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Du Pont's early policy on the rotation of audit firms

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Abstract

E.I. du Pont de Nemours & Company adopted a policy from 1910 onward of rotating its external audit firm every year, and later every several years, until the 1950s, when it finally consented to appoint a permanent auditor. This practice of audit firm rotation was exceptional, if not unique, among U.S. companies. It is the purpose of this article to review this policy and to present evidence of the company's reasons for its adoption and, in the end, the decision to appoint a permanent auditor.
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1. Introduction

An issue that has come to the fore in the wake of the collapse of Enron has been whether companies should be required to rotate their external audit firms after specified periods of time. Prior to Enron, the topic had been discussed occasionally within the U.S. accounting profession, but the policy recommendation had always been not to impose such a requirement (see, e.g., Commission on Auditors' Responsibilities, 1978, pp. 108–109; Division for CPA Firms, 1992). But, following Enron, mandatory audit firm rotation was advocated in Congressional testimony by Arthur Levitt, Jr., former chairman of the Securities and Exchange Commission (SEC); former SEC chief accountant Lynn E. Turner; and Charles A. Bowsher on behalf of the Public

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Oversight Board, which he chaired; among others. [1] Audit firm rotation would be imposed by the Truth and Accountability in Accounting Act of 2002, introduced on March 14, 2002 by Rep. John D. Dingell (Democrat, Michigan) and others. [2] Many state and local government agencies in the U.S. adhere to audit firm rotation. The practice is required by law in several other countries. [3] The chairman of the Australian Securities & Investments Commission has embraced the "principle" of audit firm rotation, and a Treasury select committee in the U.K. has recommended that the government require mandatory auditor and audit firm rotation. [4]

The principal argument for mandatory rotation of the audit firm is that it would contribute to enhanced auditor independence vis-à-vis the client company, and the principal argument raised against mandatory rotation is the higher cost and the substantial risks confronting the audit firm during the initial year of an audit engagement. [5]

The almost universal practice of U.S. publicly traded companies has been to reappoint their external audit firm as an almost unquestioned practice at shareholder meetings. Only where significant differences arise between the company and the audit firm over accounting or auditing issues does one see the replacement of one audit firm by another.

Yet one major U.S. enterprise, E.I. du Pont de Nemours & Company ("Du Pont"), systematically rotated its external audit firm between 1910 and 1954. [6] Indeed, from 1911 to 1928, with only one exception, Du Pont changed its audit firm every year. Haskins & Sells and Price, Waterhouse & Co. held the majority

[1] The prepared remarks by these three individuals were made in hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on February 12 and 26 and March 19, 2002, respectively. Bowsher said he was conveying the view of the Public Oversight Board.

[2] H.R. 3970, 107th Congress, 2nd Session.

[3] Italy currently has a statutory requirement for audit firm rotation every nine years, and Austria recently approved a law that requires audit firm rotation by the end of six years. In 1989, Spain adopted legislation mandating audit firm rotation by the end of nine years, but the legislation was repealed in 1997, one year before it would have had a practical effect. Greece requires audit firm rotation every six years for public sector entities, and beginning in March 2002 the Singaporean central bank has required that banks incorporated in Singapore change their audit firms at least every five years.

[4] See Knott (2002), Mackintosh (2002, pp. 5–6), and Perry (2002). David Knott is chairman and Ian Mackintosh was then the chief accountant of the Australian Securities & Investments Commission.

[5] For a discussion of the international debate and experience as well as a recitation of the arguments for and against mandatory rotation, see Catanach and Walker (1999, pp. 43–48). Also see the recent report of the Institute of Chartered Accountants in England and Wales (Mandatory Rotation of Audit Firms, 2002).

