

## ДОКЛАДЫ НА ПЛЕНАРНОМ ЗАСЕДАНИИ

### PLENARY SESSION PAPERS

# CONDEMNATION, PROHIBITION, AND DISAPPEARANCE OF PUBLIC ACCOUNTING FIRM ORGANIZED AS CORPORATIONS IN THE UNITED STATES ACCOUNTING

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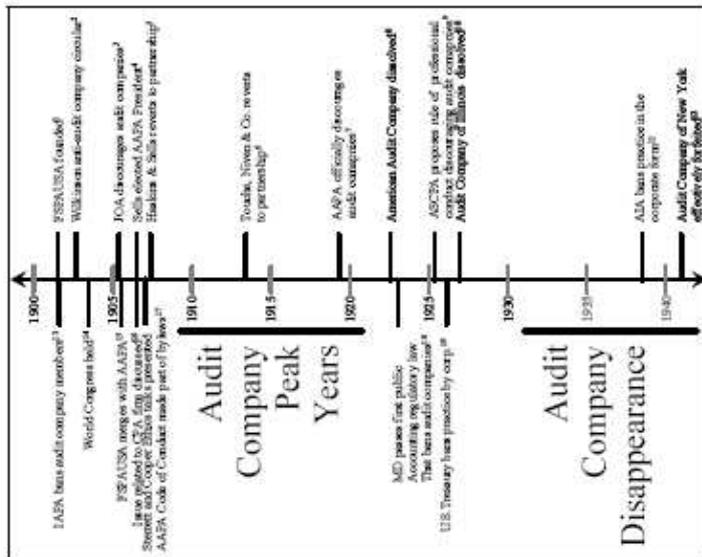
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## 1. Introduction

In the early 1900s, some of the largest public accounting firms in the United States were organized as corporations (*author* 2009, 24). By 1920, these firms along with other accounting firms collectively known then as "audit companies" became quite common. Over 570 of them existed in 1920 in the United States as compared to just over 1,090 partnerships (*author* 2009, 33). Many of these firms had prominent leaders such as Elijah Watt Sells, Ferdinand W. Lafrentz, Alvin C. Ernst, and Arthur C. Andersen (*author* 2009, 36). Yet by the 1930s, most of these firms ceased to exist. While the rest of the audit profession contracted somewhat during the depression, audit companies virtually disappeared. This paper will describe the condemnation, proscription, and disappearance of these audit companies. Figure 1 provides a time-line of significant events related to audit companies occurring prior to the late 1940's.

The term "audit company" used in this paper is an imprecise term and was ambiguously used by contemporaries. The term audit company in this paper, consistent with usage in the early part of the twentieth century, includes any of the four following scenarios involving public accounting practices: (1) corporate entities with fictitious names usually of an impersonal nature (e.g., The Audit Company of New York); (2) corporate entities with names indistinguishable from a sole proprietorship or partnership (e.g., Haskins & Sells, Certified Public Accountants); (3) unincorporated entities with fictitious names usually of an impersonal nature (e.g., Accounting Service & Audit Co.); and (4) unincorporated entities whose names included a partner's name but also included the term Audit Co. (e.g., E. C. Little Audit Company) (*author* 2009, 5-6). Just adding the term company to a firm name, such as Price, Waterhouse & Co., did not cause the firm to be considered an audit company.

Figure 1: Time-Line of Events



Sources: <sup>1</sup> (National Federation of Accountants 1902), <sup>2</sup> (Accountants' Notes 1903), <sup>3</sup> (AAPA 1905b), <sup>4</sup> (AAPA 1905b), <sup>5</sup> (Haskins & Sells Company 1907), <sup>6</sup> (Touche, Niven & Company 1913), <sup>7</sup> (ALA 1920, 66), <sup>8</sup> (F. W. Lafrantz & Co. 1949, 23), <sup>9</sup> (Report of Committee on Code of Ethics 1925), <sup>10</sup> (The Audit Company of Illinois 1926), <sup>11</sup> (ALA 1935a), <sup>12</sup> (The Audit Company of New York 1945), <sup>13</sup> (Reckitt 1953, 74), <sup>14</sup> (FSPAUSA 1904a), <sup>15</sup> (FSPAUSA 1905), <sup>16</sup> (AAPA 1907b), <sup>17</sup> (AAPA 1908a, 108-46, 238), <sup>18</sup> (Reik 1924, 93-4), and <sup>19</sup> (Treasury Department 1927, sec. 4)

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There are several characteristics that were often associated with audit companies. An audit company would perform public accounting and usually have two or more of the following characteristics: (1) performing public

accounting functions, though possibly in conjunction with other activities such as publishing; (2) using the corporate form which usually implied limited liability; (3) using impersonal names; and (4) having non-accountant ownership (*author* 2009, 6). Non-accountant ownership, and its potential ramifications, and use of impersonal names probably brought out the most criticism by early audit company critics. Later in the twentieth century, the existence of limited liability seemed the biggest argument against practicing in the corporate form. Some audit companies such as The Audit Company of New York had all four of these characteristics (The Audit Company of New York 1897; Official Roster of Accountants' Association 1897).

The paper contributes to the literature by exploring the backgrounds and motivation of audit company critics and the interrelationships among these same critics. This paper suggests that these critics as opinion leaders helped to establish professional societal code of ethics changes that discouraged audit companies. The paper further suggests that these code of ethics changes may have led to legal proscriptions against audit companies. Evidence presented in this paper suggests that pressure within the accounting profession and state and federal laws caused most of these firms to either change to more traditional forms of organization or leave the practice of public accounting altogether.

The remaining sections are organized in the following sequence. First, the methodology used in researching this paper is explained. Second, the condemnation of the corporate form made by various constituencies is considered. Third, prohibitions of audit companies or the corporate form of practice is discussed. Forth, the virtual disappearance of audit companies is talked about. Finally a brief conclusion is presented.

## **2. Methodology**

This paper uses a variety of published and unpublished archival materials to analyze the history of audit companies in the United States. Previously published non- contemporaneous references to audit companies are few and limited in detail. Some references were made in firm histories by firms that once were audit companies or had contact with an audit company (e.g., F. W. Lafrentz & Co., 1949; DeMond, 1951; Ernst & Ernst: A History of the Firm, 1960; Foye, 1970; Higgins, 1963; Swanson, 1972; Wise, 1982; Allen and McDermott, 1993) . Some non-contemporaneous references were made by accounting historians primarily discussing professional society code of ethics that also briefly discussed proscriptions against audit companies or a person's association with an audit company (e.g., Cook, 1962; Casler, 1964; Carey, 1969; Merino 1975; Preston, Cooper and Scarbrough, 1995; Previts & Merino, 1998). Most non-contemporaneous sources did not consider the multiple

contemporaneous and near-contemporaneous available sources that discussed audit companies.

To document the condemnation, proscription, and disappearance of audit companies within public accounting in the United States in this paper, several contemporaneous and near-contemporaneous primary and secondary sources were used in addition to the non- contemporaneous sources previously mentioned. The contemporaneous and near- contemporaneous sources primarily used included: public accounting societal minutes, state accounting board minutes, city and telephone directories, books, corporate filings, early accounting periodicals, treasury regulations, early Moody's manuals, and early SEC filings. Minutes examined for inclusion included: minutes of the Federation of Societies of Public Accountants in the United States of America (FSPAUSA), American Association of Public Accountants (AAPA), and The American Institute of Accountants (AIA). These minutes were provided by their successor organization the American Institute of Certified Public Accountants (AICPA). Minutes from Maryland's accountancy board and the Maryland Association of Certified Public Accountants (MACPA) were also utilized. State corporate filings were obtained from various state agencies, usually the Secretaries of State. SEC filings were obtained from the National Archives. Other publications reviewed were obtained from the The Library of Congress, The New York Public Library, The Enoch Pratt Free Library, the University of Maryland Theodore R. McKeldin Library, Maryland State Archives, Maryland State Law Library, and the collections of the United States Department of the Treasury.

### **3. Condemnation**

Soon after the emergence within the United States of audit companies and of the public accounting profession itself, there seemed to have been a momentum building toward the elimination of the use of corporate organizational form in public accounting firms. Rarely were audit companies cited as the most pressing ethical problems in the writings of early public accounting commentators concerning ethical issues. Advertising, for example, seemed one of the consistent ethics issues addressed (e.g., Cooper 1908, 139-40; Sterrett 1908, 1246). However, in the early twentieth century, when multiple ethics issues were discussed in a given paper, the concern over audit companies would often arise.

This section considers the criticisms of audit companies primarily by a group this paper refers to as the audit company critics. The initial discussion is of the early contemporaneous accounting critics and the interrelationships they had with other critics. Motivations of the critics and why the comments were

sometimes restrained are then considered. A summary of the criticisms made by the critics follow.

