money?' When I say 'Yes,' he extends his hand, and says, 'How are you?' "

The magic of that single figure obsesses far too many stockholders, and the evil also permeates the financial columns of the press. An intelligent comprehension of financial statements requires a review of *all* the related facts, and, by all means, a study of the surplus account in relation to the operating statement, as well as a careful reading of the independent C. P. A.'s report. Every now and then one hears the startling and absurd opinion that the very presence of the name of reputable accountants on a report should lend credence to the soundness of the venture. This, again, emphasizes the importance of stressing the fact that the statements are primarily the representations of the issuer, and that the accountant's dissent or exceptions, if any, should be expressed in his report.

It is unnecessary to labor the form which more detailed disclosure has taken in recent years. In the balance sheet, it has resulted in the more consistent application of generally accepted principles of accounting, the elimination of erroneous and illogical condensation of classifications, more careful and detailed descriptions, and more accurate disclosure of the bases of stating amounts.

There has evolved, also, a more candid disclosure of the activity in general reserves, and a sharper distinction between the uses of undistributed profits and capital surplus; these are indicative. In the Profit and Loss Statement, there is found a more general acceptance of the fact that operations are of far greater importance than financial position in gauging the trend of an enterprise. Registration statements require far more detailed disclosure of the elements of profit and loss than was customary in published statements a decade ago, and, with some obvious reluctance, there is a gradual trend in published statements today towards the registration minima prescribed by the S. E. C. In the roaring twenties and theretofore, too many operating statements started with gross profit or sales; relatively few disclosed sales, and, if so, showed a composite deduction of cost of goods sold, selling, general, and administrative expenses. In more and more cases today, these details, and others, are disclosed separately, and significant sub-classifications are shown specifically in annual reports.

It was a common fault in years gone by to omit reference to changes in accounting methods, but reference to such changes is now recognized as generally accepted practice.

In all of these things, the Securities and Exchange Commission has strengthened the hand of public and private accountants in supporting standards which accountancy has championed for many years. Likewise, the profession has enjoyed, for many years, the cooperation of the Committee on Stock List of the New York Stock Exchange, particularly in the person of Mr. J. M. B. Hoxey, the Executive Assistant to that Committee. Mr. John Haskell, serving today as Vice-President of the Exchange, succeeded Mr. Hoxey. He, too, brings to the problem the same enlightened attitude, and accords the profession the same cooperation and support. We shall have the benefit of his views *in* tomorrow's session. In 1930, at the Colorado Springs Convention of the Institute, Mr. Hoxey said: "The need of accurate information for the aid of management is still paramount; but, under conditions of today, the next object in order of importance is to give stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect, and as will put them in possession of all information needed and which can be supplied in financial statements, to determine the true value of their investments. The Stock Exchange desires that financial statements should be fully and fairly informative."

A document of historical and prophetic importance in the development of financial reporting during the past decade, which has been lost in the welter of subsequent material, is the published report of the Institute's Committee on Cooperation with Stock Exchanges, published in 1932, entitled, "Corporate Accounts and Reports." Among other things, the report directed attention to the importance of method, and particularly the consistency of method from year to year, and, in discussing ways and means of improving the existing situation, argued strongly against the selection of detailed sets of rules binding on all corporations of a given class, but recommended that "Every corporation be free to choose its own methods of accounting within broad limits, but require disclosure of methods employed and consistency in their application."

Although the rule of consistency has won general support, and published reports regularly disclose material changes in the application of generally accepted accounting principles, the fundamental precept of disclosure of methods employed is lagging. True enough, there are many annual reports which describe unusual accounting procedure, such as the application of the base stock or last-in, first-out inventory methods, or the production-unit method of depreciation, but, by and large, the surface has been barely scratched. The policy should be fostered by all who have any influence in the field of financial reporting.

FINANCIAL REPORTING AND PUBLIC RELATIONS

In one important respect, the philosophy of single-purpose reporting has had commendable application in an increasing number of annual reports. Investors, labor, potential customers, as well as stockholders, have a real interest, or at least some curiosity, about the operations of industry—Its products, services, problems, and objectives. This interest can be turned into substantial goodwill by a disarming and simple portrayal of these matters. The opportunity merits the attention of all industrial executives and their professional advisors.

The reports of United Air Lines, Borg-Warner, American Telephone & Telegraph, Magna Copper, Greyhound Corporation, Caterpillar Tractor, Diamond Match, U. S. Steel, American Rolling Mills, and Libbey-Owens-Ford are just a few examples of reports which show the skilled hand of public-relations counsel. There are many others which indicate that corporate policies are being turned in the same direction.

The considerations governing the substance of these reports are analagous to those involved in the question of single-purpose statements. In the *Executive Service Bulletin* of April, 1940, Mr. Heacock, the President of Caterpillar Tractor, said, "When preparing to issue our report in 1937, there was not enough corporate experience with respect to employee reports to guide our course. Should *one* report be prepared and issued to stockholders and employees alike, or should there be a separate report for each group? We have been reluctant to expose ourselves to the accusation that we have one story to tell one group and a different story to give another."

Caterpillar has issued single, all-purpose reports for 1937, 1938, and 1939, supplementing the objective of sound employee relationships by a local broadcasting program, which has run the gamut of corporate organization, operation, and finance, with very satisfactory results.

A few of these published reports have missed the public information objective by merely burying the orthodox statements in a mass of photographs; others have gone too far *in* narrative material, *in* my humble opinion, with the result that the grain is hidden in a mountain of chaff, a criticism which is not unlike that leveled against unnecessarily verbose explanatory notes accompanying financial statements. It seems that it would be wise to retain and set apart the basic financial statements prepared in technical form, with due regard to adequate disclosure of material fact, and to supplement these official representations with whatever other material may be wisely pertinent. Incidentally, judging from annual reports, the major utilities are doing a particularly thorough and effective job of this kind.

RENEWED EMPHASIS ON RESPONSIBILITY

Since the enactment of Securities and Exchange legislation, new emphasis has been focused repeatedly upon the joint and several responsibilities of financial officers, directors, controllers, and independent C. P. A.'s. At the same time, there has been a marked awakening of public interest—a realization that reliable accounting requires intelligent, technical direction and improved internal control. This has increased the potentialities of the position of controller; it has stressed the importance of the independence of professional accountants; it has warned management to assay and fortify its accounting and its financial reporting.