[6] Du Pont published its first annual report carrying an audit firm's certificate for the year 1910.

of the appointments during this period. The roster of Du Pont audit firms for the fiscal years 1910 to the present is as follows: [7]

1910 Price, Waterhouse & Company
1911 The Audit Company of New York
1912 Haskins & Sells
1913 The Audit Company of New York
1914 Haskins & Sells
1915 The Audit Company of New York
1916 Haskins & Sells
1917 The Audit Company of New York
1918–19 Haskins & Sells
1920 Ernst & Ernst
1921 Price, Waterhouse & Co.
1922 Haskins & Sells
1923 Price, Waterhouse & Co.
1924 Haskins & Sells
1925 Price, Waterhouse & Co.
1926 Haskins & Sells
1927 Price, Waterhouse & Co.
1928–29 Peat, Marwick, Mitchell & Co.
1930–38 Price, Waterhouse & Co.
1939–42 Haskins & Sells
1943–45 Arthur Andersen & Co.
1946–53 Lybrand, Ross Bros. & Montgomery
Since 1954 Price, Waterhouse & Co. [8]

2. Du Pont's reason for audit firm rotation becomes evident

2.1. Exchange of letters in 1922

Du Pont says nothing in its annual reports about this policy of rotating the external audit firm. [9] But internal correspondence throws light on the reason

[7] Price, Waterhouse & Co. and Lybrand Ross Bros. & Montgomery are today part of PricewaterhouseCoopers; Haskins & Sells is part of Deloitte & Touche; Ernst & Ernst is part of Ernst & Young; and Peat, Marwick, Mitchell & Co. is part of KPMG. The Audit Company of New York, a corporation, was acquired in 1932 by R.G. Rankin & Co., which in 1955 merged with Price Waterhouse & Co. (Partner Retires, 1958). It was said to be "the single most significant merger in PW's history," because of the important clients it brought to the firm (Allen and McDermott, 1993, p. 117).

[8] In 1951, the firm removed the comma from its name.

[9] One reason for omitting mention of this matter is that, until the 1940s or 1950s, it was the president, not the board of directors or the stockholders, who appointed the external audit firm.

for the policy. In a letter to Irénée du Pont, the company President, dated June 23, 1922, Frank G. Tallman, a director, a member of the executive committee, and a longtime member of the upper management of Du Pont, wrote as follows: [10]

> Referring to the matter of policy of changing auditors each year, I state this has been done in the past largely because Mr. P.S. du Pont favored it and because the basic principle governing having auditors at all seems to indicate that the proper result would be more fully obtained by changing auditors annually.
>
> If I have the correct idea of the purpose of an annual audit it is that we may have:
>
> (a) a certificate of reliable, capable, independent, and disinterested accountants that our books are correct, that they have been properly kept, and that the balance sheet and profit and loss account fairly set forth the financial position of the Company;
> (b) this to be attached to the annual report for the information and benefit of all stockholders, bankers, investors, and others interested in the true condition of the Company.
>
> In order to secure the foregoing result it would seem that the auditors should be entirely separate and divorced from any immediately preceding connection with our Company. Auditors as I see it are "check-ups", such as National Bank examiners; Directors appointed to count over and report on securities in the custody of our Treasurer; checking up magazine stocks; counting cash and going over accounts of our branch offices; requests from chartered accountants to depositors in and borrowers from banks as to the condition of their accounts and collateral on any certain date, etc., etc.
>
> If I am correct in the foregoing our annual audit should be made by chartered public accountants who did not make the previous annual

[10] Accession 1662, Box 7, Folder C-44 in the Du Pont Archive, Hagley Museum and Library. These materials have been quoted by courtesy of the Hagley Museum and Library. All of the letters cited below are also in this holding. Tallman wrote on Du Pont stationery bearing the title of vice-president, but, according to Chandler and Salsbury (1971, p. 429), he was one of several "valued old hands" who were retired from line administration and the executive committee in 1919. Pierre S. du Pont, mentioned in Tallman's letter, relinquished the Du Pont presidency in 1919 and was succeeded by Irénée du Pont. In 1919, Irénée du Pont designated Tallman as the company officer who was to engage the external auditor each year.

> audit and who have not been connected in any way with us during the year to be audited, on tax matters or otherwise.

In the same letter, Tallman explained why an exception was made in 1919, when Haskins & Sells was retained for a second year. He wrote that, after conferring with Irénée du Pont, "I made an arrangement with Haskins & Sells, who were our auditors for the preceding year, the main reason being that there was expected to be so much difficulty and so large an amount of work connected with closing up war work and accounts, that it seemed best to waive the desirability of a different auditor in order to partially relieve the great congestion in work of our accounting department at that time." The annual rotation of audit firms resumed in 1920.