### 3.1 Audit Company Critics

The early twentieth century audit company critics, whose writings can be found, were influential and likely the driving force that led to the prohibition and ultimate disappearance of audit companies. It was their criticisms of the practice that made this alternative organizational form into something seemingly unethical. These critics were individuals of accomplishment equal in prominence at the time to the most prominent audit company members. The critics whose views have been recorded included: Richard Brown, John Alexander Cooper, Sir A. Lowes Dickinson, J. S. Morris Goodloe, J. Porter Joplin, Robert H. Montgomery, Carl Henry Nau, Alfred G. Platt, Ernest Reckitt, Alphyon P. Richardson, Joseph Edmund Sterrett, and George Wilkinson. Three of the individuals (Montgomery, Dickinson, and Sterrett) were inducted into The Accounting Hall of Fame (The Ohio State University 2001) and four (Joplin, Montgomery, Nau, and Sterrett) had been AAPA or AIA presidents (Presidents of the American Association of Public Accountants and American Institute of Accountants 1917, 13; Montgomery 1939, 61-80; Perine 1920, 492). Cooper, Goodloe, Joplin, Montgomery, Nau, Platt, Reckitt, Sterrett, and Wilkinson were state society presidents (Merino 1975,96;In Memoriam 1934; AAPA 1912,16; Montgomery 1939, 61-80; AAPA 1909, 13; Wilkinson 1904, 110; Reckitt 1953, The Author; FSPAUSA 1904a, 13; Illinois Accountants 1902). Sterrett and Cooper were considered ethics leaders of their time (Previts and Merino 1998, 203) and Cooper, Joplin, and Nau had served on AAPA and AIA ethics committees (Merino 1975, 376-8; Perine 1920, 492). Richardson was the editor of the *Journal of Accountancy*, as well as Secretary of the AAPA and AIA (Chief Staff Officers of the AICPA 1987), a position nearly equivalent to Barry C. Melancon, President and CEO of the AICPA today. Of course the views of most public accountants were never recorded and are unknown except for indications from societal votes.

Many of these critics had several characteristics in common. Table 1 shows that six of the ten critics whose birthplaces were identified were born in England and later immigrated to the United States. Of the 52 audit company members whose birthplaces were identified, none were born in England. Three of the critics were born in the United States, whereas 44 or 84% of the audit company members were born in the United States. British birth alone seems to be associated with a person being a critic.

This table includes accountants found to be associated with audit companies whose firm names were encountered in researching the paper and whose birth places were identified. Early audit company critics include individuals mentioned in the paper whose birth places were identified.

Birthplaces of audit company members were identified primarily using Perine (1920), Merritt (1925), and firm histories.

**Table 1: Place of Birth Comparisons Between Selected Audit Company Members and Early Audit Company Critics**

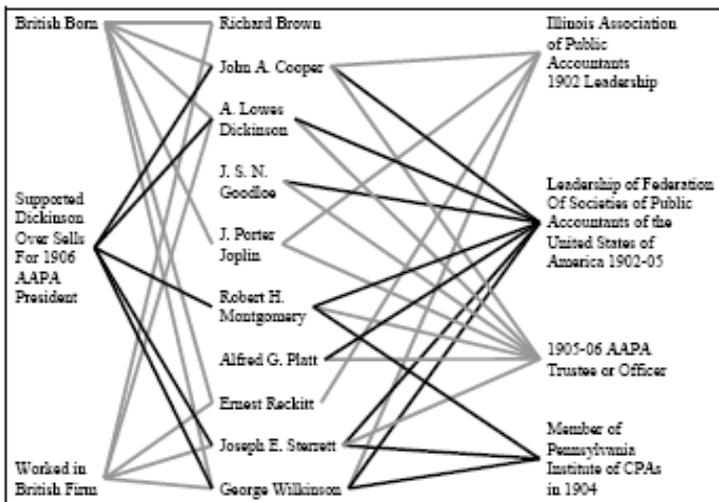
Birthplace	Audit Company Members		Early Audit Company Critics	
	Frequency	Percent	Frequency	Percent
United States	44	84%	3	30%
England	0	0%	6	60%
Scotland	4	8%	1	10%
Canada	2	4%	0	0%
Other Foreign	<u>2</u>	<u>4%</u>	<u>0</u>	<u>0%</u>
	<u>52</u>	<u>100%</u>	<u>10</u>	<u>100%</u>

Figure 2 shows the relationships or social network that the early critics held in common, suggesting that the lives of many of the critics intersected on numerous occasions in the period of initial condemnation occurring from around 1903 to 1907. Note that Nau and *JOA* editor Richardson were not included in the web, having fewer interrelations with the others and voiced criticism publicly after the 1907 period. These relationships were present or occurring during the emergence of the published criticisms toward audit companies. Membership or leadership in these organizations or being British born did not mean that a person would become a critic. In fact some audit company members such as Elijah Watt Sells of Haskins & Sells were members of some of these same national and state public accounting organizations. However, these relations are important because it shows these individuals had opportunities to interact with each other and to express their views. Wilkinson, Cooper, and Sterrett, among the most vocal audit company critics, each had at least five of the seven relationships with other critics.

In addition to the British birth that several critics had in common, some critics also had worked for British firms including the American born Sterrett. In 1907, the year of his professional ethics speech at the AAPA convention, Sterrett was invited by the United States Price, Waterhouse & Co. managing partner Dickinson to merge his practice into Price, Waterhouse & Co. (Allen and McDermott 1993, 41). Wilkinson and Reckitt were members in their own public accounting partnership during much of the period of the significant audit company criticism (Reckitt 1953, The Author).

Many of the critics were active in Illinois, Pennsylvania, and Ohio accounting society leadership positions during the limited existence of the FSPAUSA. This state leadership made them part of the FSPAUSA leadership (since the the FSPAUSA was a federation of public accounting societies) and thus these individuals interacted with each other. Wilkinson began his criticisms of audit companies as early as 1903 (Accountants' Notes 1903) and expressed these views at his widely publicized speech at the 1904 World Congress (Wilkinson 1904). Among the list of individual audit company critics noted in this paper, only Nau and Brown were not present at the 1904 World Congress (FSPAUSA 1904a, 2245).

**Figure 2: Social Network Diagram of Relationships of Early Audit Company Critics**



Sources: British Born: (Brown 1905, 404; Marino 1975, 85, 92; Perine 1920, 374; Rackitt 1953, The Author, 82); Supported Dickinson Over Sells For 1906 A.A.P.A. President: (Annual Meeting of the A.A.P.A. 1906); Worked in British Firm: (Allen and McDermott 1993, 41; Rackitt 1953, The Author; Brown 1905, 404); Illinois Association of Public Accountants 1902 Leadership (Merino 1975, 89, 96; Illinois Accountants 1902); Leadership of FSPAUSA 1902-05: (FSPAUSA 1904b; FSPAUSA 1904c; FSPAUSA 1904d); 1905-06 A.A.P.A. Trustee or Officer (A.A.P.A. 1905a, A.A.P.A. 1906b); Member of Pennsylvania Institute of CPAs in 1904: (Ross 1942, 14, 18; FSPAUSA 1904a, 13)

Prior to the 1905 merger of the FSPAUSA into the A.A.P.A. (FSPAUSA 1905), it appears from Webster's (1954, 327-99) biographical sketches of 214 A.A.P.A. fellows prior to 1905 and the 1907 membership roster (A.A.P.A. 1908a, 12-

3) that only Dickinson and Wilkinson of the audit company critics were members of the AAPA. Both Reckitt and Sterrett had been members but had resigned prior to the merger. Upon the merger, most of the audit company critics became members of the AAPA Board of Trustees (AAPA 1906b). When the United States native, Sells, ran for AAPA President in October 1906 against the British born Dickinson, fellow critics joined support of Dickinson (Annual Meeting of the AAPA 1906). It should be noted that Nau, an audit company critic, voted for Sells. Despite their opposition, Sells won the election. However, Sells changed his firm back to a partnership within three months of the election (Haskins & Sells, Certified Public Accountants 1907). Sells was already a member of the AAPA whereas the others supporting Dickinson came from the FSPAUSA faction. Though the election may not have been about the issue of audit companies, it did involve numerous audit company critics. Thus, the timing of the election and reversion to a partnership seems more than coincidental.

The state public accounting society interactions are likely as important as that of the national public accounting societies. Much of the audit company antagonism came from the Illinois society which Wilkinson and Cooper were actively involved. Wilkinson, one of the early audit company critics from the Illinois society, also probably had early Pennsylvania state society interactions with Sterrett, another early critic. Wilkinson became a nonresident member of the Pennsylvania society in 1904 (Ross 1942, 18), where Sterrett was already a member.

Though Wilkinson (Accountants' Notes 1903) seems to have been the first published critic, it is not clear who influenced whom. It is possible that these individuals independently drew their negative opinions regarding audit companies. However, it would seem likely from these interactions that some negative views toward audit companies were either formed or at a minimum reinforced.

