

AUDITS OF CORPORATE ACCOUNTS

Correspondence between the
Special Committee on Co-operation with Stock Exchanges

OF THE

American Institute of Accountants

AND THE

Committee on Stock List

OF THE

New York Stock Exchange

1932-1934

American Institute of Accountants
135 CEDAR STREET
NEW YORK

TO MEMBERS OF THE AMERICAN INSTITUTE OF
ACCOUNTANTS AND ALL OTHERS INTERESTED.

GENTLEMEN:

I have pleasure in transmitting for the information of accountants generally the following series of letters passing between the Institute's special committee on co-operation with stock exchanges and the committee on stock list of the New York Stock Exchange.

These letters constitute a history of an important development in the recognition of the place which accountancy occupies in modern finance and business.

I urge all accountants to read the entire series of letters.

Yours truly,

JOHN F. FORBES
President

JANUARY 21, 1934.

American Institute of Accountants

JANUARY 19, 1934.

TO THE EXECUTIVE COMMITTEE OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

On September 22, 1932, this committee addressed a communication to the Committee on Stock List of the New York Stock Exchange, copies of which have already been furnished to all members of the Institute. Since that time discussions with the Exchange have continued, which have resulted in certain expressions of opinion by the Committee on Stock List and in the preparation of a form of standard audit report or certificate which has been approved by the Committee on Stock List of the New York Stock Exchange. Attached hereto are copies of the communications exchanged with the Committee on Stock List and other relevant documents. We suggest that these copies should be sent to all members of the Institute, and their careful consideration of the various suggestions made should be invited.

We recommend that attention should be drawn particularly to (1) the principles set forth in the communication of this committee dated September 22, 1932, and the general acceptance thereof reported in the communication of the Committee on Stock List to the Governing Committee of the Exchange dated October 24, 1933; and (2) the views expressed both by the Committee on Stock List and the committee of the Controllers Institute of America regarding the desirability of uniformity (so far as it is attainable and warranted by the circumstances of the particular case) in the form of audit reports.

Respectfully submitted,

ARCHIBALD BOWMAN
ARTHUR H. CARTER
CHARLES B. COUCHMAN
SAMUEL D. LEIDESDORF
WALTER A. STAUB
GEORGE O. MAY, *Chairman*
Special Committee on Co-operation with
Stock Exchanges

Resolved, That the Executive Committee of the American Institute of Accountants concurs in the recommendations of the Special Committee on Co-operation with Stock Exchanges dated January 19, 1934, and orders publication of the relevant documents for the information of members of the Institute and others concerned.

JOHN L. CAREY, *Secretary*

JANUARY 20, 1934.

American Institute of Accountants
INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA

SPECIAL COMMITTEE ON
CO-OPERATION WITH STOCK
EXCHANGES

GEORGE O. MAY, *Chairman*
ARCHIBALD BOWMAN
ARTHUR H. CARTER
CHARLES B. COUCHMAN
SAMUEL D. LEIDESDORF
WILLIAM M. LYBRAND

NOTE

The accompanying communication addressed by this committee to the Committee on Stock List of the New York Stock Exchange was placed in evidence by the chairman of that committee in a hearing before the United States senate committee on banking and currency January 12, 1933, and is now circulated for the information of members of the Institute and others interested.

ARCHIBALD BOWMAN
ARTHUR H. CARTER
CHARLES B. COUCHMAN
SAMUEL D. LEIDESDORF
WILLIAM M. LYBRAND
GEORGE O. MAY, *Chairman*

SPECIAL COMMITTEE
ON CO-OPERATION WITH
STOCK EXCHANGES

SEPTEMBER 22, 1932.

THE COMMITTEE ON STOCK LIST,
New York Stock Exchange,
New York, N. Y.

DEAR SIRs:

In accordance with suggestions made by your Executive Assistant, this Committee has given careful consideration to the subject of the general line of development of the activities of the Exchange in relation to annual reports of corporations.

It believes that there are two major tasks to be accomplished—one is to educate the public in regard to the significance of accounts, their value and their unavoidable limitations, and the other is to make the accounts published by corporations more informative and authoritative.

The nature of a balance-sheet or an income account is quite generally misunderstood, even by writers on financial and accounting subjects. Professor William Z. Ripley has spoken of a balance-sheet as an instantaneous photograph of the condition of a company on a given date. Such language is apt to prove doubly misleading to the average investor—first, because of the implication that the balance-sheet is wholly photographic in nature, whereas it is largely historical; and, secondly, because of the suggestion that it is possible to achieve something approaching photographic accuracy in a balance-sheet which, in fact, is necessarily the reflection of opinions subject to a (possibly wide) margin of error.

Writers of text-books on accounting speak of the purpose of the balance-sheet as being to reflect the values of the assets and the liabilities on a particular date. They explain the fact that in many balance-sheets certain assets are stated at figures which are obviously far above or far below true values by saying that the amounts at which such assets are stated represent “conventional” valuations. Such statements seem to involve a misconception of the nature of a balance-sheet.

In an earlier age, when capital assets were inconsiderable and business units in general smaller and less complex than they are today, it was possible to value assets with comparative ease and accuracy and to measure the progress made from year to year by annual valuations. With the growing mechanization of industry, and with corporate organizations becoming constantly larger, more completely integrated and more complex, this has become increasingly impracticable. From an accounting standpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future; and how such expenditures shall be dealt with in accounts is the central problem of financial accounting. How much of a given expenditure of the current or a past year shall be carried forward as an asset can not possibly be determined by an exercise of judgment in the nature of a valuation. The task of appraisal would be too vast, and the variations in appraisal from year to year due to changes in price levels or changes in the mental attitude of the appraisers would in many cases be so great as to reduce all other elements in the computations of the results of operations to relative insignificance.

Carrying the thought one stage further, it is apparent that the real value of the assets of any large business is dependent mainly on the earning capacity of the enterprise. This fact is fairly generally recognized by intelligent investors as regards capital assets such as plant and machinery, but it is not equally generally recognized that it is true, though to a lesser extent, in respect of such assets as inventories and trade accounts receivable. Those, however, who have had experience in liquidations and reorganizations realize that in many industries it becomes impossible to realize inventories or accounts receivable at more than a fraction of their going-concern value, once the business has ceased to be a going concern. To attempt to arrive at the value of the assets of a business annually by an estimation of the earning capacity of the enterprise would be an impossible and unprofitable task. Any consideration of the accounts of a large business enterprise of today must start from the premise that an annual valuation of the assets is neither practical nor desirable.

