

Winter 1977

Generally Accepted Accounting Principles: Instruction H(f) and the Preferability Issue

Follow this and additional works at: <https://scholar.valpo.edu/vulr>



Part of the [Law Commons](#)

Recommended Citation

Generally Accepted Accounting Principles: Instruction H(f) and the Preferability Issue, 11 Val. U. L. Rev. 229 (1977).

Available at: <https://scholar.valpo.edu/vulr/vol11/iss2/2>

This Notes is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



NOTES

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES: INSTRUCTION H(f) AND THE PREFERABILITY ISSUE

INTRODUCTION

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted by Congress to protect the private sector from fraud, misrepresentation and excessive speculation in the issuing and trading of securities.¹ To administer that function, the Securities and Exchange Commission (SEC) was formed under the 1934 Act.² In subsequent years the SEC was given additional administrative duties.³ Essentially, the Commission is empowered to regulate activities of enterprises engaged in the securities industry, to require full disclosure of information relating to security offerings, and to prescribe reports from the companies whose securities are traded. Because accounting and accountants play an important role in achieving its objective of a full and fair disclosure of financial data, the SEC has broad powers relative to financial accounting practice.

Financial accounting is the recording, classifying and summarizing of the transactions and events which comprise the financial character of an enterprise.⁴ The financial statements derived therefrom disclose the current economic status of an enterprise, the results of operations, and changes in financial position.⁵ A fair

1. 29 SEC ANN. REP. 20 (1963); SECURITIES AND EXCHANGE COMMISSION, THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION (1974). See Securities Act of 1933, 15 U.S.C. §§ 77a *et. seq.* (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et. seq.* (1970).

2. 15 U.S.C. § 78d (1970).

3. These duties were conferred under the following laws: Bankruptcy Act, 11 U.S.C. § 665 (1970); Trust Indenture Act of 1939, 15 U.S.C. §§ 77sss, 77uuu (1970); Securities Investor Protection Act of 1970, 15 U.S.C. § 78ggg (1970); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79k, 79m, 79t (1970); Investment Company Act of 1940, 15 U.S.C. §§ 80a-29, 80a-30 (1970); Investment Advisors Act of 1940, 15 U.S.C. 80b-4 (1970). See also K. SKOUSEN, AN INTRODUCTION TO THE SEC 17 (1976).

4. AICPA, Accounting Principles Board Statement No. 4, ¶ 40, 2 APB CCH ACCOUNTING PRINCIPLES 9,067 (1973). See also E. HENDRIKSEN, ACCOUNTING THEORY 102 (rev. ed. 1970).

5. AICPA, Accounting Principles Board Statement No. 4, ¶¶ 10-16, 2 APB CCH ACCOUNTING PRINCIPLES 9,062 (1973).

presentation of these outcomes facilitates informed business decisions by investors and other users of the reports. There are, however, various alternatives under which information may be collected and analyzed. Consequently, to promote uniformity the accounting profession, together with other regulatory bodies such as the SEC, has identified the most acceptable methods of financial presentation. These methods of measurement and disclosure are known as "generally accepted accounting principles."⁶

Generally accepted accounting principles (GAAP) incorporate the conventions, rules, and procedures necessary for equitable financial reporting.⁷ These principles dictate which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be measured, what information should be disclosed, the methods of disclosure to employ, and which financial statements should be prepared.⁸ GAAP are not formally derived; rather, they develop by authoritative agreement on the basis of experience, reason, custom and need in the accounting industry.⁹ Furthermore, GAAP are not constant. They change in response to varying economic and social changes, to new knowledge and technology, and to demands by users for more serviceable financial information.¹⁰ Consequently, there may be disagreement as to the most appropriate principle to apply in a given situation; circumstances may occur in which equally acceptable accounting principles are available.¹¹

The SEC acknowledges that GAAP vary with time and that in a given situation more than one principle may apply.¹² The SEC has sought to encourage financial presentation in the manner most meaningful to users of financial data. Accordingly, the Commission

6. *Id.* ¶¶ 137-42, at 9,083. There are three types of accounting principles—the pervasive principles, the broad operating principles, and the detailed principles. The pervasive principles form the basis for much of the accounting process. They specify the general approach accountants take in recognizing and measuring the events that affect the financial character of an enterprise. Broad operating principles are the guides in selecting, measuring and reporting events in financial accounting. Detailed principles are the large body of practices and procedures that prescribe definitely how transactions and other events should be recorded, classified, summarized and presented. *Id.* ¶¶ 143-219, at 9,084.