### 3.2 Motivations for Criticisms

The motivation that caused the audit company critics to condemn the audit companies may have included:

- making public accounting appear more professional;
- emulating practices of other countries;
- emulating practices of other professions;
- acquiescing to antipathies towards corporations in general;
- avoiding of perceived ethics problems arising from audit companies; and

experiencing of fear and possible jealousy of prominent firms.

One common thread that runs throughout any printed critiques of audit companies relates to the issue of professionalism. While there has been discussion in the literature to whether or not accounting is a profession (Burns and Haga 1977; Root 1936), it is clear that even in the early twentieth century that leading accountants considered themselves part of a profession (Sterrett 1908, 111). The desire to become a recognized profession may be a reason that led to concern about audit companies. Maintaining a professional image was again raised as the motivating issue when the discussions of the removal of prohibitions against practicing in the corporate form appeared again in the 1960s (Carey 1970, 472). If public accounting eliminated unethical actions, perceived or real, it was thought that this could help build public trust (Chilton 1992, 122).

Concerns with professionalism may have been related to the wish to emulate public accounting in Great Britain. Looking to England and wishing for the respect that accountants there received is a recurrent theme in early accounting publications (e.g., Incorporated Accountants' Journal 1899; The Question of an International Accountants' Association 1899; Notes and Comments 1883). One accountant stated in 1899, "We grant that English accountants of the higher class are much older in experience and cover many more experts, besides furnishing the world with more first-class literature on this subject, than those of other countries" (The Question of an International Accountants' Association 1899).

Kittredge, editor of *Accountics* was certainly not an Anglophile as evidenced by his early criticisms of some of the aspects of the British Accounting system (Accountancy in Great Britain 1899). Yet even Kittredge conceded that based on their large numbers of accountants and their relatively longer period of professional establishment that many looked to the British for establishment of precedent and procedures (Accountancy in Great Britain 1899; The Monthly Statement 1899b).

Sells made the following statement in 1906,

There are three subjects connected with the advancement of the profession to which I would especially invite your attention. These are, first, a continued elevation of the standard of professional ethics; ... In two of these fields of professional advancement [included professional ethics] we have much to learn from Great Britain. As loyal Americans and as accurate observers we are convinced America is far ahead of great Britain in the character of our professional work. In the field of accountancy ethics and accountancy education we are still, however, behind our English brothers. (Sells 1906)

Given these comments, it then may not be surprising that some of the early leaders in accounting ethics in the United States including Wilkinson, Cooper, Joplin, and Reckitt were British born. Sterrett though not British born had extensive interactions with British public accountants, becoming Price, Waterhouse & Co.'s first American born partner (O'Malley 1990, 10).

It is not clear what the actual attitudes toward audit companies were in Britain itself or whether there were audit companies operating there. Brown, the Scottish accounting historian, certainly deplored audit companies and implied it was more of an American phenomenon (Brown 1905, 339). A commentary on a matter involving audit companies in the United States found in the English publication, *The Accountant* (Audit Companies 1912, 675), implies criticism of audit companies while mentioning that there were some audit companies being established in Britain. However, in the 1927 book on ethics in the Institute of Chartered Accountants in England and Wales, no mention of audit companies arises (The Etiquette of the Accountancy Profession: By a Chartered Accountant 1927). This may be because the condition did not exist widely in England or that if it had existed, the condition had been eliminated.

One might look to some other British Commonwealth countries such as Canada and New Zealand to get indications of audit company practices in Britain. In the 1920 accounting directory of United States and Canadian public accountants (Perine 1920) there were approximately 570 audit companies out of approximately 6,000 American accounting firm listings (*author* 2009, 33). Using the same directory, Canada had only five audit companies out of approximately 800 firms listed, with four of the five located in Quebec (Perine 1920, 260-91). In his 1962 dissertation, Cook evaluated code of ethics in English speaking countries. Both New Zealand and Canada had explicit prohibitions of using the corporate form by the late 1950's or early 1960's suggesting audit companies might have existed in order for a prohibition to be established (Cook 1962, 120,142).

Germany had its own version of audit companies in the early 20th century. Evans (2003, 50) notes some criticism of audit companies appeared as early as 1905. However, there is no indication that those German views were passed on to their Anglo-American counterparts. Based on the success of the German corporate form for audit firms, those views were not sufficient to cause a large decline of German corporate audit firms.

Not all British must have been biased against audit companies. Touche, Niven & Co. and Marwick, Mitchell & Co., both with British founders (Touche, Niven & Company 1906; Wise 1982, 3), established corporations in the United States for brief periods (Touch, Niven & Company 1900; Marwick, Mitchell & Company 1904) . Another prominent British public accountant associated with audit companies was James Martin. In 1904, at the time of Congress of

Accountants held in St. Louis, Martin was the Secretary of the Society of Accountants and Auditors in Great Britain and Ireland (Reckitt 1953, 285). Martin's accounting firm Martin Farlow & Company became associated with Lafrentz's The American Audit Company as early as the first decade of the 1900s (F. W. Lafrentz & Co. 1949, 16) representing The American Audit Company in England.

At the beginning of the twentieth century, public accounting in the United States was attempting to establish itself as a profession. Evidence suggests that accountants looked to the more established professions of law and medicine on behavior and etiquette (The Monthly Statement 1899a; The Monthly Statement 1899b). Though the medical and legal professions had been established for quite a period of time, their codes of ethics were established around the same time period as that of the accounting profession. The American Medical Association adopted the *Principles of Medical Ethics* in 1903 and the American Bar Association adopted its code, *Model Rules of Professional Conduct* in 1908 (Chilton 1992, 77). Other professions such as dentistry, pharmacy, and veterinary medicine had formal codes of ethics established prior to 1870 (Wilensky 1964, 143). Sterrett in his influential speech regarding professional ethics given in 1907, referred to the 1903 American Medical Association code and the ongoing American Bar Association deliberations concerning their own code that was ultimately adopted in 1908 (Sterrett 1908, 110) as positive examples to follow.

The legal profession also preceded the accounting profession in prohibiting the corporate form of practice. Prior to 1909, the New York Stock Corporation Law was enacted prohibiting law practice in the corporate form (Ohl 1962, 272). Around 1909, New York State made the practice of law by corporations a crime (Ohl 1962, 273). In 1908 the American Bar Association adopted Canons 1 through 32, which 31 states adopted by 1914 (Ohl 1962, 273). Canon 31 proscribed the direction of legal work by non-lawyer directors (Committee on Professional Ethics 1962, 160). In 1928, the American Bar Association adopted Canons 33 to 45 (Ohl 1962, 273). Canon 33 contained the prohibition that in firm names there should be "no false, misleading, assumed or trade name" used (Committee on Professional Ethics 1962, 160). Though Opinion 303 of the American Bar Association stated in 1962 that corporations were not banned outright by prior Canons (Committee on Professional Ethics 1962, 160), certain practices of law firms if operated as corporations such as ownership by non-lawyers and unrestricted limited liability were proscribed.

Medicine also established prohibitions against physicians practicing as corporations. By 1922 the American Medical Association prohibited the corporate form saying it would destroy the intimacy between patient and physician (Cook 1962, 181-2).

At the beginning of the twentieth century, there appeared to be an antipathy against operating in the corporate form in general by at least some of the public. Such views may have been worse for a company that provided professional services such as an accountant, a lawyer, or a doctor. In a 1898 article promoting the use of the corporation organizational form with no reference to their use for the professions, Charles Dutton, who had been owner of an audit corporation prior to the article's publication, described some of the negative opinions that existed toward corporations, "... [a] larger number of intelligent people than we imagine are of the opinion that corporations are formed simply and solely for the manipulation of some dark scheme ... that, as a matter of fact, corporations are a curse" (Dutton 1898, 8).

Dutton then quoted a prominent business man who was told that he should incorporate his business to provide for his heirs. The man rejected the advice stating, "I have been in business a great many years, have made my money honestly and my name is honored in the community. Now I do not propose to allow that name to be brought into disrepute. I shall never consent to have my business conducted upon dishonest principles" (Dutton 1898, 8). Given that the Sherman Antitrust Act was only passed in 1890 (Previts and Merino 1998, 176) and that Theodore Roosevelt at the turn of the twentieth century was attacking large corporations often referred to as trusts (Butterfield 1947, 328; Micklethwait and Wooldridge 2003; 73), it is not surprising that there was a bias by some early accounting leaders against practicing in the corporate form.

However, some in the public must have accepted audit companies. In 1934, when audit companies were in decline, the American Society of Certified Public Accountants (ASCPA) President George Price Ellis wrote,

The legal and the medical professions both have condemned the ethics of corporate practice of law and of medicine, but in so doing have challenged a public opinion at odds with the profession. The public has found such practice useful and is not concerned with the niceties of professional etiquette. (Ellis 1934).