Some method, however, has to be found by which the proportion of a given expenditure to be charged against the operations in a year, and the proportion to be carried forward, may be determined; otherwise, it would be wholly impossible to present an annual income account. Out of this necessity has grown up a body of conventions, based partly on theoretical and partly on practical considerations, which form the basis for the determination of income and the

preparation of balance-sheets today. And while there is a fairly general agreement on certain broad principles to be followed in the formulation of conventional methods of accounting, there remains room for differences in the application of those principles which affect the results reached in a very important degree.

This may be made clearer by one or two illustrations. It is a generally accepted principle that plant value should be charged against gross profits over the useful life of the plant. But there is no agreement on the method of distribution. The straight-line method of providing for depreciation which is most commonly employed by industrial companies, the retirement-reserve method used by utilities, the sinking-fund method, the combined maintenance-and-depreciation method, and others, are supported by respectable argument and by usage, and the charges against a particular year may vary a hundred per cent or more according as one or the other permissible method is employed.

Again, the most commonly accepted method of stating inventories is at cost or market, whichever is lower; but within this rule widely different results may be derived, according to the detailed methods of its application. For instance, at times like the present, cost of finished goods may be deemed to be the actual cost, as increased by subnormal operation, or a normal cost computed on the basis of a normal scale of operations. It may or may not include interest during the period of production or various kinds of overhead expenses. Market value may be either gross or net after deducting direct selling expenses. The choice between cost or market may be made in respect of each separate item or of classes of items or of the inventory as a whole. Frequently, whether a profit or a loss for the year is shown depends on the precise way in which the rule is applied. And since the conventions which are to be observed must, to possess value, be based on a combination of theoretical and practical considerations, there are few, if any, which can fairly be claimed to be so inherently superior in merit to possible alternatives that they alone should be regarded as acceptable.

Most investors realize today that balance-sheets and income accounts are largely the reflection of individual judgments, and that their value is therefore to a large extent dependent on the competence and honesty of the persons exercising the necessary judgment. The importance of method, and particularly of consistency of method from year to year, is by no means equally understood.

In considering ways of improving the existing situation two alternatives suggest themselves. The first is the selection by competent authority out of the body of acceptable methods in vogue today of detailed sets of rules which would become binding on all corporations of a given class. This procedure has been applied broadly to the railroads and other regulated utilities, though even such classifications as, for instance, that prescribed by the Interstate Commerce Commission allow some choice of method to corporations governed thereby. The arguments against any attempt to apply this alternative to industrial corporations generally are, however, overwhelming.

The more practicable alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency in their application from year to year. It is significant that Congress in the federal income-tax law has definitely adopted this alternative, every act since that of 1918 having contained a provision that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer" unless such method does not clearly reflect income. In its regulations the Internal Revenue Bureau has said, "the law contemplates that each taxpayer shall adopt such

forms and systems of accounting as are in his judgment best suited to his purpose.” (Reg. 45, Art. 24.) The greatest value of classifications such as those imposed on regulated utilities lies in the disclosure of method and consistency of method which they tend to produce.

Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year. Reverting to the illustrations already used, the investor would not need to be greatly concerned whether the straight-line or the sinking-fund method of providing for depreciation were being employed by a given corporation, provided he knew which method was being used and knew that it was being applied in the same way every year. But if depreciation is charged in one year on the straight-line basis applied to cost and in another is charged on a sinking-fund basis applied to a valuation less than cost, the investor may be grossly deceived unless the change is brought to his notice. For this reason, the requirement of the Exchange that the depreciation policy of a company applying for listing shall be stated in the application is valuable, and it might well be amplified to include an undertaking to report to the Exchange and to stockholders any change of policy or any material change in the manner of its application.

Again, it is not a matter of great importance to investors whether the cost-or-market rule for stating inventories is applied to individual items or to the inventory as a whole, but it is very important to the investor that he should be advised if the test is applied to individual items at the beginning of the year and to the inventory as a whole at the close thereof.

It is probably fairly well recognized by intelligent investors today that the earning capacity is the fact of crucial importance in the valuation of an industrial enterprise, and that therefore the income account is usually far more important than the balance-sheet. In point of fact, the changes in the balance-sheets from year to year are usually more significant than the balance-sheets themselves.

The development of accounting conventions has, consciously or unconsciously, been in the main based on an acceptance of this proposition. As a rule, the first objective has been to secure a proper charge or credit to the income account for the year, and in general the presumption has been that once this is achieved the residual amount of the expenditure or the receipt could properly find its place in the balance-sheet at the close of the period, the principal exception being the rule calling for reduction of inventories to market value if that is below cost. But if the income account is to be really valuable to the investor, it must be presented in such a way as to constitute to the fullest possible extent an indication of the earning capacity of the business during the period to which it relates. The Committee feels that the direction of the principal efforts of the Exchange to improve the accounting reports furnished by corporations to their stockholders should be towards making the income account more and more valuable as an indication of earning capacity.

The purpose of furnishing accounts to shareholders must be not only to afford them information in regard to the results being achieved by those to whom they have entrusted the management of the business, but to aid them in taking appropriate action to give effect to the conclusions which they reach regarding such accomplishments. In an earlier day, stockholders who were dissatisfied with the results secured by the management could perhaps move effectively to bring about a change of policy or, failing that, a change of management. With the growth in magnitude of corporations and the present wide diffusion of stock holdings, any such attempt is ordinarily impracticable because of the effort and expenditure that it would entail. The only practical way in which an investor can today give expression to his conclusions in regard to

the management of a corporation in which he is interested is by retaining, increasing or disposing of his investment, and accounts are mainly valuable to him in so far as they afford guidance in determining which of these courses he shall pursue.

There is no need to revolutionize or even to change materially corporate accounting, but there is room for great improvement in the presentation of the conclusions to which accounts lead. The aim should be to satisfy (so far as is possible and prudent) the investor's need for knowledge, rather than the accountant's sense of form and respect for tradition, and to make very clear the basis on which accounts are prepared. But even when all has been done that can be done, the limitations on the significance of even the best of accounts must be recognized, and the shorter the period covered by them the more pronounced usually are these limitations. Accounts are essentially continuous historical record; and, as is true of history in general, correct interpretations and sound forecasts for the future can not be reached upon a hurried survey of temporary conditions, but only by longer retrospect and a careful distinction between permanent tendencies and transitory influences. If the investor is unable or unwilling to make or secure an adequate survey, it will be best for him not to rely on the results of a superficial one.