Tallman's letter was precipitated by one dated June 16 from the Comptroller, James B. Eliason, addressed to Walter S. Carpenter, Jr., [11] the Treasurer, in which, among other things, Eliason questioned the wisdom of the annual rotation policy:

> While I hold no brief for Messrs. Price, Waterhouse & Company, and fully recognize that there are a number of other auditing concerns in this country who undoubtedly can serve us in an equally satisfactory and efficient manner, and whose reputation and standing are equal to that of Price, Waterhouse & Company, I wish to express my conviction that the Company's policy of changing auditors each year is without any particular merit and is expensive. A new auditing concern, for instance for 1922, would be obliged to cover to a considerable extent the same ground which has already been covered by Price, Waterhouse & Company in their work for 1921 and they would be without the knowledge of where to go and how to acquire information which Price, Waterhouse & Company, by reason of their familiarity gained during the last audit, would be in a position to get without any lost motion.
>
> It should also be remembered that Price, Waterhouse & Company are at present, and will undoubtedly be throughout the balance of this year, associated with us on our tax problems, and that there is some advantage to us in having the same people who are working on our tax problems also auditing our accounts, as since the accounts and the tax problems are inseparable, I cannot help but

[11] Carpenter went on to become the President of the company in 1940. Carpenter thus became the first President of the company who was not himself a du Pont (apart from Hamilton M. Barksdale, who was acting President in 1912–13), yet his brother, R.R.M. Carpenter, was married to the youngest sister of the brothers Pierre, Irénée and Lammot du Pont.

> feel that some embarrassment would result from having others making the audit for 1922.

Carpenter, in a brief letter to Irénée du Pont dated June 17, said that "I heartily subscribe" to Eliason's view, and he added, "The importance of the Price, Waterhouse association from the standpoint of Government taxes is difficult to exaggerate." In his reply, dated June 23, Tallman conceded that Price, Waterhouse & Co. had been the auditor of United States Steel Corporation since its organization in 1901, and that "some large companies have continuous audits for which it would seem to be desirable to have the same auditors year after year." Yet he said that he was not in agreement with the views of the Comptroller or Treasurer, but that they "may wish to put both sides of the matter before the Finance Committee."

Irénée du Pont settled the matter in a letter to Carpenter dated June 29:

> It seems to me that without having the least mis-trust of you or Mr. Eliason, that good auditing should require a firm who could not be criticized by reason of any other connection with the Treasurer's Department, and as Price, Waterhouse & Co. are engaged as experts by the Treasurer's Dept., they should not be used at the present time for that reason also.

The reason given by Irénée Du Pont raises interesting questions about the scope of non-audit services that an audit firm should render to an audit client.

3. Du Pont modifies its policy of rotating its audit firm

3.1. Eliason's skepticism toward annual rotation secures favor

F.G. Tallman made a decision in 1928 to experiment with the same audit firm (Peat, Marwick, Mitchell & Co.) in consecutive years. In a letter dated April 28, 1928 to Lammot du Pont, who had become President in 1926, he wrote, "If there is any virtue in a diversification of auditors we ought to discover something at the end of this year." The result of the experiment must have been positive, because, with the support of J.B. Eliason, Price, Waterhouse & Co. ("PW") was retained as the company's auditor for nine consecutive years, from 1930 to 1938. In a letter to F.G. Tallman dated March 6, 1931, Lammot du Pont wrote, "It is my recollection that, from the standpoint of efficiency and intelligent handling, Price-Waterhouse & Company are the first choice of our Treasurer's Office. I see no reason why we should not retain Price, Waterhouse & Company for another year." Eliason, who as Comptroller had opposed the policy of annually rotating the audit firm, had become

Treasurer in June 1930 and thus was in a position to exert greater influence. Lammot du Pont wrote a similar letter to Tallman on March 7, 1932, leading to a further reappointment of PW.