Some of the distaste for audit companies may have resulted from perceived ethics abuses that happened to be committed by audit companies or their members. For example, in 1906, the *JOA* claimed that two audit companies were established to gain confidential information of clients (Editorial: Two Kinds of Auditing Companies 1906).

Though it is probable that the notion of professionalism and perceived or real abuses of audit companies dominated the motivations of the audit company critics, it is possible that fear and professional jealousy may also have played a role. The Audit Company of New York, one of the largest and most significant accounting firms of the early 1900s, had non-accountant ownership. Several

prominent individuals were associated with audit companies, such as Sells, Clarence Knisely, Maurice Kuhns, and Alden Dunning, which may have led to professional jealousy. Audit company leaders, along with Illinois Association of Public Accountants (IAPA) members, worked to secure passage of the 1903 Illinois CPA law (Reckitt 1953, 72). Yet though the IAPA member, Reckitt, was named to the first board of accountancy, the two other board members were from audit companies (Reckitt 1953, 77). Dunning, one of the two, was from The Audit Company of New York. Though initially banned from membership, it was only after the passage of the Illinois CPA law that these individuals from audit companies were invited to join the IAPA (Reckitt 1953, 74). The invitation to join the IAPA may have been due to their help in passing the Illinois law as Reckitt (1953, 74) claimed. Alternatively, the invitation may have been that the IAPA wanted all members of the board of accountancy to belong to their organization.

There could have been some organizational rivalry between the Chicago-based IAPA that had Wilkinson, Reckitt, and Joplin as members and a possible rival Chicago society called the Chicago Society of Accountants. In 1897, the IAPA was formed (Reckitt 1953, 51). In 1897, Kuhns who was associated with the Safeguard Account Company, was also President of another accounting group called the Chicago Society of Accountants (Accountants' Associations 1897). The title used to refer to Kuhn's organization was the "original" Chicago society in a notice about accounting associations in 1897. Whether there was any organizational rivalry is not known. Kuhns joined the IAPA in 1903 (Reckitt 1953, 74).

#### 4.3 Early Restraint in Criticism

Several early critics made distinctions early on between audit companies controlled by accountants versus those controlled by non-accountants (Editorial: Two Kinds of Auditing Companies 1906; Sterrett 1908). One reason some of the early critics might have had to mince some of their words was due to the prominence some audit company members held in the early public accounting profession as detailed previously. Most of the leaders seemed to be involved with firms of the "good" audit company type (i.e., no non-CPA directors). Given these leaders' prominence, it is not surprising that the critics had to be careful about their words. The lack of discretion by one early critic, Cooper, might have in part cost his election to a Presidency of the AAPA (Merino 1975, 96). While criticism seemed to cause some of these early audit company leaders to change from audit companies to partnerships, later the criticism seemed to be expanded to include audit companies with CPA owners.

### 3.4 Audit Company Criticisms

Within a few years after their emergence, some leading public accountants began criticizing audit companies. These criticisms included existence of non-accountant owners and directors, loss of client confidentiality, conflicts of interest, identities of auditors unknown, disrepute to the profession, commercialization of the profession, and limitations on liability. Those included among the critics were individuals whose direct quotes made it clear that they were critical of audit companies. Table 2 includes a list of audit company critics whose quoted remarks included specific concerns. This table also classifies their criticisms made toward audit companies.

**Table 2: Summary of Criticisms Made By Early Audit Company Critics**

	Non-Accountant Owners and Directors	Not Personal in Nature	Loss of Client Confidentiality	Conflicts of Interest	Identities of Auditors Obscured	Unprofessional	Act Disreputably to the Profession	Not Done in Other Professions	False Claims of Ability	Commercialize the Profession	Limited Liability
Richard Brown					X					X	
John Alexander Cooper	X		X		X		X			X	X
J. Porter Joplin	X	X									
Carl Henry Nau	X	X	X								
Alfred G. Platt									X		
Ernest Reckitt			X			X					
Joseph Edmund Sterrett	X			X	X	X	X				
George Wilkinson	X				X					X	
The Journal of Accountancy Editorials	X		X			X		X			

**Sources:** (Brown 1905, 339; AAPA 1908c, 26; Cooper 1908, 140; Joplin 1914; AIA 1919b, 43-57; Wilkinson 1904, 110; Reckitt 1953, 104-5; Sterrett 1908, 130-2; Sterrett 1910, 38-39; Accountants' Notes 1903; Wilkinson 1904, 14; FSPAUSA 1904a, 118; Editorial: Two Kinds of Auditing Companies 1906; 'Ethics' 1906; Editorial: 'Accredited Accountants' 1915; Editorial: A Touching Appeal 1916).

Most of the critics were very concerned about the presence of non-accountant directors and owners. The key concern relating to these non-accountant directors and owners was that they would exercise undue control (AIA 1919b, 43-57). The concern was in part over possible breaches in client confidentiality, but also in part that those running the company would hire inferior personnel or that the personal nature of the services provided would be lost (FSPAUSA 1904a, 112). With regard to hiring inferior individuals, Miller, an audit company member, noted that firms organized as partnerships could also hire inferior individuals (FSPAUSA 1904a, 112).

With respect to the personal nature of the services provided that would be lost if provided by a corporation, even partnerships of the time could be argued to have a similar problem. Wilkinson, a critic, practiced for a time with Barrow, Wade, Guthrie & Co. It appears from Anyon's account of the founding of Barrow, Wade, Guthrie & Co., that Wade, a Chartered Accountant, did not participate in the United States firm other than providing the necessary capital (Anyon 1925, 49). Price, Waterhouse & Co. would have had similar issues as Barrow, Wade, Guthrie & Co. In an AIA discussion of a paper on professional ethics in 1915, a member likened the dealings with associates of a large CPA partnership as being "organized corporately" (AAPA 1915b, 33).

The principal rationale used by critics for condemning non-accountant owners and directors was probably a concern that non-accountant owners might pressure the public accountant to pass on sensitive client information. For example, of the non-accountant owners of The Audit Company of New York some were bankers (The Audit Company of New York 1903, unnumbered). The critics were concerned that non-accountant owners might use the inside knowledge from the audit clients for their gain (AIA 1919b, 43-57). This issue was raised in a 1906 editorial in the *JOA* (Editorial: Two Kinds of Auditing Companies 1906).

One criticism of audit companies was that a client of an audit company would not know with whom they were dealing with when an impersonal name was used (Sterrett 1910, 39). Miller, an audit company member, pointed out those firms with deceased partners in their firm names did the same thing (FSPAUSA 1904a, 112). Concern regarding the use of names of impersonal nature and names of deceased partners led Pennsylvania in 1935 to attempt the prohibition of the use of both impersonal names and the use of names of

deceased partners (Editorial: An Attempt to Prevent Incorporation 1935). The bill was opposed by AIA through a AIA Council resolution because of the proscription of the use of deceased partner's name (AIA 1937a, 406), a common practice among long established firms.

As noted above, the desire to be a recognized profession was likely a key factor that led to the criticism of audit companies. Critics contended that operating as a corporation made public accountants seem to be more business oriented than professional (Wilkinson 1904, 14). The critics also felt that audit company members were more likely to commit discreditable acts than members of public accounting partnerships (Sterrett 1908, 130-2). Though some of the critics could see some valid points for forming a public accounting firm as a corporation, nevertheless, they felt that these benefits were not sufficient to overcome their concerns and operate as a public accounting firm as a corporation (Sterrett 1908, 1302).

One concern often expressed was the limitation of the personal liability that might result from operating as a corporation (Carey 1946, 72-3). In the early written criticisms of audit companies, only one hints that the corporation organizational form's limitation on liability was improper. More specifically, Cooper in his list of proposed rules in 1907 to prohibit audit companies, included rule number eight: "[i]n the case of legal liability as the result of negligence or criminal perversion of logical facts the ultimate responsibility rests with the practitioner, notwithstanding the financial support and control of outsiders" (Cooper 1908, 140). However, it is not clear in this quote that legal liability, where partners have their personal assets ready to satisfy debts arising from negligence, was really Cooper's concern.

### 3.5 Later Critics

After the 1919 AIA resolution discouraging audit companies was passed by the AIA Council (AIA 1938a), the tide of opinion toward audit companies became almost universally negative. After 1919, there is no indication of support in the literature for audit companies. Ellis (1934, 514), for example, did provide a grudging acceptance of audit companies. Ellis (1934, 514) writes that although the professions may find audit companies harmful, the public might find them useful. Ellis (1934, 514) felt that only if the public and the profession agreed that audit companies were harmful should audit companies be prohibited.