To summarize, the principal objects which this Committee thinks the Exchange should keep constantly in mind and do its best gradually to achieve are:

1. To bring about a better recognition by the investing public of the fact that the balance-sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

2. To emphasize the fact that balance-sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance-sheets which will disclose more clearly than at present on what basis assets of various kinds are stated (*e.g.*, cost, reproduction cost less depreciation, estimated going-concern value, cost or market whichever is lower, liquidating value, *et. cetera*).

3. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the year to which it relates.

4. To make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance (see Exhibit I attached), and within the limits of such broad principles to make no attempt to restrict the right of corporations to select 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 (see Exhibit II attached); 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 will 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.

This Committee would be glad to discuss these suggestions with you at any time, and to co-operate with the Exchange in any action it may see fit to take along the lines indicated.

Yours very truly,

GEORGE O. MAY,
Chairman.

EXHIBIT I

It is suggested that in the first instance the broad principles to be laid down as contemplated in paragraph 4 of the suggestions should be few in number. It might be desirable to formulate a statement thereof only after consultation with a small group of qualified persons, including corporate officials, lawyers and accountants. Presumably the list would include some if not all of the following:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

The Exchange would probably desire to add a rule regarding stock dividends.

EXHIBIT II

The statement of the methods of accounting contemplated in paragraph 4a of the suggestion would not be in the nature of the ordinary detailed classification of accounts, nor would it deal with the machinery of bookkeeping. It should constitute a clear statement of the principles governing the classification of charges and credits as between (a) balance-sheet accounts, (b) income account and (c) surplus account, together with sufficient details of the manner in which these principles are to be applied to enable an investor to judge of the degree of conformity to standard usage and of conservatism of the reporting corporation. Its content would vary according to the circumstances of individual companies, but some of the more important points which would be disclosed thereby would be as follows:

THE GENERAL BASIS OF THE ACCOUNTS:

Whether the accounts are consolidated, and if so, what rule governs the determination of the companies to be included in consolidation; also, a statement as to how profits and losses of subsidiary and controlled companies not consolidated are dealt with in the accounts of the parent company.

THE BALANCE-SHEET:

- (a) In respect of capital assets, the statement should show:
 - (1) What classes of items are charged to property account (whether only new property or also replacements and improvements);
 - (2) Whether any charges in addition to direct cost, either for overhead expense, interest or otherwise, are made to property accounts;
 - (3) Upon what classes of property, on what basis, and at what rates provision is made for, or in lieu of, depreciation;

(4) What classes of expenditures, if any, are charged against reserves for depreciation so created;

(5) How the difference between depreciated value and realized or realizable value is dealt with on the sale or abandonment of units of property;

(6) On what basis property purchased from subsidiary companies is charged to property account (whether at cost to subsidiary or otherwise).

(b) In respect of inventories: The statement should show in fairly considerable detail the basis of valuation of the inventory. The statement under this head would be substantially a summary in general terms of the instructions issued by the company to those charged with the duty of preparing the actual inventories. It would not be sufficient to say that the inventory was taken on the basis of cost or market, whichever is lower. The precise significance attached to these terms should be disclosed, for the reasons set forth on page 3 of the letter.*

The statement should include a specific description of the way in which any intercompany profit on goods included in the inventory is dealt with. It should show under this head, or in relation to income or surplus account, exactly how reductions from cost to market value are treated in the accounts and how the inventories so reduced are treated in the succeeding period. It is, for instance, a matter of first importance to investors if inventories have been reduced to cost or market at the end of the year by a charge to surplus account, and the income for the succeeding year has been determined on the basis of the reduced valuation of the inventory thus arrived at. Obviously, under such a procedure the aggregate income shown for a series of years is not the true income for the period.

(c) In respect of securities: The statement should set forth what rules govern the classification of securities as marketable securities under the head of "current assets" and securities classified under some other head in the balance-sheet. It should set forth in detail how any of its own securities held by the reporting corporation, or in the case of a consolidated statement any securities of any company in the group held by that or any other member of the group are dealt with in the balance-sheet. (Stock of subsidiaries held by the parent will of course be eliminated in consolidation). The disclosure of the basis of valuation of securities is covered in paragraph 2, page 6 of the recommendations contained in the letter.†

(d) Cash and receivables present few questions, though where sales are made on the instalment plan, or on any other deferred basis, their treatment should be fully set forth, including a statement of the way in which provision is made for future collection or other expenses relating to sales already made but not liquidated and to what extent deferred accounts are included in current assets.

(e) Deferred charges: The statement should set forth what classes of expenditures are in the company's practice deferred and what procedure is followed in regard to the gradual

* Pages 7 and 8 hereof.

† Page 12 hereof.

amortization thereof. (This question is of considerable importance as substantial overstatements of income may occur through deferment in unprosperous periods of expenses ordinarily chargeable against current operations, possibly followed by writing off such charges in a later year against surplus account.)

(f) Liability accounts: There is normally less latitude in regard to the treatment of liability accounts than in respect of assets. The statement should clearly show how unliquidated liabilities, such as damage claims, unadjusted taxes, etc., are dealt with. The statement should disclose whether it is the practice of the company to make a provision for onerous commitments or to deal with such commitments in any way in the balance-sheet.

(g) Reserves: A statement of the rules governing credits and charges to any reserve account (including both those shown on the liability side and those deducted from assets) should be given in detail. It is particularly important to know whether losses, shrinkages or expenses which would otherwise be chargeable against income accounts are in any circumstances charges against contingent or other reserves, and whether such reserves are built up partly or wholly otherwise than by charges to income account.

THE INCOME ACCOUNT:

An adequate statement in regard to the treatment of balance-sheet items discloses by inference what charges and credits are made to income account or surplus. The additional points required to be disclosed are the principles followed in allocating charges and credits to income account and surplus account respectively and the form of presentation of the income account. The form should be such as to show separately (a) operating income; (b) depreciation and/or depletion if not deducted in arriving at (a), in which case the amount of the deduction should be shown; (c) income from companies controlled but not consolidated (indicating the nature thereof); (d) other recurring income; (e) any extraordinary credits; (f) charges for interest; (g) income taxes and (h) any extraordinary charges.