3.2. Du Pont resumes rotation after PW's long tenure

In 1939, after PW had completed its ninth consecutive year as Du Pont's auditor, the company decided to change auditors. However, PW was concerned over a "misperception" at the coincidence of being rotated off the Du Pont audit in 1939, shortly after the auditing scandal erupted at McKesson & Robbins, whose audit firm was none other than PW (Allen and McDermott, 1993, p. 146). Even though J.B. Eliason was still the Du Pont Treasurer, the views of the du Pont family continued to support the policy of audit firm rotation, and apparently nine years for one audit firm was regarded as too much of a departure from the rotation policy. In a letter to Alfred P. Sloan, Jr., the Chairman of General Motors Corporation (in which Du Pont held a substantial investment), dated February 16, 1939, Lammot du Pont, still the President, wrote as follows, in which he cited

> five objectives to be accomplished by an audit by independent public accountants.
>
> (a) Check the accuracy of the accounting work done.
> (b) Criticise and improve accounting practices in accordance with general accounting practice.
> (c) Discover any error which is in the rank and file of management.
> (d) Discover any irregularity in the higher personnel.
> (e) Prevent or expose collusion among officers.

Items (a) and (c), he said, fall within the province of the internal audit, items (b) and (d) "will be covered by any independent auditor of good reputation," and item (e) "is the only one to be affected by the selection of the independent auditor." He added: "of course, the question involves the collusion of the *Auditor* with the Officers as well as among the Officers themselves." Evidently, the policy of rotating audit firms betrayed a generalized suspicion of plots and conspiracies. Perhaps the du Pont family (and certain old hands) were not entirely comfortable with third-party professionals in their midst.

W.S. Carpenter, now arguing in favor of the need to obtain a fresh perspective, said he supported occasional auditor rotation. In a letter dated March 28, 1938 to Donaldson Brown, the Vice Chairman of the board of General Motors, Carpenter, then a Du Pont Vice President and Chairman of the powerful finance committee, expressed the following view:

> An audit of accounts involving hundreds of millions of dollars should not be too easy and comfortable. I would rather see it vigorous and aggressive, not merely for the purpose of trying to stir up trouble or to make a show of activity, but rather for the purpose of re-examining at all times what is being done to see that the best practices known in the profession at all times are being employed.
>
> Accountancy as we know is not an exact science. There are many things in accountancy which cannot be adjudged right or wrong. It is quite natural that, as the years pass, the work of the various accounting firms becomes more or less formalized. They accept certain practices as being correct or incorrect, whereas, in fact, that is probably not true. It seems to me, for that reason, that occasionally we should have a rotation in order that the practices which we have been following, perhaps for years, are re-examined periodically from the viewpoint of a somewhat different philosophy. The effect of this also on our organization I think is good.
>
> We have been going on for many years with the same auditors [PW]. I see the same faces down here year after year until I, in fact, get them confused with our own organization. I do not question their honesty, but I do question somewhat their capacity for constantly, aggressively, opening and reopening questions about theories and practices which we are following.
>
> The public audit is an expensive procedure and is in a way a troublesome one from the standpoint of the organization, but for all of this expense and trouble I believe we should endeavor to get in return something which is beneficial to us besides a mere check on our accounts to determine that no fraud exists. I believe the best way of doing this is by occasionally getting a review and re-examination of our practices.

Carpenter's strong view in favor of occasional audit firm rotation in 1938 may seem to be at variance from the perfunctory view he expressed in 1922, but in 1922 the discussion was over changing the audit firm each year, not every several years. Also, in 1922 his motivation may have been to lend support to the opinion held by his Comptroller, J.B. Eliason. Carpenter's advocacy of occasional audit firm rotation was so marked that his biographer, when discussing Carpenter's position on rotation in 1938, has written: "At Walter's urging the company changed auditors three times in the next decade before his retirement [as President in 1948]" (Cheape, 1995, p. 90). As noted above, Carpenter became President in 1940.

In 1939, PW was succeeded as auditors by Haskins & Sells, which in turn were replaced in 1943 by Arthur Andersen & Co. Andersen served until 1946, when Lybrand, Ross Bros. & Montgomery became the auditors. Reflecting Carpenter's view, Du Pont thus reverted to a policy of rotating auditors over a shorter span of years than in the case of PW during the 1930s.

