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of

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BEFORE THE AUDITOR COMES

Sometime ago somewhere I ran across an article entitled "Before the Doctor Comes." It gave advice on the subject of keeping well. More especially it undertook to instruct laymen how to care for those afflicted with illness or injuries while awaiting the doctor's arrival. You as controllers have charge of the accounting of many large corporations and you control that accounting before and after the auditor comes. But your case differs from that of the layman and the doctor because you are as expert in the accounting field as is the auditor or the certified public accountant. Moreover, you have a first-hand knowledge of the patient's daily habits that is far more intimate than can be obtained by the auditor. Another of your jobs is to detect symptoms of trouble at the earliest possible moment and to prescribe corrective measures. For these reasons you can properly be expected to take better care of your patients than the unskilled layman. Rather your position is like that of the house physician whose work and diagnoses are subjected to review and check by a consulting specialist.

Recent events have turned the spotlight on some weak spots in the body corporate. The implication of slipshod control and superficial inspection that some will draw must be corrected convincingly and as quickly as may be. It is not enough to provide a sedative or a palliative or to amputate the offending members. What must be done is to determine how many diseased members there are. They will require thoroughgoing general physical and mental examinations. I do not believe that such examinations are going to reveal an epidemic. Rather, I believe that most of those examined will be found to be fundamentally sound. But there have been enough of these cases, so that a general examination is indicated.

The problems of corporate accounting and auditing which are posed by recent cases are, like the problems of a general physical examination, too difficult and too extensive to be discussed fully in one evening or even one week. What I would like to do tonight is to express some thoughts that have come to me while dealing with both sound and ailing corporations in our laboratory. Some of these I may have expressed before. None of them are new discoveries.

The modern corporation has grown so large that it is now necessary for those who seek to direct its activities to rely largely, for information about the business, on statistical summaries presented to them. The time has passed when such businesses can be carried in your head. Instead, a complex method of reporting facts has grown up in the form of internal accounting. The modern controller is much like the old fashioned treasurer that I knew in Vermont. He is the center of this information service. He has assumed the duty of putting the corporate life on paper. To do this he has had to develop an internal accounting machine so well poised and so well supplied with checks and balances that the chance of material error, through fault or mischance, is reduced to a minimum. The controller should know whether his patient is sick before the auditor comes. He can take the financial pulse and temperature of his patient. Fundamentally, the investor must rely upon your efforts and may look to the periodic review by independent auditors only as a sort of insurance.

I am not an accountant. And for that reason I can with propriety neither describe nor criticize a system of internal control. The fundamental principal of segregation of duties and responsibilities has so many common applications that its importance in this field is clear. The job of putting that principle into practice by adapting it to the needs and idiosyncrasies of a particular business ranks in my mind as one of your prime duties. It is not too much to say that without an adequate system of internal control, financial statements as we know them are impossible.

The independent public auditor in his yearly or more frequent visit might conceivably start from scratch and get a balance sheet. He might conceivably determine the change in net worth since some prior date. But without an integrated set of records resulting from an orderly and reliable system of recording transactions his result can be no more than an approximation, the degree of error growing larger as the size of the business increases. Even were this possible the expense of such a method would make it impracticable.

The public accountant then must utilize the results of the system. Its importance to his work makes it imperative that he familiarize himself with the methods in use. Only if he has done this and subjected it to an impartial, independent and expert analysis is he justified in accepting its product. Nor does this mean to me merely reviewing the procedures that he is told are in force. His is the duty of determining by actual observation how the patient is faring. He must watch the system work. He must test the paper results it produces against the physical facts so far as he is capable. Unless he has done this, a good part of the value of his services is lost.

As you doubtless know, we have not attempted to prescribe the scope of the examination that is essential for the purpose of certifying to statements under the Securities Act and the Exchange Act. Instead we have relied on the standards announced by the accounting profession and the general sanctions of the Acts and of common law. We have indeed specifically stated that the outside auditor may rely upon an internal system of audit provided he satisfy himself that the system is in good working order. On the other hand, we have asked for a reasonable statement of the general scope of the work he has done. This, however, has been largely honored in its breach. The usual certificate does not disclose what has been done or left undone. In effect it states there has been an audit. From my experience that is about as definitive as describing both elephants and mice as animals, or measles and cancer as diseases. There have been many cases in which the omission of a normal audit procedure has not been pointed out in the statements. After the patient has gone to the hospital the omission has come to light. In more than a few of these cases, following the omitted procedure would have diagnosed the ailment and pointed clearly to the proper remedy. It is a more shocking case to me when, by the terms of a general audit engagement, the auditor has agreed to forego one of these normal procedures. Disclosure in such cases is mandatory. Probably it is also insufficient, for an auditor who agrees not to use some of his tools is like a doctor who has agreed not to use his thermometer or his stethoscope.