Later as audit companies disappeared, ethics discussions concerning audit companies faded as well. An example of the diminishment of this issue was the 1939 autobiography of Robert H. Montgomery, *Fifty Years of Accountancy*. The book includes several discussions of ethics and was published the year after an AIA rule was established prohibiting AIA membership to members of audit

companies. Though Montgomery took part in the discussions that led to the audit company prohibition, he did not mention the controversy.

The argument against audit companies had started to change as well. In a 1935 *JOA* editorial regarding a proposed Pennsylvania law prohibiting public accountants practicing as corporations, the biggest concern was limitation of liability (Editorial: An Attempt to Prevent Incorporation 1935). John L. Carey, Secretary of the AIA, wrote several books on professional ethics. Each book had a short section on practicing in the corporate form which explained the presence of this AIA provision proscribing professional corporations. In his 1946 book, Carey wrote that the primary concern with respect to practicing in the corporate form was limited liability (Carey 1946, 72-3). Carey also stated that non-accountant officers were inappropriate because they could not be held accountable to rules of ethics or boards of accountancy (Carey 1946, 72-3). Limitation on legal liability remained one of the main arguments against corporations up until the introduction of the personal service corporations in the 1960s (Blake 1962, 42-3).

The position of accounting educators on audit companies should be mentioned. The early accounting critics for the most part likely were not educated in any sort of system that would be recognizable today as part of a standard university education in accounting. Educators did not seem to play an important role in ushering opinion against audit companies in earlier periods. Audit company members such as Lafrentz, Kittredge, and Andersen were early accounting educators. Sterrett an audit company critic was also involved in the education of future accounting profession leaders. However, once opinion seemed to coalesce against the audit companies, some early educators likely expressed negative feelings towards audit companies. Alex Rosenthal, who graduated from the Wharton School in 1926, in a telephone interview suggested that his accounting professors had ethical questions about audit companies (Rosenthal 2000). He suggested that, his professors feelings in part influenced Rosenthal's own negative bias toward the audit companies.

In 1932, J. Hugh Jackson was a Professor of Accounting and Dean of the Graduate School of Business at Stanford University. He delivered a speech entitled "The Accountant and His Profession" as part of a series of ethics in accounting speeches given at Northwestern University that year which were later published (Jackson 1933, 144). Jackson in his speech indicated that "practice under the corporate form appears not only unnecessary but also wholly illogical. Accountancy represents a personal service." He then went on to indicate that more and more states would prohibit the corporate form and that public opinion prefers practice under the partnership or sole proprietorship form of organization.

## 4. Prohibition

Soon after accounting professional societies were established, rules regarding ethical behavior were promulgated. Many of leaders who promoted codes of ethics also promoted limitations on audit companies. Among the most important of the prohibitions affecting audit companies were those coming from the AAPA and its successor organizations, state regulatory laws, and the United States Treasury Department. Though some of the audit companies began to disappear perhaps due to the critics, the legal and societal prohibitions probably also hastened their decline. This section details the establishment of societal and legal prohibitions against audit companies. It first analyzes societal prohibitions and then legal prohibitions. The national accounting societies and then the state CPA societies are then considered. State laws and then regulations from the Treasury Department and the SEC are reviewed within the section dealing with legal prohibitions. Each section considers events in chronological order.

### 4. 1 Organizational Professional Ethics Code Development and Prohibitions

In October 1902, the Federation of Societies of Public Accountants in the United States of America was created (National Federation of Accountants 1902). This group was broad based and included delegates from the state society leadership in Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, and Pennsylvania and the AAPA President F.W. Lafrentz (FSPAUSA 1902). Based on differences in goals, the AAPA withdrew from the organization by January 1903 (Federation of Societies of Public Accountants 1903). The FSPAUSA merged with the AAPA in 1905 (FSPAUSA 1905), whereupon the AAPA kept its name but was restructured into a state society federation (Wilkinson 1927). The new members coming from the FSPAUSA outnumbered the original AAPA members by nearly four to one (AAPA 1908a, 19).

The FSPAUSA existed for only a brief period of time yet was important to the discussion of audit companies. As pointed out previously and shown in Figure 2, many of the audit company critics were leaders of the FSPAUSA and possibly interacted with each other for the first time at FSPAUSA meetings. Wilkinson, Secretary of the FSPAUSA (1902-04), was one of the first public critics of audit companies both in a circular he sent out in 1903 (Accountants' Notes 1903) and in his speech on the accounting movement in the United States given at the FSPAUSA sponsored 1904 Congress of Accountants (Wilkinson 1904). On the Committee on Arrangements for the 1904 Congress were many of the audit company critics including Dickinson, Goodloe, Montgomery, Platt, Reckitt, and Wilkinson. Also on the Committee were accountant controlled audit company members MacRae, Niven, and Sells (Proposed Congress of Accountants at World's Fair 1904). In November of 1903 the FSPAUSA proposed model state CPA laws for states to adopt (FSPAUSA 1903).

The FSPAUSA was a loose collection of state societies and did not have a code of ethics. However, in 1904, Sterrett, an audit company critic, in his opening speech as Chairman of the 1904 Congress stated,

Much has been accomplished, but much more remains to be done. Policies are to be outlined, questions of practice are to be decided, a system of professional ethics must be developed. (FSPAUSA 1904a, 33)

In late December 1904, just three months after the 1904 Congress and about a month and a half before the FSPAUSA voted to merge with the AAPA, a committee was formed to further discuss audit companies (FSPAUSA 1904d). The committee consisted of audit company critics, Dickinson, Platt, Cooper, and Montgomery, and three other individuals including Herbert G. Stockwell of the Audit and Appraisal Company of America. Probably due to the dissolution of the FSPAUSA, the issue of audit companies was dropped.

The AAPA was formed in 1886 and incorporated in 1887 (Anyon 1925, 32). It was the first accounting organization focusing solely on public accountants. In 1905, the FSPAUSA members and federated state society structure became part of AAPA (FSPAUSA 1905). At the time, former audit company member, Loomis, was President of the AAPA and former FSPAUSA President and audit company critic, Dickinson, was Secretary (AAPA 1905a) in the newly combined organization.

Due to the problems associated with being organized as a federation of state societies, the AAPA was reorganized in 1916, becoming similar to its structure prior to the FSPAUSA merger (AAPA 1916). This successor organization was renamed The Institute of Accountants in the United States of America in 1916 and then was renamed again as The American Institute of Accountants in 1917 (AIA 1917, 9-12). In 1936, a rival national organization, the American Society of Certified Public Accountants, merged with the AIA (AIA 1937a, 333). The AIA was renamed in 1957 as the American Institute of Certified Public Accountants (Carey 1970, 344).

The AICPA's current code of ethics has developed over the years and today is technically binding only on its members. However, many state accounting boards and state CPA societies have at times adopted the AICPA code in part or in its entirety (Lemeron 1972). This, in effect, had given the code nearly the force of law. Though the AAPA was established in 1886, it was not until after the merger of the FSPAUSA with the AAPA that a formal code of conduct was established in 1907 (AAPA 1908a, 238). However, in the mid-1890s a rule was briefly considered limiting advertising by members (Webster 1954, 121-5).

The events surrounding the establishment of a formal AAPA code of ethics were intertwined with the emergence of the audit company issue. In December 1905 AAPA Journal Committee, chaired by Elijah Sells who was still President of an audit company, presented a committee report that resulted in the following resolution:

Resolved, That, it be the policy of the "Journal of Accountancy" not to recognize so-called Audit Companies as professional accountants, and to discourage their recognition as such by the Public in every possible way. (AAPA 1905b)

By July 1906 a special annual meeting planning committee consisting of Goodloe, Joplin, and Dickinson introduced a program for the annual convention to debate audit companies, professional fees, and advertising (AAPA 1906a). This program was postponed. Upon a motion by audit company critic Cooper, the AAPA first established a Special Committee on Professional Ethics in October 1906 immediately following the election of Sells as President (AAPA 1906c). At that 1906 meeting in Ohio, Cooper as Chairman of the Committee on Legislation presented two model CPA laws both having sections saying "and no corporation shall assume such title 'Certified Accountant' or 'Chartered Accountant' or letters 'C.P.A.' or 'C.A.' or any other words or letters or abbreviations tending to indicate that the person, firm or corporation using the same is a Certified Public Accountant" (AAPA 1908a, 215-20).