4. Issues raised by Du Pont's auditors in the 1940s

One might have supposed that a reason for Du Pont's policy of rotating its audit firm was to escape unpleasant disagreements with the auditor. There is no evidence that this was the case. In 1929, Peat, Marwick, Mitchell & Co., concluding the first of its two years as Du Pont's audit firm, did not ostensibly qualify its opinion published in Du Pont's annual report, [12] yet it recommended in a separate report to the company that the single surplus account shown in its balance sheet be segregated by source, including a designation of the portion attributable to undistributed earnings. [13] Even though Du Pont did not accept the recommendation, the firm was reappointed for a second year. As will be brought out in the next section, Arthur Andersen & Co. qualified its opinion in all three of its years as Du Pont auditor during the 1940s, yet its term as auditor did not seem to be affected.

4.1. Arthur Andersen & Co. qualifies its opinion, and Du Pont replies

The foregoing roster of Du Pont's audit firms over the years indicates that two firms served after PW in shorter multi-year engagements between 1939 and 1945: Haskins & Sells and Arthur Andersen & Co. Of the two, the Arthur Andersen ("AA") engagement was the more confrontational. In Du Pont's

[12] At least, no explicit qualification was signified. Yet the firm's opinion was curiously equivocal. It said only that "the attached Consolidated Balance Sheet, Income and Surplus Accounts have been prepared [from the books and accounts] and, in our opinion, present the consolidated financial position at December 31st, 1928, and the results of the operations for the year." Identical wording was used in the audit report given the following year. The firm did not use a qualitative adverb, such as "correctly" or "properly," whose inclusion in auditors' opinions of the day was common (see Himmelblau, 1927, pp. 47–48). In the firm's opinion on the financial statements for 1928 and 1929 of General Electric Company, another major Peat, Marwick client, it stated that the financial statements "correctly record" the results of the operations and the condition of its affairs. Peat, Marwick's audit reports for Du Pont and General Electric were both issued from its New York City office, at 40 Exchange Place. One supposes that the firm would have developed common criteria for major audits based in the same office.

[13] Although Peat, Marwick's separate report has not survived, Walter Carpenter replied to the firm, in a letter dated May 24, 1929, in which he defended the company's practice with respect to surplus.

annual report for 1943, the first year for which AA was the auditor, the firm qualified its report. AA disagreed with Du Pont's practice of not allocating the balance in its combined surplus account to earned surplus, paid-in surplus, and surplus arising from revaluation of assets, and in this respect it took a stronger position than did Peat, Marwick, Mitchell & Co. in 1929. In an internal memorandum to Du Pont, the firm showed how the allocation should be performed. But Du Pont was unconvinced. In a three-page statement appearing immediately after AA's audit report, Du Pont's committee on audit, composed of members of the board of directors who did not occupy a position in the company's active management, rejected the grounds for AA's exception. The committee contended that any such allocation would be arbitrary and very likely inaccurate; furthermore, the committee said that a segregation of surplus by source was irrelevant for determining the availability of dividends under the Delaware corporation law. Since the inception of the Securities and Exchange Commission in 1934, it has been rare for the auditor of a U.S. company to qualify its opinion (other than for uncertainties), but it has been rarer still for a U.S. company to respond publicly to such an exception. (AA's audit report and Du Pont's reply are reproduced in an appendix.)

So unusual was this event that *The Journal of Accountancy* reprinted both the auditor's report and the company's reply, and, in an editorial in the same issue, the *Journal* praised the two parties for providing a full disclosure of their irreconcilable differences (When Accountant and Client Disagree, 1944). Leonard Spacek, then a partner in AA's Chicago office, later recalled that "it was great publicity," showing that the firm stood on principle (Spacek, 1989, p. 62). [14]

AA also took exception for the same reason in the 1944 and 1945 annual reports. The audit committee's statement was not repeated, but in the 1944 report (as in its predecessor) the Chairman of the board and the President, in their letter to the stockholders, said that the company could not accept the auditor's view. One might suppose that Du Pont would not have reappointed AA after the clash of views exhibited in the 1943 annual report, but in fact AA remained the auditor for two more years and, as noted, did not back down from its stated belief that the combined surplus should be apportioned into three classes.