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. See L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 3.3 (3d ed. 1972).

12. SEC Accounting Series Release No. 150 (Dec. 20, 1973).

recently adopted a rule of "preferability" to help assure that registrants' financial reports produce adequate disclosure for investors.¹³ The objective of this new rule is to permit changes in GAAP applied to financial statements only where the change will effect an improved method of financial reporting.¹⁴ In short, the rule, Instruction H(f) of Form 10-Q,¹⁵ requires that where financial reports reflect a change in the application of generally accepted accounting principles, they must be accompanied by a letter from the registrant's independent accountant. It is the accountant's responsibility in this letter to declare that the alternative principle is the preferable application.¹⁶

Although the SEC believes that Instruction H(f) furthers both its own objective and that of the accounting profession, the "preferability" rule has not been well received by the profession and was recently subject to attack in *Arthur Anderson & Co. v. Securities and Exchange Commission*.¹⁷ In general, Instruction H(f) has been criticized as being vague and arbitrary because it fails to provide sufficient criteria for making a determination as to which accounting principles are preferable in a given situation. The profession claims that often such determinations are impossible. In addition, the SEC, in interpreting the rule, prohibits the application of different GAAPs for similar clients of a single accounting firm.¹⁸ The profession claims that this is an impermissible classification which facilitates "accountant shopping." Although it has given careful consideration to the views of the accounting professionals and the American Institute of Certified Public Accountants (AICPA), the Commission has stood firm in declaring Instruction H(f) sound.

The function of this note is to examine Instruction H(f) of Form 10-Q and its effect upon securities regulation. Although the regulation will be shown to have been promulgated pursuant to SEC authority, issues of legality will suggest that the interpretations of its application should be reconsidered. In light of the rule's effect on the practice of accountants and their possible liability for noncompliance, criteria should be provided to guide application of the rule relative to accounting principle changes of the various clients of an accountant or accounting firm.

13. SEC Accounting Series Release No. 177 (Sept. 10, 1975).

14. *Id.*

15. [1976] 3 FED. SEC. L. REP. (CCH) ¶ 31,031.

16. SEC Accounting Series Release No. 177 (Sept. 10, 1975).

17. Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976) (order denying preliminary injunction). *See* note 79 *infra*.

18. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976).

Instruction H(f) will be reviewed in three parts. The history of the rule and the reasons for its adoption will be presented in the second section. The third portion of the note will consider the expedience of the rule, defenses in its favor, and criticisms of its application. Initially, however, the development of GAAP and the effect of various authorities on that development will be summarized for the reader unfamiliar with that process.

ACCOUNTING PRACTICE UNDER THE SECURITIES LAWS

Many of the reports filed pursuant to securities law are accompanied by prescribed financial statements. These statements typically consist of balance sheets, income statements and related schedules reflecting changes in financial position. They contain the vital information upon which security investments are based. Accordingly, to help assure full and fair disclosure of the financial data, the securities laws deal extensively with accounting practices. The obligations of accountants and registrants under the securities laws and the accounting principles they apply in financial statement presentation are given shape and definition by the SEC, by the accounting profession through the financial accounting standards boards, and by the courts.¹⁹

SEC Authority

The SEC has unlimited control over the development of accounting practices under the securities laws. Its first grant of control derived from the Securities Act of 1933,²⁰ and throughout the years the Commission's statutory authority has broadened. The 1933 Act regulated initial offerings and sales of securities. It empowered the Federal Trade Commission, and subsequently the SEC, to make, amend, and rescind necessary rules of implementation.²¹ Specifically, the SEC may define accounting terms and prescribe the form and content of financial statements.²² Subject to regulation are the methods employed in the preparation of required registering state-