By January 1907, various ethics cases were submitted to the Special Committee on Professional Ethics that John Cooper was chairing (AAPA 1907a). The most prominent of these cases was one involving a CPA firm, resulting in a lengthy discussion at the AAPA Board of Trustees in October of 1907 at the annual AAPA meetings held in Minnesota (AAPA 1907b). The charge discussed in that October meeting was that the CPA firm, operating as a corporation, issued an audit report on a bank while not disclosing that the bank vice-president was also the vice-president of the CPA firm (a corporation). The minutes state that the CPA firm responded with written personal attacks against Cooper as well as the AAPA. Based in part on this case, Cooper had prepared a set of rules to counter the perceived abuses, including audit companies, that he later presented in his speech at the annual meeting following Sterrett's presentation of his essay entitled, "Professional Ethics." At the October AAPA Trustees meeting prior to Sterrett's talk and immediately following the discussion about the CPA firm, Cooper stated,

That as the outcome of the ethical essay that my friend Mr. Sterrett hands in on Wednesday, there will be coming in from the chairman of the ethics committee [Cooper] a set of rules - precepts, rules, or whatever you like to call them - covering that very feature,... We want a standard of ethics, and if we are going to have this kind of

thing going on all the time, we are nothing but a lot of traders.  
(AAPA 1907b)

At the 1907 convention, Sterrett presented his paper "Professional Ethics" followed with Cooper's reply and set of rules (AAPA 1908a, 64). Sterrett at the end of his speech, just as in his 1904 address, welcomed a set of professional ethics standards (AAPA 1908a, 1323). At the same October 1907 AAPA meetings and through the Illinois Society of CPAs, Cooper presented a list of rules as bylaw changes that were similar to some of the rules he presented in his paper (AAPA 1908a, 58-65). None of the proposed rules directly addressed audit companies.

In 1907, five of these rules were adopted with most of Cooper's wording unchanged and became part of the AAPA's Constitution and By-Laws (AAPA 1908a, 238). Though not officially included in the by-laws but in the 1907 AAPA yearbook, the Committee on Professional Ethics made the following statement, "This committee is of the opinion that a method of doing a professional business, where the public is not informed as to the distinction between a firm itself and an incorporated audit company, is ethically, legally and practically wrong; is contrary to the spirit of this Association, and should be condemned" (AAPA 1908a, 26).

In 1907, Cooper was appointed Chairman of the Rules of Ethics Committee while remaining Chairman of the Professional Ethics Committee (AAPA 1908a, 12). This committee's purpose was to define rules of ethical conduct. In 1908, there were complaints that an audit company incorrectly stated that its associates were members of the AAPA (AAPA 1908d). In Cooper's 1908 ethics committee report, there was a letter of support for Cooper's opposition to audit companies when there were non-accountant owners and directors (AAPA 1909, 98-9). Cooper used this letter to propose the addition to the rules of professional ethics, "(1) (Addendum) Nor shall he conceal his personality under a corporate name, either nominal, personal, or fictitious" (AAPA 1909, 98-100). The rule was not adopted.

Cooper was again reappointed as Chairman of the Professional Ethics Committee in 1908 (AAPA 1909, 14) and 1909 (AAPA 1910, 14). In his 1908 report, Cooper promoted the amendment of the rule proposed in the previous year and spoke of a case of another audit company improperly using the initials CPA as part of its name (AAPA 1910, 86-7). Cooper also suggested that the committee become a permanent and not just a special committee. Neither suggestion was adopted. In his last report as Chairman of the ethics committee presented at the end of his 1909-10 term, again an audit company ethics matter was presented (AAPA 1911, 80-1). In 1913, Cooper was appointed as Chairman of the Special Committee on Code of Ethics where the committee prepared a set of rules on the profession and ethics (AAPA 1914, 228) but the Special

Committee on Professional Ethics in the following year decided to do nothing with the rules (AAPA 1915a, 217).

In 1915, the ethics committee became a standing committee called the Committee on Professional Ethics (AAPA 1915a, 68-9). In 1916, in the same meeting where the AAPA was reorganized and became the Institute of Accountants in the United States of America, Nau was elected as Chairman of the Committee on Professional Ethics for the 1916-17 term (Institute of Accountants in the United States of America 1916). His committee of five included Joplin and Herbert G. Stockwell, a former audit company member. When operating as the AAPA, the rules of professional conduct were part of the professional ethics section of the by-laws. In early 1917, the "Rules of Professional Conduct" were separated from the "Constitution and By-Laws" and distributed to all members (AIA 1917, 173-4). One of the AIA's rules of professional conduct approved in April 1917 was:

(1) A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Accountants," but... a corporation, or an individual or individuals practising under a style denoting a corporate organization, shall not describe themselves as "Members of the American Institute of Accountants." (Edwards 1960,255)

Though a person could belong to the AIA, the firm he or she belonged to was not supposed to use the title Members of the American Institute of Accountants in their notices to the public if the firm was a corporation. This was the first official prohibition affecting audit companies in the history of the AIA and its predecessor AAPA.

Next in 1919, seemingly as a result of a complaint from a terminated employee of an audit company, Nau, still Chairman of the ethics committee, proposed a ban on audit companies to the AIA Council (AIA 1919b, 43-57). This resulted in the following resolution being presented to the membership:

Resolved, That there be submitted to the general meeting of the Institute a proposition that within three years from this date no member of the Institute be permitted to continue his membership if he be an officer, director or responsible manager of an audit company or other corporation or other company maintaining a department organized for the purpose of carrying on a general accounting and auditing practice, unless all the stockholders and directors and officers of such corporation be and continue to be practising public accountants. (AIA 1920, 66)

There was debate on whether such an action could be taken that affected the membership to such a degree without given prior notification and allowing

these members a response. To at least show the immediate will of the council and to discourage the practice by audit companies until a rule could be established in subsequent meetings, the following resolution was adopted:

RESOLVED, That it is the sense of this meeting that audit companies and similar organizations are detrimental to the best interests of the accounting profession. (AIA 1920, 66)

The matter seems to have been dropped for the most part after the resolution discouraging audit companies. The AIA ethics committee reports do not mention audit companies in the ensuing years. In April 1938, the question of audit companies came up again at an AIA Council meeting with Montgomery moving that the ethics committee prepare a rule concerning them (AIA 1938b). As a result of this instruction in September 1938 the AIA Council passed the following resolution (AIA 1938a):

After September 16, 1939, no member or associate of the Institute shall be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia. (AIA 1939, 109)

The date chosen was because it was the twentieth anniversary of the 1919 resolution (AIA 1938a). In a 1940 AIA Council meeting, the code of ethics was revised including the former rule 13 shown above regarding audit companies (AIA 1941, 50). The revised rule was renumbered and became rule 11 with the date omitted becoming:

A member or an associate shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

By 1958, based on changes in membership rules, the words "or an associate" was removed from rule eleven (Edwards 1960, 253).

After 1912, the AAPA only accepted new state societies into the AAPA if all members were CPAs (AAPA 1915a, 351). Yet non-CPAs who were already members did not lose membership in the AAPA. It was not until 1921 that an effective national organization limited solely to CPAs was again formed, named the American Society of Certified Public Accountants (Meeting of Officers 1922). In 1925, memberships of the two leading national accounting organizations, the ASCPA and the AIA, were almost equal, at just more than 2,000 (Carey 1969, 370). Many individuals belonged to both the ASCPA and the AIA (Carey 1969, 370). The ASCPA merged with the AIA in 1937 (AIA 1937b).

By March 1923, a Committee of Ethics of the ASCPA was formed with Arthur C. Upleger, a former audit company member, as Chairman (Committee on Ethics 1923). With a task of forming a code of ethics, the committee in 1924 came up with nineteen rules (Report of Committee on Ethics 1924). The rule regarding audit companies was "Corporate form of organization should be discouraged, but when used does not absolve the individual from or alter the moral obligations of individuals." In an editorial in the same issue of the ASCPA's journal, *The Certified Public Accountant*, members attending the forthcoming Conference of Members of State Boards of Accountancy and Officers of State Societies of C. P. A.'s in Washington D.C. were asked to consider various matters including "Should corporations be permitted to practice public accountancy?" (Conference on Uniform Accountancy Laws 1924)

In September 1925, the ethics committee proposed the modification of the previous proposed but un-enacted rules of ethics (Report of Committee on Code of Ethics 1925). The proposed corporation rule became "Corporate form of organization should be discouraged, but when used does not absolve the individual from or alter the moral obligations of individuals. The certified public accountant receives his title by examination and this title can not be transferred to a corporation except through the personal contact of certified men" (Report of Committee on Code of Ethics 1925). When some of the rules became the "Precepts of Professional Conduct" as part of the ASCPA constitution and by-laws, the rule regarding the corporate form was not included (Revised Constitution and By-Laws of the American Society of Certified Public Accountants 1926).

It is unclear why the rule discouraging the corporate form was not part of the final set of rules. As was explained previously, there were still quite a number of audit companies present when the rules were adopted in 1925. The members of these firms may have opposed the inclusion of the rule, though no minutes or accounts exist that describe why rules were included or excluded. The AIA itself did not pass a prohibition until 1938.