4.2. Lybrands also qualifies its opinion, but on another matter

In 1946, Lybrand, Ross Bros. & Montgomery ("Lybrands") became the Du Pont auditor, and it continued to serve for a total of eight years. In Du Pont's

[14] In his oral history, Spacek (1989, pp. 60–63) confused Du Pont's use of the equity method of accounting for its investment in General Motors with the dispute over the allocation of the combined surplus.

1946 annual report, Lybrands referred in its opinion to the issue regarding the combined surplus but said that it lacked "a definitive and authoritative basis upon which to predicate retrospective allocations of the various charges and credits which have been made to surplus since incorporation of the Company," and it did not qualify its opinion on the financial statements. In the 1947 annual report, Lybrands did qualify its opinion, because the company had made a charge against net income for "excessive construction costs" occasioned by the postwar inflation. The extra charge was 17% of Du Pont's net income. Du Pont was one of several prominent manufacturing corporations to make such a supplemental charge for rising costs (see Blough, 1947; Notable Deviations from Accounting Principles, 1948). Provisions such as this, which excited controversy within the accounting profession, were disapproved by the Committee on Accounting Procedure (Depreciation and High Costs, 1948) and by the Securities and Exchange Commission (Blough, 1949, p. 65). After the SEC acted to disallow the practice, Du Pont chose to record "accelerated depreciation" on historical cost in 1948.

It is curious that none of Du Pont's auditors publicly took exception to its location of Reserve for Depreciation and Obsolescence on the liabilities side of the balance sheet, rather than as a subtraction from Plants and Properties on the asset side. The company explained, "Our depreciation and obsolescence reserve is much more in the nature of a contingency reserve to provide for obsolescence than an indication of reduction in the value of our plants." [15] The company cited an article in the accounting literature as support for its aberrant practice (Simon, 1959), although its practice antedated the article by decades.

Lybrands continued as Du Pont's audit firm through 1953, a tenure of eight years. One supposes, therefore, that Crawford H. Greenewalt, who succeeded Walter Carpenter as President in 1948, did not share Carpenter's view about the frequency with which audit firms should be rotated.

5. Price, Waterhouse & Co. becomes Du Pont's permanent auditor

Du Pont's policy of rotating audit firms ostensibly continued in 1954, when PW once again became its auditor. Yet, as one retired PW audit partner recalled, the firm was determined to persuade Du Pont to abandon its rotation policy and retain PW as its permanent auditor. [16] Several years later, PW

[15] Letter to the author from H.W. Evans, Treasurer, dated July 30, 1965.

[16] Written transcript of the interview by Kathleen McDermott of Robert Hampton, III, May 31, 1989, p. 51, included in the PricewaterhouseCoopers Archive, housed in the Rare Book and Manuscript Library, Columbia University. Hampton was a manager in the firm's research department from 1953 to 1961.

achieved its goal. The history of PW commissioned by the firm briefly recounts the episode as follows:

> When PW once again had the opportunity to serve as auditors [of Du Pont], Paul Grady became deeply involved in the engagement, and the Philadelphia office "put a lot of power on that job, into trying to keep Du Pont happy." The increased scale and complexity of Du Pont's worldwide operations, the fact that very few auditing firms could handle such work, and the tremendous effort made by PW and Grady's "ministrations" convinced Du Pont to end its rotation policy and to remain permanently with PW (Allen and McDermott, 1993, p. 146). [17]

It is not known when Du Pont resolved to retain PW on a permanent basis, but the decision is likely to have been taken by 1960, when Paul Grady retired from the firm. A review of PW's audit reports on Du Pont's financial statements for the three decades following 1954 reveals that they all contained unqualified opinions.

For its part, Du Pont's senior management was no longer dominated by a du Pont. In January 1948, Lammot du Pont had resigned as board Chairman and was succeeded by Walter Carpenter, who thereupon resigned as President. The board chairmanship carried little authority and was largely a ceremonial position (Cheape, 1995, p. 229). Succeeding Carpenter as President, as noted above, was Crawford Greenewalt, a distinguished scientist and previously a company vice president. Greenewalt was married to Irénée du Pont's daughter. Yet, even though both Carpenter and Greenewalt were within, or on the edge, of the du Pont family, 1948 marked the first year in which a du Pont was neither Chairman nor President, although a clutch of du Ponts continued on the company's board, which numbered more than 30 members. The du Pont oligarchy was receding into the background and perhaps with it the sway of the du Ponts' concern about protecting against collusion among officers and even with the external auditor.