19. See 1 L. LOSS, *SECURITIES REGULATION* 326-51 (2d ed. 1961, Supp. 1969); L. RAPPAPORT, *supra* note 11, at 3.1; K. SKOUSEN, *AN INTRODUCTION TO THE SEC* 85 (1976); Derieux, *Public Accountability Under Securities Laws*, 35 OHIO ST. L.J. 255 (1974); Fiflis, *Current Problems of Accountant's Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975); Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201, 211 (1975).

20. 15 U.S.C. § 77s (1970).

21. *Id.*

22. *Id.*

ments and prospectus, the valuation of assets and liabilities therein, the determination of depletion and depreciation, and the differentiation of income.²³

Congress enacted the 1934 Securities and Exchange Act in order to regulate the trading of securities after their initial offer and sale. Regarding the resale of securities, the SEC inherited authority over accounting practice identical to that covering the initial sale in the 1933 Act.²⁴ This power was coupled with additional control over periodic reporting by registered enterprises.²⁵ The SEC accordingly prescribes the detail and form included in periodic reports made pursuant to the 1934 Act. Together, the 1933 Act and 1934 Act serve as a base for the additional authority granted to the SEC in subsequent years.

While deriving its primary authority from the 1933 and 1934 Acts, SEC control of accounting expanded in later years. The Public Utility Holding Company Act of 1935 granted even broader control to the SEC over accounting practice. Registered companies must file the forms and records deemed necessary and appropriate by the SEC.²⁶ Further, the SEC may specify the accounting system used and the records to be maintained.²⁷ The Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisor Act of 1940, Chapter X of the Bankruptcy Act, and the Securities Investor Protection Act of 1970 give added authority to the SEC to review, certify, and examine the application of accounting practices.²⁸ Cumulatively, the various acts grant the SEC broad power to regulate the accounting activities of registered enterprises. The SEC, however, has not exercised that power to its full potential.

Although the SEC may act to control accounting disclosures and practices, it has refrained from excessive use of its power. When it has exerted its authority, the Commission has distinguished requirements of form and content of financial statements from expressions of policy regarding the establishment of generally accepted accounting principles.²⁹ Extensive regulations of the form and content of the financial reports filed under the acts are codified in Regulation S-X.³⁰

23. *Id.* See also L. RAPPAPORT, *supra* note 11, at 1.2.

24. 15 U.S.C. §§ 78m, 78c(b) (1970).

25. *Id.* See also L. RAPPAPORT, *supra* note 11, at 1.6.

26. 15 U.S.C. § 79t (1970).

27. *Id.*

28. See note 3 *supra*.

29. L. RAPPAPORT, *supra* note 1, at 3.1; Strother, *supra* note 19, at 230.

30. SEC Reg. S-X, 17 C.F.R. § 210 (1976).

The SEC, however, has expressed views on the promulgation of GAAP in fewer pronouncements. Its policy is to rely upon the accounting profession to establish the acceptable methods of practice.³¹

Regulation S-X is the primary accounting pronouncement of the Commission.³² It was adopted in 1940 and has since been amended several times. Through this pronouncement the SEC has standardized the form and content of financial statements filed under the various acts. In most respects, the requirements set forth in Regulation S-X coincide with the accounting profession's viewpoint of good accounting practice. There are, however, differences between general accounting practice and the provisions of Regulation S-X which prescribe additional disclosures not regarded as essential to fair presentation.³³ Further, the SEC may disqualify an accountant or accounting firm for failure to comply with the provisions of Regulations S-X.³⁴

Notices of additions and amendments to Regulation S-X are presented in Accounting Series Releases (ASRs).³⁵ ASRs are the published opinions of the SEC relating to major accounting questions

31. See note 29 *supra*. But see Kripke, *The SEC, The Accountants, Some Myths and Realities*, 45 N.Y.U.L. REV. 1151 (1970); Address by J. Whitney II, Washington Society of Investment Analysts (Feb. 5, 1933). Kripke and Whitney argue that the SEC should assert its authority to play the primary role in the establishment of generally accepted accounting principles.