The term "internal control" relates to the entire plan of functional 'Subdivision of business, each a foil and check in relation to the others, accomplished through the alloted responsibilities, routines, and approvals required of each in carrying out the transactions of the business, and in creating an intelligible and accurate record. In a narrower sense, accountants use the term in reference to the subdivision of clerical duties in such a manner that the work of each employee is counter-checked by the work of another. The hearings of the S. E. C. on Auditing Procedure, held early in 1939, include a wealth of material on this subject which should be studied with great care. The major need in respect to internal control is that of effectiveness. An ideal routine may be prescribed but may be worthless because it is not observed. No system of internal control can be relied upon satisfactorily without some provision for internal auditing, and, naturally, greater reliance may be placed upon such work if it be conducted by a department which is independent of the accounting department. Similarly, the independent C. P. A. should undertake sufficient review and testing of the prescribed system to ascertain its effectiveness and to satisfy himself as to the degree to which he may rely upon it in determining the method and extent of his own sampling and testing of transactions. The work of both the Controller and the independent C. P. A. is expedited by effectively operated standards and budgets. These are the life blood of internal control, for variances flash the warnings which invite investigation and remedial action.

Recent trends clearly evidence a determination to strengthen the position of the controller. The New York Stock Exchange and the profession advocate increasing his responsibility, authority, and facilities. The report of the Committee on Stock List, promulgated in August, 1939? suggests active interest on the part of Boards of Directors in his selection, and recommends that he report to the Board. The controller's functions should not be combined with any other incompatible function nor should it be subordinated to any other. The right man in the position is entitled to a place on the Board, and on the planning committee of any well-organized corporation. Although he may report to the President, he should be directly responsible to the Board and should be dischargeable only by that body, to assure a maximum of independence in his position.

Proxy notices of many of the large corporations this winter indicate an increasing consideration of the proposals to strengthen the position of external auditors, through election by stockholders or by nomination by the directors, with subsequent approval by stockholders. The direct election by stockholders seems to be meeting with considerable opposition; the stockholders of General Motors, just two weeks ago, defeated the proposal by an overwhelming majority. It is needless to argue the pros and cons of this proposal at this time. It seems far more practical for the Board as a whole, or an auditing committee of board members, to make the nomination, and to have the appointment confirmed by stockholders. One thing is certain, the appointments should be made early in the year, by

Board action, to assure effective contact throughout the year, affording opportunity for observation and checking of procedures and details at various times, and a more deliberate cooperative planning of both external and internal auditing.

It is difficult to avoid discussing the recent extensions of auditing procedure which have such an important bearing on sound financial reporting. However, so much has been written on that subject in recent months, and is *in* the course of preparation *incident* to the regional meetings of the American Institute, that it will suffice to point out that the early appointment of external auditors and the adoption of natural business years will expedite the more effective observation of physical inventories. Increased use of reliable perpetual inventories, subjected to staggered physical count, should be fostered constantly in the interests of economy and accuracy. The inherent hazards incurred by management and all others concerned in financial reporting are minimized if fiscal years are fixed at periods when the validation of inventories is simplified, and when other complexities are at a low ebb. These factors alone, if clearly appreciated, will inevitably accelerate the adoption of natural business years.

CONCLUSION

Great hope for the evolutionary improvement of corporate accounting practice and the simplification of financial reporting lies in the consistent, aggressive, and cooperative effort which is being devoted to the subject by accountants in academic, private, and professional practice. Those in the respective fields may not always agree with each other along the path of progress, but the continued interchange of ideas, academic studies, the research in progress in the American Accounting Association, the American Institute of Accountants, and the National Association of Cost Accountants will bear fruit inevitably. The constant plea must be for evolution rather than revolution.

Accounting standards, like the law, keep pace with the requirements of changing business needs. Chester T. Lane, General Counsel of the Securities and Exchange Commission, has said, "Laws are the product of public demand for the codification of standards evolved by the public conscience; and the articulate members of interested professions are the most potent force in the crystalization and codification of those standards."

FIFTH SESSION

SATURDAY, MAY 18, 1940 — 10:00 A. M.

Commerce Auditorium

Chairman:

BERL G. GRAHAM, *C.P.A., Member of Council, American Institute of Accountants; Partner, Gano and Cherrington, Cincinnati*

Paper: "Audit Reports for Management"

MAURICE E. PELOUBET, *Member, Executive Committee, American Institute of Accountants; Partner, Pogson, Peloubet and Comfany, New York*

Paper: "Current Trends in Accounting and Auditing Methods of Companies Listed on the New York Stock Exchange"

JOHN HASKELL, *Vice President, The New York Stock Exchange, New York*

INTRODUCTORY REMARKS

By BERL G. GRAHAM, *C.P.A.*
Member of Council, American Institute of Accountants-,
Partner', Gmo and Cherrington> Cincinnati

Members of the Accounting Institute: I wish I had the gift to express adequately my appreciation of the opportunity to preside at one of these sessions. My friends in the profession have given me many honors,, and this is not the least.

We had talks yesterday on accounting reports for management, from the standpoints of both distribution and production. This morning, our subject for discussion is "Audit Reports for Management." I cannot resist the temptation to give a few of my own conceptions on audit procedure as distinguished from audit reports themselves. To me, it seems the main purpose of audit procedure should be to place the auditor in a position to formulate an opinion or make up his mind on the financial position of a company and on the results of operation for a given period. Also, it should place him in a position to formulate opinions as to the adequacy and effectiveness of internal accounting control. These principles have been constantly applied from year to year.

Another thing—it should place the auditor in a position to act in an advisory capacity to management as to general business policy, especially on problems arising from rapidly changing tax laws. I rather imagine from the title of his paper that it is about this second purpose that our first speaker will talk.

There has been a slight change in the program. Mr. Mathieson is ill, but we have been fortunate in obtaining as a pinch-hitter Mr. Maurice Peloubet, a member of the Executive Committee of the American Institute of Accountants. Incidentally, this is the committee that does all the work^ Mr. Peloubet is past-Chairman of the Board of Examiners of the American Institute of Accountants. He has been on various committees in the last few years, and is now Chairman of the Committee on Membership. Without further ado, it gives me pleasure to present to you Mr. Maurice Peloubet.