6. Conclusion

Du Pont's policy of rotating audit firms, initially each year and then every several years, was instituted so as to assure a disinterestedness on the part of the auditor. Pierre S. du Pont was said to favor this policy, but his reasons are not on the record. Irénée du Pont held the view that Du Pont's audit firm

[17] Paul Grady, the senior technical partner in PW's executive office in New York City, was one of the acknowledged leaders of the accounting profession.

should not be rendering other expert services to the Treasurer's Department. Lammot du Pont believed that the annual audit should be conducted by a firm that had no involvement with the company during the immediately preceding year. He seemed especially concerned to prevent or expose any collusion among officers, and even the external auditor was not above suspicion. Another argument, advanced by Walter S. Carpenter, Jr., was that audit firm rotation provided the company with a fresh perspective. By the 1950s, however, the du Ponts and Carpenter no longer held a senior management position in the company. Following the reappointment of Price Waterhouse & Co. as auditor in 1954, the firm succeeded in persuading Du Pont to allow it to remain as the permanent auditor, especially in view of the increasing size and complexity of the company and its extensive overseas operations. [18]

The unique Du Pont experience with audit firm rotation teaches a lesson today in view of questions that have been raised about the celebrated instances of unduly congenial relations between auditors and client companies that have been exposed in the media. One can almost argue that, in some of these audit engagements, a state of virtual *de facto* collusion seemed to exist between the auditor and the company. If that is so, one can reflect on Du Pont's concern of more than a half century ago that decisive steps must be taken when setting the terms of the audit engagement to assure that the auditor will assume a truly independent posture, which is not compromised by its partners developing overly familiar ties with company officers or board members. Whether the rotation of the partners assigned to the audit engagement will achieve the same result remains to be seen.

Acknowledgments

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[18] PW was clearly the dominant U.S. audit firm during the early to middle 1960s. The earliest compilation of rankings by size of the Big Eight public accounting firms in the United States, drawing on data for 1964, placed PW well ahead of the other seven firms. In 1964, PW audited 136 of the 639 industrial, merchandising, transportation and utility companies in the *Fortune* list. The second firm, Haskins & Sells, audited 87 of the companies, followed by Peat Marwick, with 84. The advantage in favor of PW was also decisive when one examines the aggregate revenues of its client companies ($79.3 billion versus $59.5 for Haskins & Sells and $46.0 for Lybrands). See Zeff and Fossum (1967, p. 302).

Appendix A

AUDITOR'S OPINION AND COMMITTEE ON AUDIT RESPONSE

67 Wall Street
New York

To the Board of Directors,

E. I. DU PONT DE NEMOURS & COMPANY.

We have examined the consolidated balance sheet of E. I. du Pont de Nemours & Company and its wholly owned subsidiary companies as of December 31, 1943, and the statements of consolidated income and surplus for the year ended that date, have reviewed the system of internal control and the accounting procedures of the companies and, without making a detailed audit of the transactions, have examined or tested accounting records of the companies and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary; it was not practicable to confirm all receivables from United States Government departments and as to those not confirmed we have satisfied ourselves by means of other auditing procedures.

The company maintains a combined surplus account which includes earned surplus, paid-in surplus, and surplus arising from revaluation of assets. In our opinion the respective amounts of these different classes of surplus should be stated separately.

With the exception stated in the preceding paragraph, in our opinion, the accompanying consolidated balance sheet and related statements of consolidated income and surplus present fairly the financial position of E. I. du Pont de Nemours & Company and its wholly owned subsidiary companies at December 31, 1943, and the results of their operations for the year ended that date, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

ARTHUR ANDERSEN & CO.

New York, N. Y.

February 21, 1944

Statement by Committee on Audit Concerning Exception Stated in Certificate of Arthur Andersen & Co. with Respect to Surplus Account

In their Certificate, the Public Accountants, Arthur Andersen & Co., have qualified their opinion with respect to the company's financial statements at December 31, 1943, for the reason that in their opinion the respective amounts of earned surplus, paid-in surplus, and surplus arising from revaluation of assets should be stated separately.