The company's proportionate share of the undistributed earnings or losses for the year of companies controlled but not consolidated should be disclosed in a note or otherwise on the face of the income account. Stock dividends if credited to income should be shown separately with a statement of the basis upon which the credit is computed.

JANUARY 6, 1933.

An announcement by Richard Whitney, President of the New York Stock Exchange, in regard to the requirement adopted by the Exchange that listed companies have their annual accounts audited by independent public accountants.

Since April of 1932 all corporations applying for the listing of their securities upon the New York Stock Exchange have been asked to enter into an agreement to the effect that future annual financial statements published more than three months after the date of the agreement shall be audited by independent public accountants qualified under the laws of some state or country, and shall be accompanied by a certificate of such accountants showing the scope of the audit and the qualifications, if any, made by them in respect thereto. The Committee on Stock List has considered any reasons advanced why this procedure should not apply in particular cases, but has made exceptions only in the case of certain railroad companies.

During this period, the New York Stock Exchange has not required that audited statements be filed with applications for listing, because it was felt that applicants who had relied upon the former practice of the Exchange would have been subjected to undue delay if the Committee had pursued any other course.

The New York Stock Exchange now announces that its present policy in this respect will be continued until July 1, 1933, after which date all listing applications from corporations must contain the certificate of independent public accountants, qualified under the laws of some state or country, certifying to the correctness of the balance-sheet, income statement and surplus statement for the most recent fiscal year. In general, the audit or audits must cover all subsidiaries, and the scope of the audit must be not less than that indicated in a pamphlet entitled "Verification of Financial Statements" issued by the Federal Reserve Board in May, 1929, and obtainable from that board at Washington, D.C. All applications must include an agreement to the effect that future annual reports published or sent to stockholders will be similarly audited and accompanied by a similar certificate.

The Committee on Stock List may make exceptions to these requirements in unusual or extraordinary cases where the enforcement of the requirements would, in its opinion, be manifestly unwise or impracticable. The Committee has concluded that for the present it will not require audited statements from railroad companies reporting to the Interstate Commerce Commission, except in the case of those railroads whose accounts have heretofore been currently audited by independent accountants.

Representative houses and banks of issue have been advised of the foregoing program, and have expressed themselves as in accord with the plan outlined above which they believe is sound and consistent with the importance of affording to the public the most complete and accurate information in regard to the financial condition of corporations whose securities are publicly dealt in.

*Letter to presidents of corporations listed on
New York Stock Exchange.*

NEW YORK STOCK EXCHANGE

OFFICE OF THE PRESIDENT

JANUARY 31, 1933.

DEAR SIR:

The New York Stock Exchange has recently announced its intention of requiring audited statements in connection with listing applications made after July 1, 1933. The public response to this announcement indicates clearly that independent audits are regarded by investors as a useful safeguard.

If, however, such a safeguard is to be really valuable and not illusory, it is essential that audits should be adequate in scope and that the responsibility assumed by the auditor should be defined. The Exchange is desirous of securing from companies whose securities are listed, and which now employ independent auditors, information which will enable it to judge to what extent these essentials are assured by such audits. In furtherance of this end, we should be greatly obliged if you will secure from your auditors, upon the completion of the audit for the year 1932, and furnish to the Committee on Stock List, for its use and not for publication, a letter which will contain information on the following points:

1. Whether the scope of the audit conducted by them is as extensive as that contemplated in the Federal Reserve bulletin, "Verification of Financial Statements".
2. Whether all subsidiary companies controlled by your company have been audited by them. If not, it is desired that the letter should indicate the relative importance of subsidiaries not audited as measured by the amount of assets and earnings of such companies in comparison with the total consolidated assets and earnings, and should also indicate clearly on what evidence the auditors have relied in respect of such subsidiaries.
3. Whether all the information essential to an efficient audit has been furnished to them.
4. Whether in their opinion the form of the balance-sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.
5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.
6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.

I shall personally appreciate very much your prompt consideration of this matter and any co-operation which you may extend to the Exchange in regard thereto.

Faithfully yours,

(Signed) RICHARD WHITNEY
President.

*Statement of Certain Accounting Principles Recommended by
Committee of American Institute of Accountants on
Co-operation with Stock Exchanges.*

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

NEW YORK STOCK EXCHANGE
COMMITTEE ON STOCK LIST

FRANK ALTSCHUL
Chairman

J.M.B. HOXSEY
Executive Assistant

HERBERT G. WELLINGTON
Vice Chairman

W.O. LOOMIS
Secretary

OCTOBER 24, 1933.

TO THE
GOVERNING COMMITTEE,
NEW YORK STOCK EXCHANGE.

GENTLEMEN:

On January 31, 1933, the President of the Stock Exchange addressed a general inquiry to all listed corporations, designed to secure information regarding the scope of audits and the responsibilities assumed by auditors which would put the Exchange in a better position to judge the value of audits to investors. In this letter, the request was made that companies whose accounts were audited should secure from their auditors and furnish to the Exchange, for its use and not for publication, answers to six questions. Of these questions, three dealt with the scope of the audit and three with the principles governing the accounting methods of the corporation and the form of presentation of accounts to shareholders.

The response to this request has been satisfactory, replies having been received from a large majority of the companies employing independent auditors regularly. A careful study of the replies received has brought to the attention of the Committee a number of points affecting particular companies which it has been deemed desirable to take up with those companies. In a few cases, the questions involved have been of very substantial importance, but the majority have been of relatively minor significance.

The replies have indicated very general acceptance of certain principles which the Exchange regarded as of primary importance and set forth in a statement attached to the letter of request, as follows:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing-house industry) in which, owing to the impossibility of determining costs, it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a

reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

This Committee feels that all these principles should now be regarded by the Exchange as so generally accepted that they should be followed by all listed companies—certainly, that any departure therefrom should be brought expressly to the attention of shareholders and the Exchange.