AUDIT REPORTS FOR MANAGEMENT

By MAURICE E. PELOUBET
Member, Executive Committee, American Institute of Accountants; Partner; Pogson, Peloubet <md Company, New York City

As there are, broadly speaking, two types of audits *in* which the management of a company is interested, there are, naturally, two types of reports—those from their own internal auditors, and those from their independent auditors. The reports of the internal auditors are mentioned first, not because they are necessarily more important, although this often may be so, but because the nature and coverage of the internal audit have a definite and, in some cases, almost a controlling bearing on the type of audit and report made by the independent auditor. It is always easier and more pleasant to deal with ideal situations than with actual conditions and, while we may know that the ideal condition seldom or perhaps never exists, it is, nevertheless, useful to have it before us as a sort of gauge, which may be applied to actual conditions to let us know whether the differences between the ideal and the actual are within the limits of a reasonable tolerance, or well beyond them.

The ideal situation *in* a corporation large enough to warrant the employment of a staff of internal auditors would be for the internal audit staff to report to an official who would be designated as the chief accounting officer, and who would report directly to the Board of Directors. This official, who might be designated as controller, or some similar title, would not himself keep or be immediately responsible for the keeping of the company's records, except in so far as to prepare statements from data drawn from such records. The internal audit staff would consist of men of approximately the same training and caliber as that of the seniors and juniors on the staff of a practicing accountant. Audit programs would be more specific and definite than those generally found, at the present time, in the office of a public accountant, as they would deal with repeated audits of the same companies or departments. They would not be so specific and definite, however, as to limit the initiative of the internal auditor or prevent him from distributing his time to the best advantage where conditions not foreseen when the audit program was prepared were brought to light.

Unless the internal audit staff were very small, the internal auditors would be assigned to different companies or departments from time to time, rather than kept continuously auditing one branch of the organization. Probably, most large companies that employ staffs of internal auditors have some such ideal as this in mind. Few achieve it completely, but many approach it quite closely. We can all, from our own experience, think of good and bad examples.

Naturally, as in most auditing work, the results are expressed in reports, but these reports are generally constructed somewhat differently, as I think they should be, than the report of the independent auditor. In the first place, they are addressed to a technically-trained accountant, whereas the report of the independent auditor, while it may be read by some officials who are technically-trained accountants, must be so constructed as to tell its story to the official who has not had such training. Generally, the report of the independent auditor comes to the notice of others than officials and directors of the corporation, and, even if the independent auditor's report is not intended to pass beyond the limits of the company, it must always be written on the assumption that it may. With the internal audit report, this is so exceptional that, for all practical purposes, *it* may be disregarded.

It is quite possible that the internal audit report, at times, may be of more significance to the management than the report of the independent auditor, and it is for this reason, in addition to the fact that the independent auditor should make extensive use of the internal audit report, that the accounting profession has a direct interest in the form and content of internal audit reports.

Since these reports go to a technically-trained accountant familiar with the affairs of the company, they contain, properly, much detail which would be quite out of place in the independent auditor's report. The internal audit reports should contain either a statement of the audit program with the extent and nature of the work done under each item indicated, or it should contain a list of the books and records examined, with the nature and amount of the work done on each. Generally, a complete statement of any errors and discrepancies discovered should be made. Even though these may be small *in* amount, they should be stated *in* detail, as the smallest error might be indicative of a weakness in the system, or, where such uniformity was prescribed by the company system, of a lack of uniformity.

Pay-roll errors of a few cents might lead, conceivably, to the discovery of fraudulent substitutions of rates, or the inclusion of bills of large denominations in a petty cash fund might indicate either that the fund was excessive or that it was replenished temporarily for the auditor's benefit. Some of these indications might not be apparent to the internal auditor himself but would be significant to the official under whom he was working and who had all internal audit reports before him for comparison.

It is not customary, I believe, *in* most internal audit work to check IOO per cent of the work on most company records. It is, therefore, particularly valuable to the official in charge to know exactly how much work is done and just what periods have been covered. Many details of this nature, which would be considered, by the independent auditor, appropriate for inclusion *in* the working papers only, and which would affect the report only indirectly as a basis for general recommendations, should be shown in detail in the internal audit report. The internal audit report should cover, with considerable particularity, the way in which records are maintained; that is, neatness, legibility, care in handling and preservation, and similar details which are generally considered beyond the scope of the report of the independent auditor, but which might be vital to the official to whom the internal auditor reports.

Any work done by the internal auditor in the way of physical check of inventories, inspection of plant additions, confirmation of receivables, or any check, confirmation or verification beyond that covered in his notes 'of clerical work done under the audit program, should be set forth in detail. The internal auditor in making his report is under no compulsion to be interesting, to present only significant facts, to present facts in an order which will give the correct impression or to exclude facts which are immaterial or of no significance. The independent auditor, however, must consider all these things. The internal auditor may follow, therefore, a comparatively rigid form in his report and may include many matters which would be covered only in the working papers of the independent auditor.

A good and complete internal audit report should contain a fairly extended section on personnel. The internal auditor, besides satisfying himself of the integrity of the various employees whose work he is checking, should state his opinion of their fitness for the work they are at present doing, their general attitudes and, possibly most important of all, their capacities for advancement or lack of it. As a rule, this analysis of personnel is confined to those closely connected with the accounts, but it may extend beyond this occasionally, where employees and officials have direct and important connection with the accounts. The value of this section *in* an internal audit report can hardly be overestimated. The higher accounting officials cannot know well every employee in each branch of a large corporation. The internal auditor must know quite well the men he is working with, if he is to carry out his duties satisfactorily. Obviously, internal audit reports must not be available to the employees of the accounting department, if the auditor is to express his opinions on personnel with the freedom which is necessary to make this section of the report as useful as it should be.

As a rule, the independent auditor should receive copies or summaries of the internal audit reports, and these reports should be available to the directors and executive officers of the company. However, not many directors or officers will be able to read intelligently such a technical report, nor will they wish to do so. The controller, or other officer in charge of internal audit work, frequently will wish to make special reports to the directors or officers covering either the general status of the internal audit work or special points which these reports bring out. Where reports of this type are made, the controller will do well to follow much the same methods of presentation as those outlined for independent auditors' reports.

Besides the usual periodical internal audit work, special investigations may be made occasionally for the purpose of improving or unifying the system, uncovering defalcations which have come to light otherwise than through auditing means or which are suspected, determining the advisability of purchasing property, or for other purposes for which special accounting investigations are made. Here, the reports of the internal auditor will be much more detailed than those of the independent auditor, as it is his duty to state what work he has done and how he has done it, as well ias to state his conclusions and opinions, which, generally, is all that is required from the independent auditor.

