

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 underrated 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, insofar 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 overstatement 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.

Very truly yours,

(Signed) Arthur Andersen & Co.

Barrow, Wade, Guthrie & Co.

Deloitte, Plender, Griffiths & Co.

Haskins & Sells

Lybrand, Ross Bros. & Montgomery

Peat, Marwick, Mitchell & Co.

Price, Waterhouse & Co.

Touche, Niven & Co.

Arthur Young & Co.