In announcing on January 6, 1933, its intention of requiring after July 31, 1933, that there should be included in all listing applications, certificates of independent accountants in respect of the balance-sheet, income statement and surplus statement for the most recent fiscal year, the Exchange indicated that in general the audit must cover all subsidiaries and the scope thereof be not less than that indicated in a pamphlet entitled “Verification of Financial Statements” issued by the Federal Reserve Board in May, 1929. The request of January 31 called for information as to whether these standards were currently being maintained in the audits of listed companies.

Upon the subject of the scope of audits, the existing position is outlined in a communication addressed by nine leading firms of accountants to the Exchange under date of February 24, 1933, a copy of which is attached hereto. In the interests of investors it seems desirable to make clear what is the scope of audits as currently conducted and to consider how far it is practicable to extend such scope and the responsibilities of auditors within the limits of a wise economy.

The bulletin issued by the Federal Reserve Board, to which reference has been made, indicated clearly that the scope of the examination therein provided for was not such as would lead naturally to detection of (1) defalcations on the part of employees or (2) any understatement of assets and profits resulting from charges to operations of items which might have been carried as assets. The nine firms of accountants in the letter above referred to pointed out that the former limitation is particularly applicable to examinations of the larger companies which, generally speaking, constitute the class whose securities are listed on the New York Stock Exchange.

Your committee is satisfied that the detailed scrutiny and verification of the cash transactions of large companies can most efficiently and economically be performed by permanent employees of the corporation, particularly today, when bookkeeping is to so large an extent done by mechanical means, and that it would involve unwarranted expense to transfer

such work to independent auditors or to require them to duplicate the work of the internal organization. Your committee, however, feels that the auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcation of major importance. Unless so satisfied, the auditors should make clear representations on this point—in the first place, to the management and, in default of action by the management, to the shareholders. Your committee also suggests that this limitation on the scope of the audit, though an entirely proper one, should be specifically mentioned in the common form of audit report.

The Committee feels that the auditors should recognize a responsibility to verify and, if necessary, to report to the shareholders upon any transactions affecting directors or officers of the corporation in respect of which there might be a conflict of interest between such directors and officers and the general body of shareholders.

Turning to the second limitation on the scope of audits as outlined in the Federal Reserve bulletin, the accountants indicated that, generally speaking, their examination of the income or profit-and-loss account was perhaps less extensive than the procedure contemplated in that bulletin. The classification of the income or profit-and-loss account is clearly a matter of great importance to investors. Whether income is of such a nature that it may reasonably be expected to recur or is of an exceptional character is often a vital consideration in the appraisal of an enterprise, and failure to make such distinctions clear in annual accounts is one of the defects to which the Exchange has had to call attention most frequently in the accounts of listed companies.

The Committee recognizes that it is neither necessary nor reasonable to hold auditors responsible for minor errors in classification, or to ask corporations to incur the expense of examinations such as would justify the acceptance of such a responsibility. Auditors should, however, in addition to satisfying themselves that the net income reported is not overstated, accept the burden of seeing that the income received and the expenditures made are properly classified in so far as the facts are known to them or are ascertainable by reasonable inquiry. For instance, when non-recurring income, shown separately on the books, is merged with recurring income in the annual accounts, or when items properly chargeable against current income are charged against surplus or reserve, the facts are bound to come to the attention of the accountant who makes even the most cursory examination, and he should not certify without a clear qualification accounts in which anything of this kind has been done.

The inquiry has again emphasized the importance and the difficulty of the problem of properly reflecting the operations of subsidiary and controlled companies. Consolidation of accounts of companies in which there are very substantial outstanding interests is not a satisfactory solution—indeed, the Committee is satisfied that no method can be prescribed which could be applied in every case. Operations of controlled companies may be as important an element in the value of the parent company as those of the parent company or its wholly-owned subsidiaries. Even where the operations of controlled companies are conducted at a negligible profit or loss, this fact can not be ascertained if the result of such operations is nowhere reflected in the published financial statements. The Exchange has recognized that there must be an element of flexibility in the method of such presentation, so that corporations may choose, from among the several methods which will give the desired information, that one most suitable to its individual circumstances. For a considerable period of time past, the agreement covering this matter which the Exchange has requested from corporations applying for listing has read as follows:

“To publish at least once in each year and submit to stockholders at least fifteen days in advance of the annual meeting of the corporation, but not later than, a Balance-Sheet, and Income Statement for the last fiscal year and a Surplus Statement of the applicant company as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or, in lieu thereof, eliminating all intercompany transactions;

“A similar set of consolidated financial statement. If any such consolidated statements exclude any companies a majority of whose equity stock is owned, (a) the caption will indicate the degree of consolidation; (b) the Income Account will reflect, either in a footnote or otherwise, the parent company’s proportion of the sum of or difference between current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of report; and (c) the Balance-Sheet will reflect, in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions. Appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries, in either parent-company statements or consolidated statements.

“Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking-fund or redemption-fund requirements of any controlled corporation whether consolidated or unconsolidated.”

The most costly, and the less satisfactory in some respects, of the suggested methods is the publication separately of the financial statements of each unconsolidated controlled corporation, for the reason that this imposes upon the stockholder, or analyst, the burden of determining for himself the equity of the parent company in the earnings of each such corporation, making it a burdensome matter for him thus to secure a true picture of the results of operation of the system as a whole.

With less information than is suggested by one of the methods in the foregoing agreement, the reports of any company having unconsolidated majority-owned companies are necessarily incomplete and may be positively misleading. The Committee believes that this is a subject which might well receive the consideration of corporate management and of organized bodies of accounting officers and independent accountants in order that adequate disclosure may become generally prevalent and not be confined merely to those companies which have executed the foregoing agreement with the Exchange.

At the same time, it might be desirable to attempt to develop a form of audit report or certificate which would be more informative to and more clearly understood by investors than the forms now currently in use. It would, in the opinion of the Committee, be advantageous if audit reports were so framed as to constitute specific answers to the last three questions embodied in the President’s letter to listed companies of January 31, 1933, namely:

4. Whether in their opinion the form of the balance-sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.

5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.

6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.

As suggested earlier in this communication, also, it might contain a clear statement of the scope of the audit in relation to detection of defalcations by employees.

The matters herein discussed seem to the Committee those in respect of which clarification and improvement of accounting practice are most desirable in the interest of investors. It suggests to the Governing Committee that these matters should be brought to the attention of listed companies and organized bodies of accountants and accounting officers, with a view to definite action along the lines indicated herein.