The forms of the reports of the independent auditor are as various as the persons to whom they are addressed and the purposes for which they are prepared. There are, however, two general classes of reports, and the first thing to do in reporting on any piece of work is to decide which of these types is required. These might be called the "conclusion report" and the "description report." The "description report" might be further subdivided into the concise or summarized report and the comprehensive or encyclopedic report. As a rule, "conclusion reports" are not of great value to management, but are designed more for the use and information of third parties. They are usually of financial rather than operating significance. Published accounts, annual reports to the Securities and Exchange Commission, reports for credit purposes, and reports to trustees under bond indentures are examples of "conclusion reports," Here, the auditor, in effect, states either that everything is satisfactory, *in* accordance with generally accepted accounting principles or with some particular instrument or agreement, or he points out where and to what extent the accounts are not in agreement with such principles, but he does not give any basis for his conclusions, nor does he describe by what method he has arrived at them. In the "description report," the auditor tells what he has found, what he has done, and, frequently, why he has done it. Such reports frequently are of great value and significance to management. They are designed, usually, to be read by men not technically trained in accounting, but who are either familiar with or interested in the enterprise reported on. For this reason, the first consideration in preparing the text of the report should be to eliminate in so far as possible language or statements of a technical accounting form or nature, and, although this is not entirely possible in statements, it should always be borne in mind that, in a report of this nature, the less technical a statement is and the more nearly it is designed along the lines on which an operating man thinks, the more useful it will be to management, and the more likely that its story will be fully understood.

I think everyone will agree that it is easier to prepare a complicated statement than a simple one, partly because, in preparing a simple statement, some definite point of view must be adopted and there must be some definite point which it is intended to bring out. In a complicated statement, which is perhaps nothing more than a transcript or an analysis of an account, this selection and determination of a purpose is not required, and, where there is no special purpose in a statement, the lack of it is clearly evident. For example, a statement of the differences shown by a detailed comparative balance sheet for two years would be quite easy to draw up, would be fairly complicated and would present no clear picture or definite point to the reader. Such a statement of differences, however, with a little additional information, could be arranged in the form of a statement of cash receipts and their application; it could be made into a statement showing the disposition of the increases and decreases in current assets; *it* could be made to show where and how funds were realized which were expended on plant and equipment or other fixed assets; or it could be arranged to show increase or decrease in investment of stockholders or creditors and in what assets this increase or decrease lay. There are, of course, other points which could be brought out by rearrangement and possibly a little amplification of the differences shown by the comparison of detailed balance sheets at the beginning and end of a period. The principal point is that a mere statement of the differences, although mathematically correct and balanced, and containing all the figures used in the other statements, would be unintelligible unless it were rearranged and interpreted.

In order to make such a rearrangement and interpretation for the benefit of management, the auditor must decide what points are important and how they should be brought out. It is a mistake, generally, to try to bring out more than one point in one statement or table. If there is more than one point which should be illustrated by the same figures, it is better to make two statements or tables than to make one table and try to describe the two points. It is a good idea to keep in mind the old colored man's method of finding a mule: A number of men had spent some time looking for a stray mule. They asked the old colored man to help them and, in a very few minutes, he returned leading the mule. When they asked him how he was able to find the mule so quickly, he said, "Well, I sat down a minute or two and thought to myself, if I was a mule, where would I go, and that's where I went." Without making any invidious comparison between the subject of this anecdote and management, I think the first thing for an auditor to do when he prepares the text of his report is to sit down and ask the question, "If I were an operating man, what would I want to know?" He should make a great effort to divest himself of his acquired accounting technique, and to put himself in the place of the man who is interested in facts described either in ordinary language or in the technical language of the trade or industry.

It is necessary, and usually not difficult, to acquire the vocabulary of the trade or industry on which we are reporting. In our own practice, we have several clients who are printers, and I remember quite clearly some of the struggles which we had in learning the language of that fascinating but somewhat exotic trade. It was quite an effort at first to remember that "imposing stones" were not so-called because they were large and impressive architectural adornments made of marble or limestone, but were so-called because they form a flat bed on which type can be leveled. I remember, also, being somewhat confused when I heard the linotype operators talking about matrices (mattresses). I realized later that they had nothing to do with providing the operators with opportunities for occasional cap naps, but meant merely the plural of matrix. We can all think of numbers of odd technical terms which we have come across, but we should remember that they are odd only because they are unfamiliar to us. No matter how strange they sound, they are the most familiar and ordinary terms to the people working in the industry, and it is our job to learn their language and to express our conclusions in their language rather than to expect them to learn ours. Also, I am inclined to think that, frequently, the technical terms of different trades and industries are somewhat more picturesque and attractive than the rather dry and abstract language of technical accounting.

Without spending too much time on this point, I would recommend to anyone who is interested in language to think over the technical and trade terms used in an average machine shop, and to notice the color, force and brilliance of the metaphors which are used as ordinary trade terms by the machinists and mechanics, who, I think, often recognize these qualities in them unconsciously, although they, of course, seldom express any such appreciation consciously.

Besides arrangement, emphasis is of the greatest importance in an auditor's report, and is the most useful help to management in deciding on the importance of facts brought out or recommendations made. There are several cheap and unpleasant means of emphasis which are more or less self-defeating and, generally, should be avoided; such as, the use of superlatives, underlining, improper use of capitals and the like. The best and most legitimate method of emphasis is by position, and this, of course, follows, to a large extent, the ordinary rules of composition and newspaper work. The first and last parts of the report are the most emphatic, the first being the most emphatic and the last probably coming next, except where the text is of great length.

These points have been treated, of course, at some length in a number of excellent books and articles, but it is still worth repeating that, when the managements of enterprises pay several hundreds or thousands of dollars, or even more, for reports, they should be entitled to as good an arrangement and as clear a description as is found in an item *in* a newspaper, which costs only three cents or five cents.

Literary excellence can hardly be attempted or guaranteed, but it is not unreasonable to expect force, clearness and logical arrangement—qualities which are within the reach of anyone who is literate and understands his subject—in a report prepared by a man who claims to be a member of a learned profession. The comprehensive or encyclopedic report is intended, usually, for the use of the accounting officers, and, while it does not contain as detailed a statement of the audit work done as an internal audit report, it is generally even fuller in its accounting features. Such a report should contain a detailed schedule supporting each item in the balance sheet and profit and loss account, most of which should be comparative. If the report covers a consolidated balance sheet, schedules should be included showing the book figures of the constituent companies, the method of consolidation, and adjustments resulting from or incident to consolidation. In such a report, it is neither necessary nor desirable to try to make the schedules particularly striking or interesting. No one will use such schedules unless they have some definite purpose, and, as long as they are clear and properly referenced, completeness and accuracy are the principal requisites. In our own practice, especially for larger clients, *it* is found desirable, often, to prepare both a short descriptive report and a completely comprehensive one. The actual mechanics of preparing a comprehensive report are discussed in several books on accounting and auditing. Here again, the client is entitled to the best efforts of the auditor in the preparation of the report as well as in the detail work leading up to it.