32. Requirements of Regulation S-X must be applied in the preparation of reports filed under the 1933 Act, the 1934 Act, the Public Utility Holding Company Act and the Investment Company Act. SEC Reg. S-X, 17 C.F.R. § 210.1-01 (1976).

The importance of the regulation's provisions is indicated by Skousen in AN INTRODUCTION TO THE SEC, when he states:

[D]ue to the interaction between such standard-setting bodies as the American Institute of Certified Public Accountants and the SEC in developing reporting standards, and due to the size and importance of the filing companies and their auditors, it is probably not an exaggeration to state that the SEC's regulatory power extends, directly or indirectly, to virtually all public accounting situations.

SKOUSEN, *supra* note 19, at 87.

33. Compare 17 C.F.R. § 210.3-16 with AICPA, Accounting Principles Board Statement No. 4 ¶¶ 10, 13, 39, 133, 199, 2 APB CCH ACCOUNTING PRINCIPLES (1973). Rappaport notes that the AICPA permits capital stock subscriptions to be carried as an asset, but that the SEC requires that they be deducted in the capital section from capital stock subscribed but not issued. L. RAPPAPORT, *supra* note 11, at 16.5.

34. 17 C.F.R. § 201-2(e) (1976). The sanctions available under this rule are disbarment and suspension. See Derieux, *Public Accountability Under Securities Laws*, 35 OHIO ST. L.J. 255, 266 (1974).

35. [1976] 5 FED. SEC. L. REP. (CCH) ¶ 72,001.

and financial statement presentation.³⁶ In 1950, Regulation S-X was amended to direct attention to the ASRs.³⁷ All releases related to Regulation S-X were incorporated by reference. The amendment did not, however, constitute a blanket adoption of all prior releases. Indeed, some ASRs are beyond the function of Regulation S-X. For example, they also form the basis of the Commission's limited involvement in the establishing of GAAP.³⁸

While Regulation S-X prescribes rules of form and content of financial statements filed, the SEC has generally refrained from regulating the establishment of GAAP. Rather, the Commission has adopted the policy that in cases in which it has not expressed a position, it will look to the most authoritative voice in the private sector to provide accounting principles.³⁹ This policy derives from the SEC's acknowledgement that the accounting profession has the expertise to fully consider the establishment of GAAP. Furthermore, SEC involvement as an alternative source would serve only to permit a proliferation of acceptable accounting methods.⁴⁰

Notwithstanding the SEC's policy to refrain, the SEC has an important impact on the development of accounting principles. The mere existence of the SEC's ability under the securities acts to control the development of GAAP can have impact upon the accounting profession.⁴¹ The SEC has not completely removed itself from review or establishment of GAAP and, upon finding inadequate standards, will act to supersede the profession.⁴² In ASR 102, for example, the SEC took action in regard to the correct classification of deferred income taxes arising from installment sales.⁴³ The account-

36. These statements primarily explain and clarify accounting procedures and practices needing special treatment. Since the topics are generally of importance, they require special notice by the Commission. See L. RAPPAPORT, *supra* note 11, at 2.4; K. SKOUSEN, *supra* note 19, at 89.

37. 17 C.F.R. § 210.1-01(a) (1976).

38. See, e.g., SEC Accounting Series Release No. 4 (Apr. 25, 1938) (administrative policy); SEC Accounting Series Release No. 150 (Dec. 20, 1973) (administrative policy).

39. SEC Accounting Series Release No. 150 (Dec. 20, 1973); Address by Commissioner Needham, The National Industrial Conference Board (Apr. 29, 1970).

40. Robinson, *Impact of the SEC on Accounting Principles and Auditing Statements*, in HASKINS & SELLS, 1974 SELECTED PAPERS 66 (1975); Strother, *supra* note 19, at 230.