By the direction of The Committee on Stock List,

J.M.B. HOXSEY,
Executive Assistant.

RESOLVED, That the Governing Committee of the New York Stock Exchange concurs in the suggestions herein contained and authorizes the Committee on Stock List to bring them to the attention of those concerned, as recommended.

ASHBEL GREEN, *Secretary.*

OCTOBER 25, 1933.

Following is the text of the letter written by nine accounting firms and enclosed with Mr. Hoxsey's letter of October 24th (see third paragraph, page 27):

NEW YORK, February 24, 1933.

RICHARD WHITNEY, Esq., *President.*
New York Stock Exchange.
New York, N.Y.

DEAR SIR:

As auditors of a substantial number of corporations whose securities are listed on the New York Stock Exchange, we have received copies of the letter in relation to audits addressed by you to such companies under date of January 31. We are anxious to do everything in our power to assist the Exchange, and it has seemed to us that it will be helpful and more convenient to the Exchange for us to deal with some of the general phases of the subject under consideration collectively in a single letter, reference to which will make it unnecessary to discuss these points in the letters which we shall in due course furnish to our clients and which they in turn will presumably furnish to the Exchange for its confidential use.

We fully recognize the importance of defining the responsibility of auditors and of bringing about a proper understanding on the part of the investing public of the scope and significance of financial audits, to the end that their importance should not be under-rated nor their protective value exaggerated in the minds of investors. This is the more necessary because the problem of delimiting the scope of audits or examinations is essentially one of appraising the risks against which safeguards are desirable in comparison with the costs of providing such safeguards. The cost of an audit so extensive as to safeguard against all risks would be prohibitive; and the problem is, therefore, to develop a general scheme of examination of accounts under which reasonably adequate safeguards may be secured at a cost that will be within the limits of a prudent economy. The position was clearly stated by a partner in one of the signatory firms in 1926 as follows:

“In any such work we must be practical; it is no use laying down counsels of perfection or attempting to extend the scope of the audit unduly. An audit is a safeguard; the maintenance of this safeguard entails an expense; and this expense can be justified only if the value of the safeguard is found to be fully commensurate with its cost. The cost of an audit so extensive as to be a complete safeguard would be enormous and far beyond any value to be derived from it. A superficial audit is dangerous because of the sense of false security which it creates. Between the two extremes there lies a mean, at which the audit abundantly justifies its cost.”

We are in accord with the general concept of the scope of an examination such as would justify the certification of a balance-sheet and income account for submission to stockholders which is implied in the reference to the bulletin “Verification of Financial Statements” contained in the first question asked by the Exchange. That bulletin was designed primarily as a guide to

procedure which would afford reasonable assurance that the financial position of the borrower was not less favorable than it was represented by him to be; and, as the bulletin explicitly states, it was not contemplated that such an examination would necessarily disclose under-statements of assets (and profits) resulting from charges to operations of items which might have been carried as assets, or defalcations on the part of employees.

This latter point is particularly applicable to financial examinations of larger companies which, generally speaking, constitute the class whose securities are listed on the New York Stock Exchange. Such companies rely on an adequate system of internal check to prevent or disclose defalcations, and independent accountants making a financial examination do not attempt to duplicate the work of the internal auditors.

The bulletin "Verification of Financial Statements," to which reference has been made, was, as was clearly pointed out in the first edition, framed to fit the case of borrowers engaged in business on a relatively small or medium-sized scale. It was recognized in that bulletin (see paragraph 131 of the present edition) that an effective system of internal check would make some portions of the procedure outlined in the bulletin unnecessary. Naturally, the larger a corporation and the more extensive and effective its system of accounting and internal check, the less extensive is the detailed checking necessary to an adequate verification of the balance-sheet. Since companies listed on your Exchange are among the larger corporations, it is in general true that the procedure in examinations of annual accounts is less detailed in the case of those companies than in the class of cases which the framers of the bulletin had particularly in mind. It is, however, true, we think, that the examinations made by independent auditors in such cases, coupled with the system of internal check, constitute at least as effective a safeguard as is secured in the case of smaller corporations having a less adequate system of internal check, in the examination of which the procedure outlined in the bulletin has been more closely followed.

The ordinary form of financial examination of listed companies, in so far as it relates to the verification in detail of the income account, is not, we believe, so extensive as that contemplated by the bulletin. To verify this detail would often be a task of a very considerable magnitude, particularly in the case of companies having complex accounting systems, and we question whether the expense of such a verification would be justified by the value to the investor of the results to be attained. The essential point is to guard against any substantial over-statement of income, and this can be reasonably assured by the auditor satisfying himself of the correctness of the balance-sheets at the beginning and end of the period covered by his examination and reviewing the important transactions during the year.

The second point on which information is requested in your letter to listed companies relates to subsidiary companies. This question is obviously pertinent, and presents no difficulty to the accountant called upon to reply to it.

The third question, calling for a statement whether all essential information has been furnished to the auditors contemplates, we take it, that the auditors shall indicate whether all the information which they have deemed essential and sought has been furnished to them. It is obviously conceivable that a management might be in possession of information which would have a material bearing on the accountant's view of the financial position if he knew of its existence, but that the auditor might have no way of discovering that such information existed.

Your fourth question relates to the form in which the accounts are submitted. We take it that you desire to be informed whether the accounts in the opinion of the auditor set forth the results fairly to the extent that they purport to do so, and that the inquiry does not go to the question whether regard for the interests of the stockholders calls for more detailed statements of

the financial position and the operations of the company than those now given. The question how much information should be given to stockholders is one on which wide differences of opinion exist, and it is not our understanding that the Exchange is attempting to deal with this point in this inquiry.

Referring to the fifth question—we attach as great importance as the Exchange evidently does to consistency of method in the presentation of financial statements by corporations. The only further comment on this question which seems called for is to emphasize the part which judgment necessarily plays in the determination of results, even if principles are consistently adhered to. There would, we take it, be no objection to an accountant answering the fifth question in the affirmative, even though in his opinion the judgment of the management had been somewhat more conservative at the close of a year than a year earlier, or vice versa. We think it well to mention this point and to emphasize the fact that accounts must necessarily be largely expressions of judgment, and that the primary responsibility for forming these judgments must rest on the management of the corporation. And though the auditor must assume the duty of expressing his dissent through a qualification in his report, or otherwise, if the conclusions reached by the management are in his opinion manifestly unsound, he does not undertake in practice, and should not, we think, be expected to substitute his judgment for that of the management when the difference is not of major importance, when the management's judgment is not unreasonable and when he has no reason to question its good faith.