The value of good auditing work frequently is obscured by careless, inexpert, or incomplete reporting. While it is quite true that what the auditor has to sell is ability and integrity, the only tangible evidence that he possesses such qualities or that he has exercised them for the benefit of his client is, often, the report, which frequently may be read and used by men who have no acquaintance or contact with the auditor. It is for these reasons that the importance of audit reports, both to the client and to the auditor, can hardly be overemphasized. Fortunately, as I said before, we are gradually building up a literature on this subject, although it is one of the later developments of the profession. The general subjects, however, of clearness, emphasis, arrangement and proper form of presentation have been the concern of brilliant writers and thinkers for many years, and a knowledge of the general works on these subjects, and particularly a good acquaintance with the writings of the best publicists, essayists and political writers from the beginning of the 18th century to the present time, should be considered an indispensable part of the equipment of the man who wishes to practice accountancy in a truly professional spirit.

CHAIRMAN GRAHAM: On behalf of the members of the Institute, Mr. Peloubet, I want to thank you for your excellent talk.

Depending on the time allowed, we may have time to discuss these papers. However, this will be delayed until after the next paper.

What has been said about the brevity of reports reminds me of a story. I had been in public accounting but a couple of years when I did a job for two men who had bought out a company and incorporated to manufacture lathes. I prepared a very elaborate picture of the results of the first year's operations, on paper 17 by 18 inches. I showed profit and loss, cost of goods sold, etc., etc., and it was all neatly ruled, at the expense of a great deal of labor on my part. Proudly, I showed it to the president. He looked at it and said, "I don't know what to think. What is it? What's the answer?" "Why," I said, "You made a substantial profit for a new company. There it is down in the corner." He tore off the corner, put it in his vest pocket, and said "Thanks." Since then I haven't had so much trouble finding paper the right size to make reports on.

Our next speaker, Mr. John Haskell, is going to speak on the subject of "Accounting Requirements and Their Effect on the Stock Exchange." Mr, Haskell is a graduate of West Point—Engineers Corps, class of 1925. He resigned to go with the National City Company, and later became connected with, the Stock Exchange, of which lie is now Vice-President. It gives me great pleasure to present Mr. John Haskell.

CURRENT TRENDS IN ACCOUNTING AND AUDITING METHODS OF COMPANIES LISTED ON THE NEW YORK STOCK EXCHANGE

By JOHN HASKELL

Vice-President, New York Stock Exchange, New York City

When I first received the invitation of the College of Commerce and Administration to attend this Institute, I did not know what phase of the subject of accounting was to be suggested as the theme for my paper. In accepting the honor as a representative of the New York Stock Exchange, I warned *my* hosts that I was *not* an accountant and that all I hoped to be able to contribute to the meeting would be comment on some of the recent trends which we laymen in the administration of the Exchange have observed in the accounting and auditing methods of listed companies. These companies, as a group, represent the leadership of American corporate enterprise, not only from the point of view of their size, national interest and widespread public ownership but also from the point of view of their reports and other business practices.

Many new accounting and auditing procedures recently have been the subject of wide discussion in professional and accounting circles and have come to public attention at stockholders' meetings of particular companies. A birdseye view of the extent of the acceptance of these practices by companies listed on the New York Stock Exchange is now available from information which hundreds of companies have given the Committee on Stock List since last January.

FINANCIAL STATEMENTS AND MARKET VALUES

I hope such a survey will be of as much interest to you as the topic first suggested—"Accounting requirements and their effect upon Stock Exchange operations"—which I have found too imponderable to tackle. There is no ready measure of the effect of accounting requirements and financial reports to stockholders on the market for a particular security, or upon stock exchange operations as a whole. The Stock Exchange is not one but many markets, and financial reports are but one of numerous factors that affect these markets from year to year and day to day.

Mr. Hancock, Chairman of our Committee on Stock List, speaking before the Accounting Clinic at Northwestern University School of Commerce in Chicago last month, referred to the futility of thinking of an annual report as giving any adequate basis for future evaluation of securities in a changing world, where every factor of the industrial life of the nation and many factors of world affairs will affect future results. Mentioning a few, he stated:

> Obviously, no one may know what character of competition will arise from present competitors, and still less from those later to come into the field. . . . No one may know whether the corporate management will have the fibre, the toughness, if you will, to face future difficulties as they arise. No one may know the strength or the capacity of management to influence people in general, the officers of the company, the supervisory staff, the great body of employees and their spokesman, the customers through advertising and public relations work, the industry through its trade association or other form of group activities or conventions. . . . No one may foresee the changing public taste toward the company's products, nor the resourcefulness of the management to meet that changing taste. No one may measure the effect of future patents secured by others, nor the probable value of reseach work to protect the company against these changes. No one can foresee the extent of future legislative and regulatory body acts. No one can be certain about the time taken from management for defense instead of building. No one may measure the changing political philosophy of the day, the attitude of future administrations toward business, changes in tariff, labor laws or taxes,—and yet unless a man considers all these problems and several more he cannot pretend to have a basis of judgment as to the future of the company, and still less can he have any judgment or even any basis for judgment as to the future value of the company's securities.

The debacle of 1929 taught us many things. Among the false theories that should be debunked by now is the concept that future values can be determined by projecting reported past earnings "raw-so" into the future.

THE MODERN ANNUAL REPORT

Recognition of the limitations of financial statements has not deterred the Committee on Stock List, and should deter no one genuinely concerned with the interests of investors from demanding the highest standards of competence, ability and professional skill to obtain a fair, informative and understandable disclosure of the position of the company and the results of its operations. Despite their limitations, such statements are the foundation upon which evaluations of the future must be built.

Management and the accountant are not interested merely in the extent and detail of the narrative information and the financial statements contained in the report to stockholders. Stockholders would be poorly served if, as an extreme example, they were provided with copies of all the books and accounting entries of the company and its subsidiaries during the year and the correspondence relating to each business transaction. It is the duty of management to assemble, evaluate and condense its records in intelligible form, and it is the duty of the accountant to provide an independent check that the financial statements are presented on the basis of sound accounting principles, so that the results may be available in understandable form. A bulky document, bristling with statistics, may obscure more than it discloses. Even if the disclosure is all there, points of special interest and value to the investor may be lost in a maze of schedules and voluminous footnotes. It is a much harder task, and calls for the exercise of much thought and judgment, to present the type of simple, straightforward report which is the indicated preference of the public today.