41. Robinson, *supra* note 40, at 68.

42. In ASR 96, issued in 1963, the SEC rejected APB Opinion No. 2 which stated that there was but one acceptable method of accounting treatment for investment credit. The APB amended Opinion No. 2 with Opinion No. 4, which provided for alternative methods approved by the SEC.

43. SEC Accounting Series Release No. 102 (Dec. 7, 1965).

ing profession had been unable to resolve the problem of choosing the most acceptable method. Therefore, the SEC took initiative to provide the proper guidelines. This interaction with the private sector fosters the development of effective and respected standards.

In summation, the SEC seeks to use its regulatory power over accounting principles in order to best protect investors. By providing them with full financial disclosure, the SEC facilitates informed business decisions. Such objectives are best accomplished when financial reports are uniformly prepared by all reporting entities, are comparable over the years, and are consistent in the application of GAAP. In the past the SEC has exerted its power by standardizing the form and content of financial reports. However, the SEC has refrained from promulgating the accounting principles to be applied in preparation. This has been left to the expertise of the accounting profession, coupled with the cooperation and review of the SEC. To this end the accounting profession has formed professional reviewing bodies to formulate generally accepted accounting principles.

The Accounting Profession's Role in Developing GAAP

The SEC's policy of relying on the accounting profession to develop generally accepted accounting principles was expressed in ASR No. 4. Under ASR No. 4, financial statements must be prepared in accordance with accounting principles with "substantial authoritative support."⁴⁴ Substantial authoritative support derives not from legislative rulings, but rather from the establishment of GAAP by the private sector.⁴⁵ Opinions of the American Institute of Certified Public Accountants (AICPA) are the most authoritative source of GAAP.⁴⁶

44. The pertinent part of ASR No. 4 reads as follows:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading . . .

45. In connection with ASR No. 4, the AICPA stated in 1964 that:

- (a) "generally accepted accounting principles" are those principles which have substantial authoritative support.
- (b) Opinions of the APB constitute "substantial authoritative support."
- (c) "substantial authoritative support" can exist for accounting principles that differ from Opinions of the APB.

However, the SEC has not stated any interpretation of the words "substantial authoritative support."

46. See note 45 *supra*.

In response to ASR No. 4, the AICPA organized the Committee on Accounting Procedure (CAP) in 1939, thus implementing the development of accounting principles with substantial authoritative support. Between 1939 and 1959 the CAP issued 51 bulletins on accounting principles as practical guides.⁴⁷ During that period the SEC looked almost exclusively to the CAP and the accounting profession for substantial authoritative support.⁴⁸ In 1959 the AICPA replaced the CAP with the Accounting Principles Board (APB) in order to administer improvement in the formulation of accounting principles.⁴⁹ The APB issued 31 Opinions and 4 Statements on accounting principles and standards.⁵⁰ The APB pronouncements were also recognized by the profession and the SEC as authoritative.⁵¹

Eventually, in 1973, following the recommendations of an AICPA committee, the current Financial Accounting Standards Board (FASB) superseded the APB.⁵² The FASB researches and adopts additional accounting principles in response to the development of increasingly complex accounting practices. AICPA members are required by recent amendment to the Code of Accounting Ethics to comply with the pronouncements of the FASB and its predecessors.⁵³

The SEC has also recognized the FASB as the current authoritative source of GAAP.⁵⁴ In December of 1973, soon after the AICPA designated the FASB as the accounting standards-setting body of the accounting profession, the SEC adopted ASR No. 150.⁵⁵ ASR No. 150

47. AICPA, Accounting Research Bulletin No. 43, 2 APB CCH ACCOUNTING PRINCIPLES 6,003 (1973) (codified and revised prior bulletins); AICPA Accounting Research Bulletin No. 44-51, 2 APB CCH ACCOUNTING PRINCIPLES 6,065 *et seq.* (1973). The CAP also issued four accounting terminology bulletins. AICPA, Accounting Terminology Bulletins, 2 APB CCH ACCOUNTING PRINCIPLES 9,501 (1973).