Your sixth question, apart from the specific reference to the principles enumerated, aims, we assume to insure that companies are following accounting practices which have substantial authority back of them. Answers to this question of an affirmative character will not, of course, be understood as implying that all of the clients of a given firm observe similar or equally conservative practices, either in the case of companies engaged in the same industry or in the case of different industries, or even that the accounting principles adopted are precisely those which the accountant would have himself selected, had the sole choice rested with him.

We agree with the five general principles enumerated in the memorandum attached to your letter, but it may, we suppose, be understood that rigorous application of these principles is not essential where the amounts involved are relatively insignificant. We mention this point not by way of any substantial reservation but to avoid possible later criticism based on narrow technicalities.

We shall be glad, if desired, to go further into any of the questions herein discussed, in such way as may be most convenient to the Exchange.

American Institute of Accountants
SPECIAL COMMITTEE ON CO-OPERATION
WITH STOCK EXCHANGES

135 CEDAR STREET, NEW YORK

DECEMBER 21, 1933.

MR. J.M.B. HOXSEY, *Executive Assistant*,
Committee on Stock List
New York Stock Exchange
New York, N.Y.

DEAR SIR:

The copy of the communication addressed by your committee on the governing committee of the Stock Exchange under date of October 24, 1933, regarding audits, which was sent to the President of the American Institute of Accountants, has been referred to this committee. We welcome the suggestion that the matters therein dealt with should be brought to the attention of listed companies and organized bodies of accountants and accounting officers, and shall be glad to co-operate with the Exchange in the manner contemplated.

We are glad to note that the replies received to the letter of the President of the Exchange dated January 31, 1933, indicate general acceptance of the principles set forth in the communication of this committee to the Exchange dated September 22, 1932, and we propose to recommend to the Institute that these rules, and such acceptance, should be brought to the attention of all members of the Institute.

We have noted with interest the views expressed by the committee on stock list with regard to the problem of safeguarding the transactions of corporations. While agreeing with your committee that in the case of large companies the safeguarding of transactions is primarily a matter of internal organization, we should like to make it clear that we fully appreciate the value of the detailed audit in appropriate cases. Where the internal check and control are necessarily limited or severely restricted, the detailed audit serves a most useful purpose, though no audit should be regarded as taking the place of sound measures of internal check and control, except in cases where the organization is so small as to make adequate internal check impracticable.

We believe that accountants, in cases where they do not make a detailed audit, now regard it as a part of their duty to inquire into the system of internal check—indeed, this duty is expressly recognized in the pamphlet “Verification of Financial Statements” as revised by the American Institute of Accountants in 1929, the first sentence of the general instructions contained in that pamphlet reading in part:

“The scope of the work indicated in these instructions includes . . . an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check.”

We would, however, point out that it is always a matter of judgment on the part of corporate management to weigh the risks against which safeguards are desirable in comparison with the cost of providing safeguards. The whole matter lies in the field of discretion, and if in any case a defalcation should occur and escape detection, the accountants can not be expected to accept any financial responsibility, but only to accept such blame as may attach to a possible error of

judgment on their part with respect to their review of the methods and extent of the internal check and control. The effect on the reputation of a public accountant, arising from such an error of judgment, is serious and quite sufficient to ensure care on his part.

We agree with your committee in the view that auditors can not properly disclaim all responsibility for the correctness of the classification of an income or profit-and-loss account merely because they are not in a position to assume full responsibility therefor. Your suggestion that auditors should “accept the burden of seeing that the income received and the expenditures made are properly classified in so far as the facts are known to them or are ascertainable by reasonable inquiry” seems to us a reasonable one and we believe it is calculated to afford investors in the great majority of cases the protection which your committee desires. Our only further comment on this portion of the communication is, that where the facts are clearly disclosed on the face of the statement it may not be necessary for the accountants to embody a qualification in their report.

We agree that the problem of reflecting the operations of subsidiary and controlled companies is one of real difficulty. Experience here and abroad confirms the view that there is no single satisfactory solution. We believe, however, that if corporate managements and accounting officers approach the question with an honest desire to make the statements as fair and informative as possible, a solution appropriate to each individual case will always be found, and we propose to ask the Institute to bring the point to the attention of all its members and urge their fullest co-operation to this end.

We shall be very glad to join in any co-operative effort to develop a form of accountants’ reports which will be more valuable to investors. We agree that such reports should be so framed as to constitute answers to the three questions contained in President Whitney’s letter of January 31, 1933, mentioned by you; viz.:

“Whether in their” (*i.e.*, the auditors’) “opinion the form of the balance-sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.”

“Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.”

“Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.”

We think it desirable, also, as suggested in our report of September 22, 1932, to emphasize the fact that accounts, and consequently any statements or reports based thereon, are necessarily in large measure expressions of opinion. To this end, we think it desirable that the document signed by the accountants should be in the form of a report, as in England, rather than a certificate, and that the words “in our (my) opinion” should always be embodied therein. It is impracticable to indicate in a standard form of report exactly the procedure followed, since it will vary in difference cases, and it will be desirable to use language which may understate what has been done rather than to incur the risk of the extent of the examination being exaggerated by the reader.

With these considerations in mind, we have drafted as a basis for discussion a form of report, a copy of which, with some explanatory notes, is attached hereto, and we should be glad to have an expression of opinion thereupon from your committee or others interested. As indicated in the first note, it would be our view that before issuing such a report as we have drafted the accountant should have at least made an examination of the character outlined in the bulletin, "Verification of Financial Statements" as interpreted in the communication of your committee to the governing committee of the Exchange dated October 24, 1933.

With renewed assurance of our willingness to co-operate, and awaiting your advice as to the way in which you think such co-operation can best be extended, we are

Yours very truly,

GEORGE O. MAY, *Chairman*
ARCHIBALD BOWMAN
ARTHUR H. CARTER
CHARLES B. COUCHMAN
SAMUEL D. LEIDESDORF
WALTER A. STAUB

To avoid confusion, the suggested form of accountant's report is omitted here. The form finally adopted, embodying slight changes, appears on page 47.