Many leading corporations are recognizing this public demand and, with the help of an attractive format, readable type and the use of succinct narrative, charts, photographs and color to supplement the key financial statements, are turning their reports from cold, complicated documents to living messages which are readable and get not only into the stockholder's hand but also into his head.

There has never been a year when annual reports to stockholders of listed companies have shown such an outstanding improvement in form and readability as in 1939. This improvement in exterior form and readability has not been at the expense of substance. In most cases, progress in both form and substance has gone hand in hand. Archaic accounting methods and uninformative financial statements are incompatible with the spirit of progressive management's open approach to stockholders and the public.

ACCOUNTING RESTRICTIONS

But, to leave reporting and come back to the theme of accounting and auditing. The stockholder cannot see every book of account and entry. He sees only whatever pertinent information an enlightened management can give him in the narrative, supplemental data in the report; he must look to the financial statements for historical information as to the position of the company at the end of the year and the results of its operations for the period. These statements speak in the language of accounting, for none other has been devised to reflect the myriad operations that make up the flow of a company's business. It is important to all of us who are sincerely interested in the future of all business and the strength of our national economy that accounting, this living language of industry, be truly expressive and not a bastard dialect. Since, to serve its purpose, it must be a living language, generally understood and intelligible, it cannot be shackled by rigid regulations and restrictions. Like any living creature or art, it cannot be choked; it must be free to live and grow.

I believe that most practicing accountants and students of accountancy who have had occasion to examine reports of railroad companies, prepared under the rigid, detailed requirements of the Interstate Commerce Commission, will agree that they are archaic in form and not based on accounting principles which, *in* all respects, are considered most sound and generally accepted today. When the Exchange, in 1933, adopted the requirement that financial statements in listing applications and reports to stockholders be audited by independent public accountants, it made a special exception for railroad companies, who pleaded that their reports were already subject to most extensive regulation by the I. C. C. Rules of the S. E. C. also exempt railroads from this requirement. As a result, we have available today a clear example of the difference in reports resulting from two opposed philosophies, as applied to accountancy: The industrial companies' accounting methods reflecting, with few exceptions, the ever higher standards developed with the aid of a profession jealous of its integrity and ability to reflect conditions of a changing world with free initiative; and the outmoded principles underlying the detailed static form of most railroads.

Decades ago, when railroad reports were first set up to reflect the detailed categories established by the rules of the I. C. C, they probably were considered models of disclosure based on accounting principles then generally accepted. But the shackles of these rules, designed with the best of intentions, seem to have thwarted improvement for so long that, in most cases, the reports are as obsolete as the old style day coach. There are hopeful signs, however, that accounting officials of the railroads and the I. C. C. are now exploring ways and means to improve the usefulness of these reports. It may serve other valuable purposes, but I do not believe that the average railroad report can compare, either as to informativeness or as to the soundness of the accounting principles on which it is based, with the independently-audited report of a listed industrial concern.

With the example we have before us of the long-term effect of such rigid detailed standardization of accounting forms and principles in the case of one great industry, all who are deeply interested in the integrity of future reports may well fear any tendency to extend this type of regulation to other fields.

DISCLOSURE OF ACCOUNTING METHODS

There is nothing new in recognition of the fact that restrictions and standardization of accounting methods will stifle progressive, evolutionary improvement and the adaptability of the art to meet new conditions. In September, 1932, the Committee on Cooperation with Stock Exchanges of the American Institute of Accountants included the following recommendation, among others, to the Committee on Stock List, at the time that both bodies were studying the form of requirement for independent audits:

To make universal acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance, and, within the limits of such broad principles, to make no attempt to restrict the right of corporations to select the detailed methods of accounting deemed by them to be best adapted to the requirements of their business; but

(a) to ask each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to be a guide to its accounting department; to have such statement adopted by its Board so as to be binding on its accounting officers; and to furnish such statement to the Exchange and make it available to any stockholder on request and upon payment, if desired, of a reasonable fee;

(b) to secure assurances that the methods so formulated be followed consistently from year to year and that, if any change is made in the principles or any material change in the manner of application, the stockholders and the Exchange shall be advised when the first accounts are presented in which effect is given to such change;

(c) to endeavor to bring about a change in the form of audit certificate so that the auditors would specifically report to the shareholders whether the accounts as presented were properly prepared in accordance with the methods of accounting regularly employed by the company, defined as already indicated.

The *five* broad principles of accounting specifically referred to in this recommendation long since have been generally accepted. The usual type of auditor's certificate for some time has expressly stated that the financial statements are presented on the basis of accepted accounting principles, consistently maintained, or has specifically referred to any deviation therefrom which materially affected the results.

Only recently, however, has a step been made in the direction of having listed corporations file a statement of their principles of accounting with the Exchange for the information of stockholders and the public. Last September, the Committee on Stock List recodified and simplified its requirements for listing applications. As part of this revision, a section of the application is now provided in which the corporation describes its business, financial and accounting policies. Theories of depreciation, depletion, amortization and the rates employed as to major categories of property are described. Methods of evaluating inventories and of making adjustments to the lower cost or market are disclosed. The term "market" is defined as to whether it means replacement market, with allowance for any decline in the price of basic commodities in finished goods and work in process, or selling market, with allowance for selling expense. The methods of computing cost of goods sold, i. e., the basis of average cost—standard cost; last in, first out; first in, first out; etc., are explained. Principles of consolidation employed are indicated along with other financial and accounting policies which are important in the light of the particular character of the business or industry. For instance, in the case of the aircraft manufacturing companies, methods of accounting for the customary heavy experimental and development expense are described in this section of the application.

This new section of the New York Stock Exchange listing application does not purport to be a complete statement of all accounting methods employed by the corporation in the same detail considered with the Committee on Corporation with Stock Exchanges in 1932, but it is designed for the same general purpose. Incidentally, copies of listing applications are sent to the newspapers, all members of the Exchange, financial institutions, securities commissions and educational institutions, and are available to any member of the public upon demand.

Disclosure of accounting methods, coupled with requirements for special notice of any subsequent material change in method, seems a better objective than standardized accounting. For the intelligent individualist, disclosure is sufficient 5 for those who demand that someone do their thinking for them, the dictatorship of regimentation is inevitable.

