

AMERICAN INSTITUTE OF ACCOUNTANTS

A Report of

The Special Committee on Coöperation with
Securities and Exchange Commission

*Adopted by the Council of the
American Institute of Accountants
May 14, 1940*

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TO THE COUNCIL OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

Gentlemen:

This report summarizes the activities of the special committee on coöperation with Securities and Exchange Commission during the past eight months. We shall also make reference in this report to certain releases of the S.E.C.

INDEPENDENT STATUS OF THE PUBLIC ACCOUNTANT

When the present chairman of the S.E.C. took office he said that the independence of the accountant must be preserved and strengthened and standards of thoroughness and accuracy protected. The interest of the S.E.C. in this matter and the influence they can exert will undoubtedly fortify the independent status of the public accountant.

Last fall, for example, the chief accountant of the Commission was directed by the Commission to discuss with committees of the Institute whether it would not be possible for the S.E.C. to help in strengthening the position of the public accountant. The Commission expressed the desire to be of assistance in cases where an accountant who insists on making an audit of adequate scope or on following an accepted accounting principle may be faced with the loss of a client. No practicable solution to this problem has yet been found, but the initiative taken by the S.E.C. in the matter is significant of their interest in our behalf.

A few months ago we were asked by one of the commissioners whether appointment

of auditors by stockholders rather than by the management would make for greater independence on the part of the auditor. We expressed our belief that the auditor's independence did not depend upon the channel of his appointment. One of the provisions in the Wagner-Lea bill for regulation of investment companies would require that accountants be selected by vote of the shareholders. The purpose of that provision, Judge Healy of the S.E.C. said in recent hearings before the Senate committee on banking and currency, was to impress upon accountants that their responsibility is to the security holders rather than to the management.

The latest amendment to the proxy regulation requires that when the election of an auditor is one of the matters to be acted upon pursuant to the proxy solicited, the proxy statement shall describe briefly any material relationship of the auditors to the company and any of its affiliates and similar information with respect to any relative or spouse of the auditor having the same home as the auditor. If such a relative holds investments in securities of the company or of any of its affiliates, there may exist a material relationship which would have to be described in the proxy statement. Here regulation is carried to an extreme, but we can have no dissent from its aim which is support of the independence of the auditor.

In accounting-series release No. 2, the Commission took the position that an accountant cannot be deemed to be independent if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune,

and that in one case a firm of accountants could not be considered independent because one of the partners owned stock in a client corporation which was substantial in value and constituted more than one per cent of the partner's personal fortune. That pronouncement by the S.E.C. was a salutary one, in our opinion. We believe that accountants would be well advised to refrain from investing in any securities of their client companies.

AUDITING METHODS

The S.E.C. has stressed the importance of examination of books and records at the place where they are kept and the practice of inspecting the company's plant and its products during an audit. Accountants should aim to familiarize themselves with the plant layout, the operating methods, the nature of the products, the personnel of the accounting department, and the methods of internal check and control, and to substantiate oral explanations received by contact with employees having firsthand knowledge of the facts or by observation of the physical aspects of the business.¹

In another case² that came before the S.E.C., the Commission found that an audit was inadequate because it did not comprise an investigation of the accounting methods followed at a branch office. The Commission based its finding on its rule of several years standing that in giving due weight to an internal system of audit the accountants shall review the accounting procedures followed and satisfy themselves that the procedures are in fact being followed.

There are some indications that the S.E.C. expects that examinations by auditors should be more detailed. Here is one of the most difficult problems confronting the

auditor. He cannot make a complete audit of all the transactions or all the accounts, and his observations of the physical plant, operations, and products must be quite restricted. He is obliged, for the most part, to draw his conclusions about the integrity of the accounts as a whole from examination of a portion of the transactions and book entries. He has to render his report promptly or the report will be of little use to the public. He has to undertake the audit at a reasonable fee to the company. If he should fail to discern that a minor discrepancy is not a bit of carelessness, but is part of a manipulation of larger proportions, the risk to him is that his oversight, in the light of after events, may be made to appear to be gross negligence.

All business concerns should not be saddled with the expense of a yearly audit as detailed as that designed for the occasional concern whose management comes under suspicion.

An auditor must expect to incur the ill will of some clients for insistence on a principle of accounting or disclosure; he will be indeed fortunate if throughout his career no ingenious fraud in bookkeeping escapes him, if he is never severely blamed for an oversight; he will seldom receive commendation for his most conscientious investigations that are conducted in accordance with the best technique and result in no spectacular discovery.

A question of audit procedure which has attracted some attention from the S.E.C. is whether the auditor, instead of depending upon his own interpretation of contracts or other legal documents or upon the explanations of them by counsel of the client company, should himself engage counsel to construe the documents. With few exceptions we think the auditor is justified in accepting the opinion of counsel of the client company on the meaning of legal documents.

¹ Securities-act release No. 2180, February 20, 1940.

² Securities-act release No. 1744, May 25, 1938.

When we read the releases of the S.E.C. we cannot fail to be impressed with the relative importance ascribed by the Commission to corporate earnings. We may ask ourselves whether the usual procedure for audit of operating accounts of a business concern is adequate in the interest of investors or whether it would not be practicable to make more use of statistical data which the auditor could ascertain at intervals during the year from the operating departments.

CERTIFICATION

In promulgating the new Regulation S-X, which we shall discuss presently, the S.E.C. announced that the rules governing certification by accountants would be reconsidered upon the completion of pending proceedings with a view to revisions deemed necessary as a result of these cases. Before issuing any new rule on certification, the Commission, following its usual practice, will undoubtedly discuss any proposed changes with a committee of the Institute.