It is not clear which one of the state societies was first to establish a code of ethics. The IAPA adopted the following rule on its formation in 1897, "member may be excluded or suspended up to two years after due hearings if: . . . he is held by the Board of Directors on the complaint of any person aggrieved, whether a member or not, to have been guilty of any act or default discreditable to a public accountant" (Reckitt 1953, 56). This rule was not part of any formal code of ethics. In 1900, the The New York State Society of Certified Public Accountants (NYSSCPA) established a standing committee on professional ethics (Accountancy As a Profession 1901). In 1901, Charles Waldo Haskins while President of the NYSSCPA talked of a need to establish a code of ethics (Haskins 1901).

The Illinois state society was likely the first to prohibit practice by audit companies. Members of audit companies there were originally prohibited from becoming members of the IAPA sometime prior to 1903 (Reckitt 1953, 74). Because of the work that Edward Gore (Audit Company of Chicago), Alden Dunning (Audit Company of New York), Kuhns (Safeguard Audit Company), and Clarence Knisely (Audit Company of Illinois) performed toward passage of the Illinois CPA law, the bylaws of the IAPA were amended to allow members of audit companies to join (Reckitt 1953, 74). These individuals joined in 1903 (Reckitt 1953, 74). It is unclear when audit companies were again prohibited by the Illinois state CPA society.

No source was found that indicates when each state society adopted prohibitions against audit companies. In its 1909 report to the AAPA convention, the NYSSCPA discussed the 1909 prohibitions against lawyers practicing in the corporate form in New York and stated the subject was under consideration of its Committee on Ethics headed by former audit company member Loomis (AAPA 1910, 106-7). Henry R. M. Cook the President of the NYSSCPA stated, "and while the report of the committee in charge has not been made public at this writing, it is believed that the popular feeling in the society deprecates the practice of accounting by and through a corporation" (AAPA 1910, 106-7). Cook also indicated that since the New York CPA law did not regulate the practice of accounting that there was not a practical impact to prohibition of the use of the CPA letters as in the legal profession (AAPA 1910, 106-7). Yet in 1926, the NYSSCPA did not have a prohibition against audit companies (Rules of Professional Conduct 1926).

Evidence provided by Lemeron (1972) indicates that at some point in time many state societies must have prohibited practice by audit companies. More specifically, Lemeron (1972, 119) indicates that 17 state CPA societies still prohibited practice in the corporate form. In addition to state CPA societies, Lemeron (1972, 136) found that eight of the 37 state public accounting societies found in the United States prohibited corporations in their codes.

#### 4.2 Legal and Regulatory Prohibitions

In 1896, New York passed the first CPA law (Previts and Merino 1998, 133). The New York law and almost all of the laws that followed until 1924 protected the use of the term CPA but did not regulate who could practice public accounting (Edwards 1960, 110). In 1904, the NYSSCPA indirectly acknowledged the presence of audit companies when the society proposed a law change to their CPA law that would have allowed audit companies to call themselves CPA firms when the majority of the members were CPAs (MACPA 1904). The amendment was apparently unsuccessful since it did not appear in the reprint of the New York CPA law that was included in the 1907 AAPA year-book (AAPA 1908a, 185-6).

At that 1906 meeting in Ohio, Cooper as the Chairman of the AAPA Committee on Legislation presented two model CPA laws that disallowed corporations the use of CPA as part of their corporate names (AAPA 1908a, 215-20). These model laws were to be used by public accountants in states with no CPA laws to establish CPA laws using the AAPA model CPA law wording. Virginia, for example appears to have used some of the wording from the AAPA's model law, based on the wording found in Virginia's CPA law adopted in 1910 (AAPA 1913, 374-5).

In 1924, Maryland passed the first "regulatory" law that required all public accountants to be registered (Reik 1924, 93-4). Oklahoma had previously passed a regulatory law in 1917 but that law was struck down in 1924 by the Oklahoma Supreme Court (Edwards 1960, 110-3). A portion of Section 8 of Maryland's 1924 CPA law read:

...and no corporation shall hereafter be permitted to practice or hold itself out to the public as an accountant or auditor; provided, however, that nothing in this article shall be construed as altering, abridging or in any way affecting the rights or powers heretofore granted any corporation by Special Act of Legislature of this State. (An Act to Repeal and Re-Enact With Amendments, Sections 1, 3, 4, 5, 6, 7 and 8 of Article 75-A of the Annotated Code of Maryland 1924)

This was a significant law change since only a regulatory law could affect the practice of audit companies. Laws present at the time in New York for example could only control when a firm could use the letters CPA. The laws could prohibit an audit company or member from calling themselves a CPA. The laws did not prevent an audit company from practicing as public accountants. Since Maryland had the first successful regulatory law and since the law proscribed the practice of public accounting in the corporate form, it is possible that Maryland's 1924 amendment was the first CPA law to prohibit audit companies organized as corporations from practicing public accounting. The provision regarding "Special Act" refers to The Baltimore Audit Company, apparently the only company created in such a manner that was still active in 1924. Many of the accounting leaders in Maryland had been associated with The Baltimore Audit Company (*author* 2009, 36).

Not all regulatory laws prohibited audit companies or at least preexisting ones. Michigan's regulatory law, passed the following year, actually made provision for licencing of corporations as public accountants when these firms existed prior to 1925 (Proposed Michigan State C.P.A. Law 1925). In 1929, Iowa had a provision similar to Michigan's law (Iowa Regulatory Law, 1929 1929).

Some states attempted and were not successful in adding prohibitions of audit companies to their laws. In 1937, such a bill was considered by the Pennsylvania legislature (State Accountancy Legislation 1937, 20). John Carey in his 1946 book on ethics stated,

Certified public accountant laws of the following states contain provisions specifically prohibiting either the practice of public accounting or the use of the designation "certified public accountants" by corporations: Arizona, California, Colorado, Delaware, District of Columbia, Florida, Illinois, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Missouri, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Tennessee, Texas. (Carey 1946, 73)

Based on the controversy surrounding the reintroduction of professional corporations in the 1960s, most states apparently had adopted prohibitions against accounting firms operating as corporations prior to that time. However, some states apparently adopted their prohibitions only a few years before the emergence of professional corporations. An audit company, in 1967 commenting to the Maryland accountancy board stated that New York did not prohibit corporations until 1959 (MSBPA 1967a). In that statement, the audit company related that they were not affected by the 1959 prohibition because of a grandfather clause.

The SEC accepted any CPA or firm licensed by a state. The rule under the Securities Act of 1933 read as follows:

Rule 650. Qualifications of Accountants (a) The Commission will not recognize any person as a certified accountant who is not duly registered and in good standing as a certified public accountant under the accounting laws of the State, Territory, or country of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the State, territory, or country of his residence or principal office. (Greidinger 1939, 392)

If a state licenced an accountant associated with an audit company, then the accountant could conduct SEC engagements. Given that a CPA firm organized as a corporation submitted a Prospectus to the SEC in 1959 (MSBEPA 1960), subsequent changes to this rule apparently did not alter the SEC's reliance on state licencing rules.

The 1913 income tax law created a new practice area for public accounting firms (Previts and Merino 1998, 182). In February 1921, the Treasury Department issued Circular 230 (Treasury Department 1959), a document that in its frequently revised form today still exists (Internal Revenue

Service 1999, 2). Circular 230, includes the laws and regulations that pertain to who can practice before the Treasury Department (Treasury Department 1921), which includes the Internal Revenue Service . When first issued in 1921, the only professionals specifically mentioned were attorneys (Treasury Department 1921). All others were enrolled as agents.

The original version stated that those representing others before the Treasury Department needed to show they were of "good character and in good repute, possessed of the necessary qualifications." This original Circular 230 also included a statement condemning advertising as unethical if the advertizing mentioned enrollment. Certificates of Character were provided from others and used as references to prove an applicant's "good moral character" (Treasury Department 1921).

Between 1921 and 1927, three revisions were made to Circular 230 (Treasury Department 1959). In the 1927 version, CPAs were not given separate recognition but there was a ban put in place against practice by corporations or by members of a corporation:

...a corporation cannot be enrolled, and attorneys agents will not be permitted to practice before the Treasury Department for account of a corporation which represents claimants and others in the prosecution of business before the Treasury Department. (Treasury Department 1927, sec. 4)

This ban on corporations by the Treasury Department was not removed until the 1960s.

## **5. Disappearance**

This section examines the virtual disappearance of audit companies. As criticisms and then prohibitions increased, audit companies began to disappear. The first aspect of audit companies to go was the corporate form. Many of the firms with personal names that chose the corporate form reorganized as partnerships. Then many firms abandoned impersonal names and adopted the names of their partners. The last to go were the partnerships that had the term audit company as part of their name, such as the Smith Audit Company.

### 5.1 Extent of Disappearance

After their peak in pervasiveness by around 1920, there appears to have been a sharp decline in the audit companies. Even before audit companies began appearing in large numbers in the early 1900s, some audit companies that had been started in earlier years had already ceased using the corporate form. One of the earliest cases of a practicing audit company discontinuing its corporate

operational form was that of Dutton's Bureau of Audit. The Bureau of Audit was established in 1893 (Bureau of Audit 1893) and ceased in approximately 1894 (Littleton 1942, 30).