THE WAR AND FINANCIAL REPORTS

In 1931 and in 1933, as a result of growing exchange restrictions and restraints on foreign trade and financial transactions, the accounting profession found it necessary to change certain methods of accounting as to foreign exchange items, both *in* balance sheets and in profit and loss statements. The outbreak of war aggravated this situation to such an extent that it appears that the financial statements of subsidiaries in many foreign countries previously consolidated *in* the reports of American companies must be deconsolidated.

When we had no actual war or economic warfare and the stream of trade and finance flowed freely between the different peoples of the world, it was obviously proper to consolidate the financial statements of subsidiaries the world over. With the growth of trade barriers, currency restrictions, national self-sufficiency and finally war, the hope of a consolidated world economy has faded, and some accounting methods of consolidation which were valid a few years or even a few months ago are no longer appropriate and must change to reflect the hard realities of the torn world.

In December of last year, the New York Stock Exchange sent a letter to the Presidents of listed corporations, calling their attention to the need of recognizing the effect of war conditions in financial statements included in reports to stockholders. With its letter the Exchange forwarded a copy of an Accounting Research Bulletin of the Committee on Accounting Procedure of the American Institute of Accountants with respect to foreign operations and foreign exchange. The war again illustrates the necessity for keeping accounting methods free and flexible so that they may adjust themselves to quickly changing conditions and best serve their purpose.

ACCOUNTING FOR STOCK DIVIDENDS

Another matter which has been the subject of considerable study by the Committee on Stock List, and which was referred, not long ago, to the research group of the American Institute of Accountants, is that of the accounting for stock dividends and shares issued as compensation or under option. The Institute has had this question under study for several months and I do not know what recommendations, if any, will be made on the subject, much less to venture an opinion as to what extent present listing requirements of the Exchange may be modified when this study is completed.

As far back as 1929, the Exchange recognized the danger to security holders, and the larger economic inflationary repercussions that might arise from the practice of issuing "stock dividends" purporting to represent earnings which were not adequately accounted for on the books of the issuing corporation, or taken up on the books of a recipient company at an inflated value. Companies' listing agreements with the Exchange prohibit a recipient company from taking up on its books stock dividends at a value greater than that at which they are charged against earnings or earned surplus by the issuing company. As a matter of policy the Exchange does not list stock issued as periodic stock dividends when charged against earnings on the books of the issuing company at an amount less than combined capital, capital surplus plus the amount of any substantial uncapitalized assets.

The term "stock dividend" is itself confusing if not misleading. No special problem arises in the case of a large so-called stock dividend which is really in the nature of a split-up of stock and clearly recognized by the public as such, but where regular periodic small stock dividends are declared, it is natural for stockholders to expect that they have been earned. The heart of the accounting phase of the problem is what should be the measure of the charge against earnings for the period?

Similar, in some ways, is the problem of accounting for stock issued either as a bonus or under option as remuneration to officers or employees. Where the stock is paid out for services, what amount should be charged against earnings—the market value of the stock at the time that it is issued, or the par or book value as shown *in* the financial statements? Since, today,, most companies have established the par or stated value of their stock at a few dollars a share, having no relation to its fair or market value, is it fair to charge earnings with only the stated or even the book value and disregard the existing market value? On the other hand, is it good accounting to recognize ephemeral market values on the books?

The problem has wide ramifications, and all that can be done at this time is to state that its existence is fully appreciated, and hope that the accounting principles involved may be clarified sometime in the near future.

NEW AUDITING TRENDS

Enough for current trends in reporting and accounting, observed from the vantage point of the New York Stock Exchange. Let us look at some new developments in another related field—auditing procedures. As far as the general public is concerned, auditing has been until lately an orphan angle of the accountant's work. One who is not a member of the profession instinctively recoils from having much to do with it. Perhaps it is better that this is the case, for there is no phase of the work of the auditor that is more difficult to standardize, or which depends, to such an extent, upon the professional skill and proficiency of the practitioner.

The public has been more interested in the exterior form of reports and even accounting methods than in the mysteries of audit procedure. When the Stock Exchange suspended dealings in the securities of McKesson & Robbins on a rainy morning in December, 1938, and Donald Coster, alias Musica, sent a bullet through his head a few days later, public interest in this phase of the accountant's work suddenly developed. During most of 1939, professional bodies, state and governmental agencies and publicists devoted hours of time and reams of paper to deliberations, reports and recommendations on this topic. I am sure you are all familiar with the recommendations which have been adopted by the various professional societies. A special sub-committee of the Committee on Stock List also reviewed its policies and general auditing and accounting procedures, and submitted a report which was adopted by the Exchange last August.

This report was addressed specifically to three aspects of auditing: First, extensions of scope and methods of audit practice; second, means by which the limitations which necessarily exist in audits could most effectively be drawn to the attention of stockholders through the auditor's repoi t or otherwise; and, third, changes *in* related corporate procedures which might improve internal checks and facilitate the work of the independent auditor.

Time does not permit my going into any detail with respect to the views outlined in the Exchange's report on the first two aspects. As to the first—extensions of scope and methods—the Committee emphasized that the accounting profession and business both had every reason to extend audit procedure to the limits of practicability and reasonable economy. The

Committee did not endorse the proposal widely discussed at the time—that the audit of independent public accountants should embrace a detailed examination of all transactions. The Exchange believes that most companies are run honestly and the huge expense which would be saddled on all corporate business for the detection of occasional misrepresentations or defalcations by the few would be an economic waste to the investor and the public. In other words, attention was directed to the qualitative rather than the quantitative character of the independent audit. As to the second aspect—the means by which limitations which necessarily existed in audits could most effectively be drawn to the attention of stockholders—the Committee urged a program of general education of the public in the significance and necessary limitations of financial statements and audits. It also recognized the value of cooperating with the accounting profession to develop the most consistent, unequivocal and illuminating form of auditor's certificate which could be devised.

Study of these first two aspects has developed a program of extensions which the accounting profession itself has actively pursued. The third—the formulation of changes in corporate procedures to improve internal accounting and facilitate the work of independent auditors—is recognized as partaking more of the nature of business policy than professional development. It is a field where the support of the Stock Exchange and managements of listed corporations can be most appropriate and productive.

Let us look at the particular recommendations which the Committee made, in this field, to business, as represented by companies listed on the Exchange. First of all, it should be underlined that these recommendations have not been adopted as requirements. They were made as suggestions subject to their applicability in particular cases. It was the purpose of the Exchange to endorse three proposals and to test their worth in the practical proving ground of industry. Those which prove sound and practicable will undoubtedly receive public support and be adopted as listing requirements. Those which appear unworkable or in need of revision will certainly be re-examined, and if any seem inappropriate to the interests of investors, they will be dropped.