48. See Zeff, *Chronology of Significant Developments in the Establishment of Accounting Principles in the United States, 1926-1972*, 10 J. ACCT. RES. 219 (1972).

49. Zeff, *Developing Accounting Principles: A Summary Review and Analysis of the U.S. Experience*, J. CONTEMP. BUS. 41 (1973). The process of adopting APB Opinions included procedures for review by the SEC and other interested parties.

50. AICPA, Accounting Principles Board Opinions, 2 APB CCH ACCOUNTING PRINCIPLES 6,501 (1973); AICPA, Accounting Principles Board Statements, 2 APB CCH ACCOUNTING PRINCIPLES 9,001 (1973).

51. See notes 39 and 48 *supra*.

52. AICPA, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS REPORT OF THE ESTABLISHMENT OF ACCOUNTING PRINCIPLES (1972) (the Wheat Study).

53. 2 CCH AICPA PROF. STANDS. ET §§ 202.01, 203.01 (1974).

54. SEC Accounting Series Release No. 150 (Dec. 20, 1973).

55. The pertinent part of ASR No. 150 reads as follows:

"[P]rinciples, standards and practices promulgated by the FASB in its Statements and

referred to the SEC's policy as stated in ASR No. 4 and reaffirmed that where the Commission has not preempted the FASB by taking independent action, it would continue to look to the standards set by the FASB as having substantial authoritative support. Accordingly, financial reports which depart from the applications of GAAP are presumed to be misleading.⁵⁶ Only where justified will departure be permitted.

Thus, while the SEC has taken extensive action to prescribe the form and content of financial reports filed under the securities laws, it has continued to look to the accounting profession for guidance in determining the acceptable accounting principles to be used in preparation. The AICPA, in response, has delegated to various bodies the task of establishing GAAP. The result has been the continued acceptance, modification, and rescission of the rules and procedures to be applied in the preparation of financial statements. Yet the development of GAAP is incomplete. GAAP respond to changes in social and economic conditions and to new knowledge and technology. The AICPA has recognized that, in some instances, more than one GAAP may apply.

The Role of the Courts

Actions taken by the SEC are subject to judicial review under the Administrative Procedure Act.⁵⁷ A court reviewing an action of an administrative agency shall set aside any action it finds to be arbitrary, capricious, an abuse of discretion, or contrary to law.⁵⁸ Consequently, court opinion of what acceptable accounting principles embody plays an integral part in SEC pronouncements.

Actions violative of the Administrative Procedure Act include those done without adequate determining principles or without

Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support." Previous pronouncements by the Committee on Auditing Procedure and the Accounting Principles Board were noted as continuing in force unless altered, amended, supplemented, revoked or superceded by the FASB.

56. SEC Accounting Series Release No. 150 (Dec. 20, 1973).

57. 5 U.S.C. § 706 (1970).

58. The pertinent part of the Administrative Procedure Act reads as follows:

A reviewing court shall,

* * *

(2) hold unlawful and set aside agency action, findings and conclusions found to be

(A) arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law.

5 U.S.C. § 706 (1970).

regard for reason and judgment.⁵⁹ They are acts which are not governed by any fixed rules or standards.⁶⁰ Courts are called upon to inquire into the facts underlying an SEC ruling to determine whether its adoption is an error in judgment.⁶¹ Should the court's judgment reveal that an SEC ruling lacks rational support or substantial foundation, the act should be set aside.⁶² In the past, however, courts have not substituted their discretion for that of the Commission "unless the administrative view is so entirely at odds with fundamental principles of correct accounting as to be the expression of whim rather than an exercise of judgment."⁶³

Accounting practices under the securities laws are given shape and definition, then, by three authorities. Initially, Congress granted complete control of its development to the SEC. This Commission has prescribed the form and content of financial reports filed under the various acts. To a limited extent, the SEC has expressed its position on the accounting methods to be applied in that preparation. However, to help assure that preparation of reports incorporate the best methods of disclosure, the SEC has practically mandated that the accounting profession standardize the methods of accounting which have substantial authoritative support.