We have often had occasion to question whether the work done was adequate for the purpose in hand, but not many of the cases have been reflected in published materials. I would like to outline one of these cases which did lead to a stop order opinion--that of the Monroe Loan Company.

This company was in the small loan business - personal loans of not more than $300, secured by pledges of personal property. Its home office was in Newark, but it had a large branch in Philadelphia. The manager of the Philadelphia branch, presumably in need of money, began to forge notes. He invented non-existent borrowers, approved their non-existent applications, paid himself the face value of their loans, and saw that their monthly payments were regularly made - the latter precaution being necessary to avoid rousing the suspicions of his home office. Since interest charges were 2% a month, the branch manager was, in a sense, losing money on his thievery. At any rate, he had to keep forging new notes to meet the payments on the old forgeries. In a little less than a year, he had 2,000 forged notes out of a total of 2,800 notes outstanding from his office.

The note forger might still be forging notes had not the Monroe Company had occasion to register with the Securities and Exchange Commission. The auditor certifying the Monroe financial statement reported that he had not visited the branch offices of the company, his investigation at the home office having been sufficient to convince him that the finances of the loan company were in proper order. Even when the Commission suggested the desirability of calling on the branch offices, the auditor insisted that he was perfectly satisfied with the home office records. Finally, however, a trip was made to the Philadelphia office and the branch manager's dishonesty was almost immediately discovered. The fact that the 2,000 fictitious applications were all in the same handwriting was in itself a demonstration that something was amiss, So was the fact that the field investigators of the company had not, for obvious reasons, been asked to investigate the financial standing of the mythical applicants. And every payment on the forged loans had been made on or before its due date - a record entirely foreign to the experience of small loan companies with respect to their legitimate loans. Yet by the time the fraud was discovered, the Monroe Company was carrying on its books more than $400,000 of assets represented by nothing more genuine than the forged notes of the Philadelphia manager.

It may have seemed to you that I have overemphasized the mechanical, recording aspect of accounting. This may be due in part to the recent events in which there was both a failure of the internal system to reject or bring to light faulty transactions and failure on the part of the auditors to discover that the system and its results were to a very material degree unreliable. But in a broader sense, it cannot be denied that the controller is the man who holds the key to sound corporate accounting. It is his system upon which adequate corporate reporting ultimately rests. The auditor, of course, plays a significant role. But he is only the periodical check-up man. There are several groups at the moment who are endeavoring to tighten up the standards of auditing practice and we have seen in the past few days some promising results of these efforts. That is essential, as I have indicated. But it is only one part of the job.

It appears to me that many of us have come to overemphasize the importance of the audit. For many stockholders, investors and others the very word, "audit", has become infested with some sort of magic. Audited accounts are too easily accepted as correct accounts. One tends to forget the limitations upon even an auditor.

What we need, it seems to me, is a return to the recognition that the primary responsibility for proper accounting rests on the corporate management in the person of the controller. Whether the books are audited or not, the stockholder has a right to look to the corporation's own accounting system for an adequate, intelligible and honest reporting of its affairs. Unless in its daily bookkeeping the corporation recognizes a responsibility to stockholders and investors, the most conscientious audits lose much of their meaning.

The business of keeping track of a corporation's financial life and financial health, however, requires a good deal more than the establishment of adequate mechanics for recording events. If the data accumulated is to be useful it must serve to convey information to those who study it. In this sense it is a language. And unless, like a language, it employs uniform definitions and is based on uniform principles it has not attained the greatest possible value, either to the management, or to those on the outside who seek to compare the results of different years or the results of different companies.

To me one of the most surprising facts about present day accounting is its lack of a reasonably well formulated body of basic principles, or axioms, or hypotheses. The answer that I have been given over and over again upon questioning public and private accountants on this point is that such a body of principles is implicit in accounting and that many principles are so well accepted that expression and adoption of them in written form is not necessary. I do not believe that this is the fact. Instead, when I press the point I find considerable disagreement as to what is an elementary principle. And there is very little agreement as to what is the proper principle to be applied in situations which are admittedly elementary.