The first of these specific recommendations was for the strengthening of the position of the independent public accountant. It was suggested that this might best be accomplished through the general assumption by Boards of Directors of direct responsibility for either the appointment of auditors or for their selection and recommendation to the stockholders for approval. The selection of auditors by a special committee of the Board of Directors, composed of directors who were not oificers of the company, was suggested where practicable.

From information received up to a few weeks ago from 347 listed companies, it appears that 87 per cent now select independent public accountants by either the Board of Directors, by a special committee of directors, by stockholders, or by directors with the approval of stockholders. Unusual methods, such as the selection of auditors by creditor banks, were reported by 2 per cent. In the case of only 3 per cent of the companies were the accountants appointed by an executive officer of the company. The remaining 8 per cent gave no clear indication of their present practice. These figures speak for themselves.

As part of its recommendations for strengthening the position of the independent accountant, the Exchange suggested his appointment early in the fiscal year, the making available to the Board of Directors the results of his examination, the addressing of the certificate to stockholders, and the affording him of an opportunity to appear at any stockholders' meeting.

The second specific recommendation was directed to increasing the responsibility, authority and facilities of the controller or internal auditor. To achieve this, the Committee suggested that his responsibilities should be fixed by the Board of Directors and that he should report periodically to it, in addition to making his customary reports to the operating management.

Almost half of the companies who informed the Committee of their practices have an officer who is called a "Controller" or a "Comptroller." Many others have one Vice-president, or other chief accounting officer, whose duties are similar to those usually performed by the Controller. In only the smaller companies is there much evidence of a combination of the duties of the chief accounting officer with those of the Treasurer or other operating official. Of some 181 companies which referred to the point, 177 indicated that the Board of Directors now took an active interest in the selection of the Controller, and the 4 others planned to do so.

Many companies have recently taken steps at board meetings or annual stockholders' meetings to define more clearly the responsibilities of the Controller, either by resolution or by by-law amendment. Of 130 companies which advised the Exchange of their policy in this connection, 105 stated that the responsibilities of this officer were now defined by the Board or ^'n the By-Laws; only 15, by the President or other executive officer; and the remaining 10 in some other manner.

A suggestion that the Controller himself sign the financial statements contained in the report to stockholders, even in annual reports where the statements are accompanied by the opinion of the independent public accountant, has not had the same general acceptance as the recommendation for defining his powers and responsibilities 5 77 companies indicated that the chief accounting officer signed or would in the future sign financial statements; 29 indicated that the statements would be signed by some other executive officer; 13 followed other practices; 9 indicated that they did not plan to have the Controller sign; and 219 companies did not state their practice. From a check of 1939 reports published in the last few months, it appears that the financial statements of only 12 per cent are signed by the Controller or some other officer or director.

The Controller's signature on the financial statements is largely of symbolic significance. It does not relieve the President and Directors of their own responsibilities. To the extent that this recommendation results in raising the issue of the necessity for a responsible and independent Controller, it should help progress. The fundamental purpose of all these methods of procedure with regard to the Controller is to obtain integrity and efficiency in the system of internal accounting and control.

The final recommendation of the report was for the adoption of the natural business year of the industry in which a company is engaged as its fiscal year. For many companies, the natural business year coincides with the calendar year. In those cases where it does not, it is obvious that a fiscal period which more truly corresponds to the annual flow of the company's business would make for better annual reports. Adoption of this practice should tend to spread out the huge peak of audit work which now occurs in the early part of each calendar year, and, in many ways, permit a more efficient and economical audit. There is nothing new in this recommendation. It has been sponsored by the accounting profession for many years, and by the New York Stock Exchange, as far back as 1936. Many companies are engaged in several businesses with different natural years, and others feel that the calendar year is their natural fiscal period. Nevertheless, we see many indications that the trend towards the natural business year by industry is growing among companies listed *in* the New York Stock Exchange.

To summarize, a large majority of listed companies have indicated general agreement with the principle that independent public accountants should be selected by the board of directors or by other representatives of the stockholders independent of the operating management; with only slightly less unanimity, it appears that the authority and responsibilities of the controller or chief accounting officer are being recognized and defined; and widening consideration is being given to the adoption of the natural fiscal year.

In the field of accounting it appears that the profession is more than ever alive to its responsibilities to the public, but there remains much to be accomplished in the way of educating security holders to the limitations of financial statements.

In the field of reporting, we are seeing a vast improvement in the form and readability of corporate reports to stockholders.

To conclude, I would like to leave this thought with you. Many changes have taken place in the last few years in auditing, accounting and reporting techniques and in business and financial policies. Now should be the time for consolidating these advances for the test that our economic, no less than our social, order faces today. Even if our tools are far from perfect, the signs of the times tell us to sharpen them and get to work.

CHAIRMAN GRAHAM: I think those of you who are students of accounting might as well realize the truth, of the last statements made by Mr. Haskell. The practitioner does owe responsibility to the public. In fact, everyone seems to be his boss. I have often thought that if I ever had the money to retire, I should like to go down to Florida from the 15th of February to the 15th of May and spend the time raising the devil with my public accountant for not getting my income-tax report done.

DISCUSSION

QUESTION: Mr. Peloubet, I wonder if you would give an opinion on the relative amount of time entailed in taking tests of accounting procedure and internal control?

MR. PELOUBET: That is a difficult question, because it is hard to distinguish between whether internal control is being checked or internal auditing work is being done. For instance, checking vouchers is doing both things.

QUESTION: But which should be emphasized more?

MR. PELOUBET: The primary purpose of internal audits is to satisfy ones self that the system of internal check and control is working. To a certain extent the auditor is interested in whether proper accounting principles are carried out, but that is subsidiary. He is there to see that what has been laid down is carried out. It is not his duty to criticize the system or the accounting principles that have been set up, but rather to find out whether they have been followed.

QUESTION: May notes receivable from old accounts be shown as current assets?

MR. PELOUBET: That is so obvious I suspect a trick. I don't see how it could be a current asset. Current assets are collectible within a year. If, in your judgment, it will be paid within a year, it is a current account. I know of one company, for instance, that gave three months' notes at intervals, and constantly renewed them. We did not put them in current assets, because we knew the circumstances. The assumption is that notes will be paid when due, but circumstances may alter the case.

SIXTH SESSION

SATURDAY, MAY I 8, I 940 — 12130 P. M.

University GolfXUubhouse

Informal Luncheon — No Program

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