We understand that the S.E.C. has taken cognizance of the Institute bulletin, "Extensions of Auditing Procedure," and that their usual policy is not to accept any auditor's certificate which indicates that in his examination of accounts receivable or inventories he has not followed the procedure outlined in the bulletin.

REGULATION S-X

During the past two years the Institute committee has had a number of conferences with the S.E.C. staff and one of the commissioners with regard to successive drafts of new accounting requirements. Finally issued in February of this year, these requirements are now known as Regulation S-X. The amendments to former

requirements effected by this new regulation were described in the March, 1940, issue of *The Journal of Accountancy*. These amendments, most persons will probably agree, do not add materially to the bulk of information required to be included in financial statements and schedules in registration statements.

Regulation S-X should not be regarded as the last word. We may expect it to be revised from time to time. The staff of the S.E.C. do not feel bound to accept all financial statements that are prepared exactly in conformity with the requirements of Regulation S-X, and they may at times call for additional information or insist that information shall be presented in somewhat different form than that indicated in Regulation S-X. Accountants should bear in mind that Regulation S-X, like previous instruction books, is only a minimum requirement.

FOOTNOTES TO FINANCIAL STATEMENTS

Financial statements in registration statements have been replete with explanatory footnotes. A substantial number of prospectuses contain, on the average, a full page of footnotes to every balance-sheet or income statement. The S.E.C. in some of the cases decided have considered that quite small items, omitted or erroneously described, were material. Accountants have to recommend, in the best interests of their clients, the disclosure of much explanatory information appended to the financial statements.

The Commission has had experience with a few cases where footnotes were manifestly used improperly. In one release the Commission held that the face of a balance-sheet containing an untrue statement through overvaluation of an asset is not curable by a footnote admitting the

overvaluation. Two years ago, in accounting-series release No. 4, the Commission formally defined its administrative policy on financial statements by declaring in substance that a financial statement founded on accounting principles for which there is no substantial authoritative support presumably is misleading despite disclosures in footnotes or in the accountants' certificate.

It may not always be possible, even with the attention that is being given to the development of accounting principles, to find a substantial authoritative precedent for every kind of transaction met with in special cases. We believe that the S.E.C. is disposed to administer accounting-series release No. 4 in the spirit rather than in the letter.

REPORTS TO STOCKHOLDERS

Uniformity or standardization of accounting and reporting is one of the avowed objectives of the S.E.C. The fact that some corporations now publish quite condensed financial statements, in the judgment of the S.E.C., points to the need of a regulation prescribing what financial information corporations shall furnish to investors in their annual reports.

The S.E.C. has tentatively considered requiring corporations subject to the securities-exchange act which solicit proxies from their stockholders to furnish annually to their stockholders a balance-sheet, income statement, surplus statement, and schedule of supplementary profit-and-loss information conforming in general with the requirements of form 10-K. In meetings with the S.E.C. legal staff and with the chief accountant of the Commission, members of our committee offered several suggestions respecting such a requirement. There are a number of difficulties to be overcome. One is the time factor. We have pointed out to the S.E.C. that if corporations should be

required to furnish to their shareholders balance-sheets, income statements, surplus statements, and supplementary profit-and-loss statements conforming with the standard accounting requirements of the S.E.C. and including, in the case of companies that have subsidiaries, consolidated statements and statements of any significant unconsolidated subsidiaries, the effect probably would be that annual meetings of corporations would be set forward and financial reports would reach the stockholders later in the year than at present.

There appears to be no disposition on the part of the S.E.C. to prescribe requirements for quarterly reports.

NATURAL BUSINESS YEAR

The congestion of work which besets many accounting firms during the winter months, owing to the preponderance of the calendar-year companies, has been the subject of discussions between our committee and commissioners and the chief accountant of the S.E.C. The S.E.C. has no power under the securities act or the securities-exchange act to require corporations to change their fiscal years, but recognize the advantages to a corporation in having a fiscal year that coincides with its natural business year. The chief accountant of the S.E.C. has already issued a release³ on this subject and the S.E.C. has offered to bring the subject to the public attention from time to time.

LIMITATIONS OF FORMAL ACCOUNTING REQUIREMENTS

Releases of the S.E.C. dealing with matters of accounting have contained many citations from accounting literature and several have included references to opinions

³ Accounting-series release No. 17, March 18, 1940.

expressed by accountants in round-table discussions at meetings of the Institute. It is apparent that the S.E.C. has given considerable weight to principles that have received substantial recognition on the part of practicing accountants and the teaching profession.

But rules and principles of accounting, however carefully defined, will not fit all cases. Developments in business and finance continually give rise to new problems in the application of accounting principles. Public accountants have the responsibility of discerning the cases that are out of the ordinary and cannot be adequately dealt with merely by conformance with a prescribed rule.

There is the danger that public accountants concentrating their attention on rigid rules, standardized forms, and theoretical principles of accounting may at times lose sight of what is more important—the economic implications and consequences of accounting reports and policies.

The S.E.C. and the accountancy profession have common objectives. Differences of opinion are bound to arise as to ways and means for accomplishing the objectives, but our experience has shown that representatives of the S.E.C. and committees of the American Institute of Accountants can discuss opposing views frankly to their mutual advantage.

Respectfully submitted,

SPECIAL COMMITTEE ON
COÖPERATION WITH SECURITIES
AND EXCHANGE COMMISSION

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