In practice, it is not too much to say that I do not believe there is a single principle, however elementary, for which there is not also a clear violation on record in our files. Let me cite a few examples.

In a balance sheet filed with us some time ago a cash overdraft was shown as an asset, cash in bank, and to make the books balance accounts receivable of twice the amount of the overdraft were left out of the statements. These statements were certified by an independent public accountant, although not a certified public accountant. Furthermore, the entire registration statement was signed as is customary by the chief financial officer of the company. Possibly an overdraft is a cash item in the sense that deficit is a surplus item, but I question whether cash in bank by any stretch of the imagination can be said to include cash not in bank.

In another case the full amount of outstanding bonds was shown as long term debt. In addition a current liability for the amount due under a sinking fund requirement was set up and offset by an asset entitled "amount required to be deposited in sinking fund." Again, a consolidated statement was built up by eliminating only the par value of the subsidiaries' stock and carrying the entire surplus at acquisition to consolidated surplus accounts. In another case a reserve was provided for losses on investments by increasing the investment and crediting a reserve therefor.

Turning to the profit and loss statement you will find a well known company that included dividends on its own reacquired shares as income in its profit and loss statement. Another company took no depreciation in a particular year because it had taken too much in previous years! And if further evidence of uncertainty is desired, one need go no further than to cite the storm of comment and criticism aroused by the publication by Messrs. Sanders, Hatfield and Moore of their "Statement of Accounting Principles".

These cases are confined to instances as to which nearly anyone would agree, in the abstract, there ought to be complete agreement. When questions are presented which involve two or three of these elementary principles, the discussion which ensues is seldom confined to an analysis of the new and uncertain factors in the case, but on close study is found to stem from unexpressed disagreement as to some of the so-called fundamental or elementary points.

Not only do we find disagreement as to principles, and violations of what we are assured are principles, but we are also constantly confronted with different principles to be applied according to the purposes for which the statements are to be used. It is not uncommon, if we criticize depreciation allowances, to be told that the amounts taken for income tax purposes are wholly excessive for general financial purposes. In other cases, the opposite view is taken. Sometimes we are told that the particular practice followed in the statements is necessary *because* it is required by the taxing officials. Indeed in one case a tax law permitted depreciation to be taken as a deduction from income only in the amount shown by the taxpayer's books. But we were told that a very large part of that allowance should, for financial purposes, be charged to paid-in surplus and not deducted in the periodic profit and loss statement. Much the same sort of differences, and arguments, are found in comparing reports to us with those to state regulatory commissions. Some of these differences may be justifiable. Some may not be eradicable without statutory changes. But neither of these arguments holds true when the comparison is between annual reports to us and annual reports to stockholders.

Between these there can be no fundamental difference in purpose. Both are for stockholders and investors as such. Both are designed to give stockholders and investors information as to the current progress and current position of the company. Taking them by and large, an observer from Mars might be struck by their general similarity and wonder why they should not be substantially the same. And except for condensation to fit the scope of the annual report to stockholders there would not seem to be any basis for differences.

Yet the results of a study made by members of our staff, and corroborated by a recently published article*, show that this is not the case. As controllers, one of your functions is the preparation of financial information for transmittal to the securityholders of your company. The very existence of this Institute testifies that you are alert and willing to accept responsibility. I think the responsibility for the quality of financial reporting to stockholders must in large part be placed on your shoulders and for that reason I want to dwell for a moment on some of the defects which our study has revealed. The examples I have chosen are entirely selected from the reports of nationally known listed companies.

In the first place, statements are often omitted which I think are ordinarily essential. Individual statements for a parent, the company in which after all the securityholder has invested his money, are conspicuous by their absence. I do not mean that such statements alone would be sufficient, but to my mind when investments in subsidiaries total large, individual statements for the parent are ordinarily essential. The need for these naturally increases as the minority interests in the subsidiaries increase.

At the other extreme we have a company who files with us a set of consolidated statements including subsidiaries in which the parent had invested some $25,000,000. But in its annual reports there were included only consolidated statements for the parent and one of its subsidiaries in which its investment amounted to some $3,000,000. As is usual, no statements were given for the unconsolidated subsidiaries despite their importanc Another company selected for inclusion in its annual report a balance sheet from one set of statements and a profit and loss statement from a different set of statements.