An analysis by Arthur Andersen & Co. of the Consolidated Surplus at December 31, 1942, sets forth the allocation of the component items as follows:

Paid-in Surplus	$ 39,895,458
Unrealized appreciation of investments, less amount capitalized through stock dividends........	126,456,462
Earned Surplus	137,141,377
	$303,493,297

With respect to the foregoing Arthur Andersen & Co. have advised as follows:

"The segregation of the surplus account which we submitted to the company was prepared on the basis of the considerations outlined below.

"Paid-in surplus credits represent the excess of consideration (cash or other assets) received upon the original issues of securities over the par value thereof and the excess of consideration received in 1933 (cash and preferred stock of Remington Arms Company, Inc.) over the cost of treasury stock issued therefor. Paid-in surplus charges represent premiums paid upon redemption of debenture stock and amounts transferred to $4.50 no par cumulative preferred stock account to increase the stated value of such stock to $100 per share. These transactions are clearly of a capital nature and accordingly in our opinion are proper paid-in surplus items.

"Unrealized appreciation of investments consists of the amounts of the write-ups of investments in General Motors Corporation common stock and Canadian Industries, Ltd. common stock, less the portion of a dividend paid in du Pont common stock in 1925 which was charged against the write-up in 1925 in accordance with a reso-

lution of the Board of Directors. In our opinion the balance of unrealized appreciation should not be combined with either paid-in surplus or earned surplus, but should be classified in the balance sheet in a separate category.

"Earned surplus consists of the net income (together with direct surplus adjustments of income) of the company since inception, October 1, 1915, and of its subsidiaries since the respective dates of acquisition; less dividends paid in cash or equivalent and in du Pont common stock (other than the stock dividend referred to above), discount on debenture stock issued, and the write-off of part of the excess of the amount recorded for the assets acquired from The Grasselli Chemical Company (approximately market price at the time of the du Pont common stock issued therefor) over the net book value of such assets. At the time of the stock dividends and the discount on debenture stock, which in the segregation were charged to earned surplus, the balance in the company's surplus account consisted only of earned surplus. The write-off of the Grasselli goodwill was reflected in part by elimination of a capital surplus balance which arose in the Grasselli acquisition; the remainder was applied as a reduction of earned surplus, there being no other class of surplus (other than unrealized appreciation) available at the time.

"In our opinion the facts surrounding each item are adequate to determine its character and segregation in accordance with generally accepted accounting principles."

The Surplus Account dates from the organization of the present company in 1915. Over the years there have been many surplus adjustments, and several stock dividends declared, generally without attempt at the time to earmark such items as falling within any particular class of surplus. Moreover, our observation has been that there does not exist sufficient uniformity or consistency of opinion among accountants with respect to the definition of the several classes into which it is suggested that surplus be divided or to the procedure which should be followed in the treatment of many specific items to enable the company to make any segregation of the Surplus Account which would not be subject to question as to its accuracy.

The amounts allocated to the respective classes of surplus by Arthur Andersen & Co. differed from those

shown in a similar analysis attempted by another firm of independent public accountants who a number of years ago examined the company's accounts and certified to its financial statements.

The Committee on Audit cannot accept the opinion of Arthur Andersen & Co. as being conclusive for the reason that it believes that certain of the items comprising the Surplus Account are not susceptible of such a segregation except on the basis of arbitrary assumptions or interpretation and that the company can have no assurance that at some later date the accuracy of the segregation may not be questioned and if found inaccurate the company might not be deemed to have published erroneous information which had served to mislead the stockholders and the investing public.

The company has been advised by counsel for years that, from the standpoint of dividend payments, the law of Delaware recognizes no distinction either in the status or in the availability of any separate parts of surplus. If in the future such a segregation should be required by statute or ruling of some official body, no doubt such action would be accompanied by such instructions as to procedure as will relieve the Directors from the responsibility of making an arbitrary segregation.

The company has consistently maintained the practice of describing in its annual reports the various changes in the Surplus Account as they occur, and we are of the opinion that such practice discloses the material facts.

COMMITTEE ON AUDIT
ELWYN EVANS, *Chairman*

NOTE—The Committee on Audit is composed of members of the Board of Directors none of whom hold any position in the active management of the company.

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