The accounting profession has in turn responded to the needs of the SEC. Through AICPA committees it has identified generally accepted accounting principles. GAAP incorporate the modes of preparation which the SEC recognizes as satisfying the requirements of full and fair disclosure. However, due to a proliferation of alternative methods and disagreement as to the most acceptable, there arise situations where more than one GAAP exist. In such instances, financial statements filed may utilize any one of several GAAP.⁶⁴ Therein lies the dilemma.

In view of the occasional situations in which more than one GAAP exists, the SEC has attempted to control the varying

59. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 416 (1971); *United States v. Cormack*, 329 U.S. 230 (1946); *Connolly v. General Constr. Co.*, 269 U.S. 385 (1926); *H & H Tire Co. v. United States Dep't of Transp.*, 471 F.2d 350 (7th Cir. 1972); *Automotive Parts and Accessories Ass'n, Inc. v. Boyd*, 407 F.2d 330 (D.C. Cir. 1968); *First Nat'l Bank of Fayetteville v. Smith*, 365 F. Supp. 898 (W.D. Ark. 1973).

60. *See* note 59 *supra*.

61. *Id.*

62. *Id.*

63. 1 L. LOSS, *SECURITIES REGULATION* 350 (2d ed. 1961), *citing* *Kansas City Southern Ry. v. United States*, 231 U.S. 423, 444 (1913).

64. AICPA, *Statement on Auditing Standards* No. 5, ¶ 9 (1975).

applications of GAAP from period to period. The result is the promulgation of Instruction H(f) to Form 10-Q. The rule as stated has been attacked by the accounting profession and is consequently the subject of court review. The courts, in considering the rationale and effect of the rule, serve as an additional source of accounting practices. With this tripartite scheme of accounting regulation in mind, a formula based upon interaction between the SEC, the profession, and the courts, one may venture into a closer examination of Instruction H(f) and the implications of its recent interpretation.

THE HISTORY AND EFFECT OF INSTRUCTION H(f)

Pursuant to the authority conferred by the Securities Exchange Act of 1934, the SEC has earmarked numerous report forms for registering securities.⁶⁵ Each form has distinguishing requirements and serves a separate purpose. The forms are chiefly narrative reports accompanied by financial statements. Registrants provide the necessary information for preparation of the reports, and independent accountants attest to the accuracy of audited financial statements.⁶⁶ These statements are to be prepared in accordance with the form and content requirements of Regulation S-X, utilizing generally accepted accounting principles as developed by the accounting profession.⁶⁷ One of these, Form 10-Q, is used to report quarterly financial results.⁶⁸

Report Form 10-Q was first introduced in 1970 by the SEC to provide for disclosure of the interim period financial position of registered entities.⁶⁹ Reports on this form are filed for the first three quarters of each fiscal year and are codified after the fourth quarter in annual reports. The information required includes financial statements summarizing income, balance sheets, and sources and application of funds.⁷⁰

In 1975, Instruction H(f) to Form 10-Q was amended to impose new restrictions on changes in accounting principles utilized in its preparation.⁷¹ Formerly the subsection had required that changes from the GAAP applied in preceding reports be identified. It had also required that the reasons for such changes be stated by letter if

65. [1976] 3 FED. SEC. L. REP. (CCH) ¶ 21,001.

66. 17 C.F.R. § 210.2 (1976).

67. 17 C.F.R. §§ 210 *et seq.* (1976); SEC Accounting Series Release No. 177 (Dec. 20, 1973).

68. [1976] 3 FED. SEC. L. REP. (CCH) ¶ 31,031.

69. 35 Fed. Reg. 18512 (Dec. 5, 1970).