Even the consolidated statements furnished often have little value because of the omission of information essential to their understanding. Seldom is any indication given either of the basis of consolidation, or of the treatment of intercompany items such as sales, profits, goodwill and the like. Nor is there disclosure of the relation of these statements to the rest of the business enterprise - no information for example as to the profits or losses of unconsolidated companies.

In the second place there are many instances where the statements filed are inadequate in detail or based on different principles. If we look at the structure of the statements themselves, the balance sheets and statements of surplus are not substantially different from those filed with us. Occasionally condensation has gone too far as when land, buildings and goodwill have been combined or reserves for contingencies, estimated liabilities, and depreciation lumped under the caption "Other reserves". True, in one case a reserve for contingencies was not broken down or the changes there in noted although it had been credited with profit on sale of fixed assets and with unrealized appreciation of securities; and had been used as a depos tary for charges ordinarily carried to earned surplus. True also, that the information given us in notes as to the amount of dividends in arrears on cumulative preferred stock or the method of amortizing debt discount is sometimes missing.

* Kaplan & Reaugh, 48 ~~Reagh, 49~~ Yale L. J. 935 (1939) - since appointed to the staff after work on the article.

But in comparison to the form of income statements, balance sheets are relatively satisfactory. The income statement, however, is ordinarily so condensed as to combine nearly all operating items in a single deduction from sales, or indeed in many cases to start with net profit from operations, giving in a collateral and somewhat grudging way the total amount of items like depreciation. Reasons of disclosure can no longer justify such treatment of the year's operations. The information is already in the public files and has been incorporated thence into the services. Here it seems to me is a fertile field for progress. Not merely to the extent of furnishing an income statement as detailed as is required by our forms but rather an opportunity to pioneer in the field of seeing to it that income statements to securityholders translate, into understandable terms, the course of the business during the year, not solely its success or failure.

These cases you will say illustrate no more than this, that annual reports to stockholders have been condensed and that there are no different "principles" followed. To some extent this is true. There is no question to my mind that the prospectus principle of Securities Act filings should also be applied in comparing a Form 10K to the stockholders report. However, condensation and omission often give the effect of a change of principle. The diversion of credits and charges to an unanalyzed reserve, the combination of liability and valuation reserves, or the grouping of tangible and intangible fixed assets go beyond the loss of information that is permissible because of the need of getting the statements into shorter compass. The transfer of items from the income account to surplus or the reverse is likewise objectionable.

In at least one case we were asked to give our approval to a bond issue by a company which in its published balance sheets showed an unsegregated fixed property account of some $125,000,000 although at the same time the company was reporting to us a fixed property account of $93,000,000 and a separate item labelled "Excess of Reproduction Cost as Adjusted" of $32,000,000. This latter account, moreover, was not provided by the uniform classification of accounts in the state having jurisdiction, and indeed reports to the regulatory commission were on the basis of approximate historical cost, with no disclosure of any "excess".

It is possibly fortunate that I am not an accountant. It privileges me to criticize without fear of losing my reputation. It enables me to make suggestions which, from an accountant, might be termed ill-considered, if not heretical. My point is this. Is it a necessary feature of accounting that such concepts as "depreciation","maintenance" and "profits", should be given separate and inconsistent definitions for stockholders, for taxing bodies and for other governmental agencies? I do not believe it is nor that such a situation will ultimately endure. It seems to me that if a machine may, by and large, be expected to wear out in five years, then that assumption ought to be equally applicable to all statements designed to show the cost of operations for that five years. In consequence, if depreciation on a straight-line basis is to be followed in an income statement to one governmental body, it is equally appropriate for use before another. Doubtless such uniformity is at the present hindered or prevented by governing statutes or other valid objections. But is it not somewhat ludicruous to conceive, even as a hypothesis that a company can report its fixed property to one person at one figure and at the same time to another person at a figure a third greate

These then are your duties as controllers: to know and record the financial health of your patient, the corporation which employs you; and to report your patient's progress and condition to its owners. These duties are of prime importance to the continuance of our present mode of economic organization. You, as controllers, are the stockholders' first line of defense against an irresponsible management. You, as controllers, are also the first in line for criticism when trouble comes. To discharge your office to the greatest benefit of your company and its stockholders is your expressed desire. To do it well it seems to me that your proposal of being appointed by, and responsible to, the board of directors is a vital need. With added powers over intra-corporate policies and activities, you will be able, as well as eager, to increase your contribution. Before the auditor comes, and after he goes, the patient's health is in your hands. You *are* the doctor.

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