NEW YORK STOCK EXCHANGE
COMMITTEE ON STOCK LIST

JANUARY 3, 1934.

MR. GEORGE O. MAY, *Chairman*,
Special Committee on Co-operation with
Stock Exchanges,
American Institute of Accountants,
56 Pine Street,
New York City.

DEAR SIR:

I am directed by the Committee on Stock List to acknowledge and thank you for the communication of December 21 from your Committee, commenting upon the letter addressed by this Committee to the Governing Committee of the Stock Exchange, dated October 24, 1933, and offering certain suggestions as to the adoption of a more or less specific form of auditor's report.

This Committee is heartily in favor of the form of accountant's report submitted by you, and has at present no suggestions to make in reference to it. We are, however, submitting a copy of your letter, together with the suggested form of report, to the Controllers' Institute of America, for an expression of their opinion in regard to it. Should that Institute have any comments upon the suggestion, we shall be glad to submit them to you and, if necessary, to arrange a meeting with your Committee at which any such suggestions may be discussed.

Yours very truly,

COMMITTEE ON STOCK LIST,
(Signed) J.M.B. HOXSEY
Executive Assistant.

Controllers Institute of America
One East Forty-Second Street
New York City

JANUARY 17, 1934.

MR. J.M.B. HOXSEY, *Executive Assistant*,
Committee on Stock List,
New York Stock Exchange,
New York City.

DEAR MR. HOXSEY:-

This Committee has carefully considered the communication of the Committee on Stock List to the Governing Committee of the Stock Exchange of October 24, 1933, and the communication from the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants dated December 21, 1933. We find ourselves in substantial accord with the views expressed in both documents.

We suggest, however, that it would involve considerable and unnecessary expense to many corporations if the application of the fifth principle mentioned in the communication of October 24, 1933, were construed to require the segregation of accounts of employees and officers arising in the ordinary course of business and normal in amount—such as sums owing by them as customers, or working funds and advances of a self-liquidating character. We understand that both you and the members of the committee of the American Institute of Accountants are in accord with us on this point, and we suggest that it would be desirable to cover the point in some public statement.

Referring to the form of audit certificate, we think it would be preferable to embody the reference to explanations received by the auditors in the first paragraph, which states the scope of the audit. We have conferred with the committee of the American Institute of Accountants and attach a revised form in which effect is given to this suggestion. This form is, we are advised, satisfactory to that committee and is entirely acceptable to us.

We recognize the fact that agreement on terminology is always very difficult, because most people have certain preferences of language, and for this reason, we can see that agreement by public accountants on a particular form may not be easy to secure. We urge, however, that the Stock Exchange stress the necessity for such uniformity of language as to the major body of the certificate with the committee of the American Institute of Accountants, so that as far as possible all accounting firms will use the same language for the main part of their certificate. The wording of specific exceptions and qualifications, we appreciate, would naturally have to be left to the individual firms, since standardization to that extent we do not believe to be practicable.

We should be glad to co-operate further with the Exchange in its efforts to accomplish the purposes indicated in the communication of your committee of October 24, 1933, above mentioned.

Yours very truly,

EDWIN F. CHINLUND, *Chairman*
Committee on Stock Exchange Relations

REVISED SUGGESTION OF A FORM OF ACCOUNTANTS' REPORT

TO THE XYZ COMPANY:

We have made an examination of the balance-sheet of the XYZ Company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 1933, and the results of its operations for the year.

NOTES

1. It is contemplated that before signing a report of the type suggested, the accountant should have at least made an examination of the character outlined in the bulletin, "Verification of Financial Statements", as interpreted in the communication of the Committee on Stock List to the Governing Committee dated October 24, 1933.
2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.
3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.
4. In the second sentence, any special forms of confirmation could be mentioned: *e.g.*, "including confirmation of cash and securities by inspection or certificates from depositaries."
5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.
6. It is contemplated that the form of report would be modified when and as necessary to embody any qualifications, reservations or supplementary explanations.

NEW YORK STOCK EXCHANGE
COMMITTEE ON STOCK LIST

FRANK ALTSCHUL
Chairman

J.M.B. HOXSEY
Executive Assistant

HERBERT G. WELLINGTON
Vice Chairman

W.O. LOOMIS
Secretary

JANUARY 18, 1934.

MR. EDWIN F. CHINLUND, *Chairman*,
Committee on Stock Exchange Relations,
Controllers Institute of America,
67 Broad Street,
New York City.

DEAR MR. CHINLUND:

On behalf of the Committee on Stock List, I acknowledge with thanks your letter of January 17, 1934, and express its appreciation of your prompt action on the matters referred to you.

This committee is entirely in accord with yours on the question of the application of the fifth principle set forth in the communication of October 24, 1933. The position of the Exchange generally is, that it is not concerned with minor questions of form or with petty details, but with the substantial accuracy and fairness of accounts. At the same time, the committee desires to emphasize the importance of not permitting the growth of exceptions to impair the effectiveness of a rule.

The revised form of report or certificate has the approval of this committee, which also agrees with you regarding the desirability of uniformity, so far as it is attainable, in the language of audit reports, and I am so advising the committee of the American Institute of Accountants.

Yours very truly,

COMMITTEE ON STOCK LIST,
J.M.B. HOXSEY
Executive Assistant.

NEW YORK STOCK EXCHANGE
COMMITTEE ON STOCK LIST

FRANK ALTSCHUL
Chairman

J.M.B. HOXSEY
Executive Assistant

HERBERT G. WELLINGTON
Vice Chairman

W.O. LOOMIS
Secretary

JANUARY 18, 1934.

MR. GEORGE O. MAY, *Chairman*,
Special Committee on Co-operation
with Stock Exchanges,
American Institute of Accountants,
56 Pine Street,
New York City.

DEAR MR. MAY:

The Committee on Stock List is glad to note that with minor changes, to which it understands your committee has already agreed, the form of certificate suggested by you is approved by the committee of the Controllers Institute of America. It also believes that uniformity in audit reports, so far as it is attainable and is warranted by the circumstances of the particular case, is extremely desirable, and expresses the hope that the American Institute of Accountants will use its influence to bring about general adoption of the form of report which has now been approved by the committee of the Controllers Institute of America and by this committee.

Yours very truly,

COMMITTEE ON STOCK LIST,
J.M.B. HOXSEY
Executive Assistant.