In *author* (2009, 32), declines in the cities of Baltimore, Boston, Chicago, and New York are illustrated. After 1920, the percentage of audit companies in New York drops by 50% from 1919 to 1925. By 1940 the percentage had dropped as low as 3% of overall firms. In Chicago, the proportion of audit companies decreased by 35% between 1915 and 1928. That paper also shows a sharp decline for Baltimore between the 1920 percentage of 18% and the 1924 percentage of 10%. This decline occurred before the introduction of Maryland's regulatory law in 1924. By 1940, Baltimore's city directory had only two listings (both for the same firm) and the telephone directory had only one (the same firm as listed in the city directory). This firm was an unincorporated business using an impersonal name. Boston also showed a decline, but did not appear to ever have as proportionately large of an audit company presence as Chicago and New York.

*Author* (2009, 33) also shows a sharp decrease nationwide in the total number of audit companies as a percentage of total number of accounting firms for the years 1920 to 1925, from 9% to 5%. The actual number of audit companies declined from 575 to 458 across the United States. The number of partnerships during the same period increased from 1,092 to 1,814. This indicates that it was not the accounting profession that was contracting, only the audit companies.

The 1930s seemed to indicate sharp declines in the number of audit companies. In 1920, the number of audit companies was important enough that the AIA felt they could not ban audit companies outright (AIA 1919a, 155-66). However by 1932, *Fortune* noted that, "C.P.A.'s practice in partnerships, almost never corporations" (Certified Public Accountants 1932). In the 1935 editorial the *JOA* writes: "Many of the older audit companies were reorganized years ago and assumed the partnership form. The few of these concerns which remain in the old form are not sufficient in number to affect seriously the profession" (Editorial: An Attempt to Prevent Incorporation 1935).

In 1938, prior to the banning of audit companies by the AIA, a council member at a AIA Council meeting inquired if audit companies still existed, with the reply by others at the meeting that they knew they existed since some complaints had been received (AIA 1938b). Reckitt in his history of Illinois accountants stated in 1953 that all but possibly one of the audit companies around in 1903 had gone out of existence (Reckitt 1953, 105). Yet though the firms mostly disappeared there were probably a few firms that continued on as audit companies. One CPA firm operated in some states as a partnership and

other states as a corporation (MSBPA 1967b) as late as the 1960s when professional corporations began emerging.

### 5.2 Reasons for Disappearance

As stated previously, the probable reasons for changing organizational firms were the increased criticism and prohibitions. Other reasons likely existed. The Account, Audit & Assurance Co. probably ceased with the death of its owner in 1903 (Anson O. Kittredge 1903). The Certified Public Accountants Company of New York City may never have operated. Some firms may have been acquired which was probably the case of The Audit Company of New York.

The critics likely explain why some firms changed. The rationale for reverting to the partnership form given by Haskins & Sells, Certified Public Accountants was as follows, "...early in 1906 there was a good deal of agitation from other accountants and some inquiries from clients as to the character of the organization. It was, therefore, decided to change the form and once again to have the practice conducted by a partnership" (Foye 1970, 30). Also, Sells was Chair of the *JOA* committee that in December 1905 chose to discourage audit companies (AAPA 1905b). Audit companies were originally on the 1906 convention agenda (AAPA 1906a). Sells had in that same late 1906 convention, barely won the AAPA presidency election beating out Price, Waterhouse & Co.'s leader, Dickinson (Annual Meeting of the AAPA 1906). Dickinson's main supporters were audit company critics. In 1913 Touche, Niven & Co. was reorganized as a partnership with the following rationale provided, "By 1913, this form of organization was considered inappropriate for a professional firm" (Swanson 1972, 84).

Some firms though providing a rationale for discontinuing the corporate form, gave reasons that were unclear. The American Audit Company changed its organizational form and became F. W. Lafrentz & Co in 1923, stating:

One effect of the rapidly changing scene was a decision on the part of the Lafrentz officers to change the firm's pattern of organization. The American Audit Company had been a corporation, conducted in accordance with the ethics of the accounting profession; but it was felt that there were advantages, in view of the firm's enlarging scope of activities and responsibilities, in changing to a partnership. (F. W. Lafrentz & Co. 1949, 23)

For larger firms, the disadvantages resulting from the then controversial issue of audit companies probably outweighed benefits obtained from the corporate form. One concern might have been loss of goodwill. Some audit companies with personal names such as Touche, Niven & Co. would lose no goodwill attached to the firm name since their firm names remained relatively

unchanged. The American Audit Company had a well known owner, Lafrentz, who likely carried a lot of the firm's goodwill. Some firms such as The Audit Company of Illinois and The Baltimore Audit Company operated simultaneously with partnerships formed by the audit company leaders. It is likely that these partnerships were creating their own goodwill. Thus, if the audit company and its impersonal name was discontinued while the partnership continued, there was probably less goodwill lost than if there were no partnership operating simultaneously.

Other rationales for forming audit companies were less important at the time for maintaining the corporate form as well. Most of the larger firms were likely well capitalized and would not have been at a competitive disadvantage if they reverted to a partnership form like most of the other accounting firms. Large firms still would have had the problems associated with the death of a partner but given the time when many of these large firms changed to partnerships, they still had relatively young name partners.

Even limited liability would not have been a big reason at the time to maintain the corporate form. For a larger firm, the firm capitalization would have been enough for most lawsuits. The big legal cases that started affecting the profession did not start to occur until the 1930s (Previts and Merino 1998, 271).

For smaller firms, the reasons for forming corporations were probably still attractive. The arguments made by critics to individuals not part of the accounting power structure and often not CPAs were probably not compelling initially. However, with the advent of the regulatory prohibitions by the Treasury Department and the various states, the corporate form became more of a liability. As the 1935 *JOA* editorial stated, "The general distaste for the incorporation of accounting firms has reduced the number of the audit companies and similar organizations" (Editorial: An Attempt to Prevent Incorporation 1935).

## **6. Conclusions**

This paper using archival information examines prohibition of the corporate form within public accounting in the United States. In the first half of the twentieth century, public accounting firms operating in the corporate form were often referred to as audit companies. Contemporaneous and near-contemporaneous primary and secondary sources were extensively used to draw inferences and conclusions. The paper contributes to accounting history literature by examining a practice once common among accounting firms in the United States that once deemed unethical ultimately led to the virtual disappearance of an organizational firm within the accounting profession. The

paper also makes contributions to the literature by exploring relationships among critics.

The paper provides insights into the criticisms and prohibitions that arose and ultimately led to the disappearance of the early audit companies. Soon after the firms appeared, criticism towards audit companies by other public accountants emerged. Critics such as Wilkinson by 1903 and Cooper and Sterrett by 1907 began to publicly criticize audit companies and discourage their use. This paper identifies several prominent critics who were leaders within the public accounting profession. Self-developed and borrowed notions of professionalism possibly led to the early criticisms of audit companies. The paper explored relationships among the critics that may have reinforced their antagonistic feelings towards audit companies. Potential motivations of the critics were suggested in the paper including the desire to increase professionalism, criticism of the corporate form in other professions, bias towards corporations in general, ethics controversies originating with audit companies, and possibly fear and jealousy. The critics arguments against audit companies included existence of non-accountant owners and directors, loss of client confidentiality, conflicts of interest, identities of auditors unknown, disrepute to the profession, commercialization of the profession, and limitations on liability.

The paper provides evidence that suggests that these audit critics were likely instrumental in effecting initial organizational censures. Public accounting organizations with some of the audit company critics as influential members and leaders began discouraging the use of the corporate form in the early twentieth century with the *JOA*, official journal of the AICPA predecessor AAPA, establishing a policy against audit companies by 1905. The AIA, successor organization of the AAPA, officially discouraged audit companies in 1919 and proscribed association with audit companies by 1939.

The paper suggests that public accounting societal admonitions turned into regulatory and public accounting societal prohibitions. By 1924, the State of Maryland had passed the first successful state law regulating the practice of public accounting which was likely the first law to prohibit the practice of public accounting corporations. By 1927, practice before the United States Treasury Department by audit companies was also proscribed.

The paper proposes that the criticism and the societal and regulatory proscriptions led to the virtual disappearance of public accounting firms practicing in the corporate form. By 1925 there were 458 audit companies compared with 1,814 partnerships, a sharp decline in the two types of public accounting firms relative proportions from 1920. By the 1930s, very few of the audit companies existed. All of the national audit companies except for The Audit Company of New York were acquired or began operating as a partnership

by the 1920s. The Audit Company of New York appeared to cease operating under its named in the middle of the 1930s.

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