70. *See note 68 supra.*

71. SEC Accounting Series Release No. 177 (Sept. 10, 1975).

they had a material effect on the financial results.⁷² As amended, Instruction H(f) requires that when the registrant adopts any change in accounting principle, Form 10-Q must be accompanied by a letter from the registrant's independent accountant stating whether the change is to an alternative principle which under the circumstances is preferable.⁷³

Amended Instruction H(f) is the culmination of many years of speculation about the effect of accounting principle changes upon full and fair disclosure in financial statements. As the accounting principles developed through the years, it became increasingly possible to improve the financial picture of an enterprise by invoking changes among equally accepted accounting principles.⁷⁴ Eventually accounting practices had taken a step toward presenting financial statements in the most favorable light, even if it were not the most realistic.⁷⁵ Because of a proliferation of accepted methods and disagreement as to the most appropriate principles, the answer to the problem was not to be found in GAAP. The authoritative sources had been unable to determine the most acceptable methods among equally feasible alternatives.⁷⁶ Consequently, enterprises invoked principle changes so as to improve financial status.⁷⁷

Instruction H(f) has the purpose of eliminating the practice of using accounting methods to change the picture of financial status. It requires independent accountants to state preferability for account-

72. Former Instruction H(f) stated:

The financial information to be included in this report shall be prepared in conformity with the accounting principles or practices (including consolidation practices), reflected in the financial statements included in the annual report filed with the Commission for the preceding fiscal year, except for a change reported as required by this instruction. Describe any such change in accounting principles or practices followed by the registrant, or any change in the method of applying any such accounting principles or practices, which will materially affect the financial statements filed or to be filed for the current year with the Commission and which has not been previously reported hereunder. State the date of the change and the reasons therefor. A letter from the registrant's independent accountants, approving or otherwise commenting on the change, shall be filed as an exhibit.

JENNINGS & MARSH, SELECTED STATUTES, RULES AND FORMS UNDER THE SECURITIES LAWS 474 (1974 ed.).

73. See p. 248 *infra*.

74. See Briloff, "We Often Paint Fakes", 28 VAND. L. REV. 165 (1975); Frishkoff, *Some Recent Trends in Accounting Changes*, 8 J. ACCOUNTANCY 141 (1970); Kripke, *supra* note 31.

75. See note 74 *supra*.

76. See AICPA, *Statement on Auditing Standards No. 5*, ¶ 9 (1975).

77. See note 88 *infra* and accompanying text.

ing principles adopted in place of those used in the enterprise's previous financial reporting. In the SEC's viewpoint the effect is to limit changes in accounting principles to those which will present improved reporting.⁷⁸ The accounting profession, although recognizing that purpose, also sees the rule as a limitation upon the servicing of clients.⁷⁹ To understand this divergence of opinion, a close examination of the meaning of "truth" in relation to specific accounting practices is necessary.

The Meaning of "Truth" in Accounting Practices

The basic objective of financial statement presentation is to provide information useful in making business decisions.⁸⁰ Accounting practice is based on the desire for consistent year-to-year financial disclosures which provide comparable accounting statements upon which business decisions can be based.⁸¹ Hence a system of uniform standards of disclosure, upon which an investor can rely in evaluating financial data, is needed by each reporting entity. When investors compare a consistent periodic presentation they can evaluate the growth potential of their investment. Further, comparing economic results of similar entities, whose records are equally consistent and which use a comparable scheme of uniform principles, aids in determining the success of the investor's own enterprise. It is at this result that the accounting profession and SEC regulations of accounting principles aim.⁸²

The SEC provides rules of form and content to be uniformly applied by all reporting entities in preparing financial statements.⁸³ The accounting profession determines the GAAP to be applied in preparing them.⁸⁴ When financial reports filed meet both the form requirements of the SEC and apply GAAP, it would appear that the investor is presented with truthful financial results. However, as the

78. The comments accompanying the text of Instruction H(f) in ASR No. 177 stated that an accounting principle change must represent "an improved method of measuring business operations in the particular circumstances involved."

79. Brief for Plaintiff at 14, *Arthur Anderson & Co. v. SEC*, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976); Brief for Coopers & Lybrand as Amicus Curiae at 13, Brief for Peat, Marwick, Mitchell & Co. as Amicus Curiae at 2, Brief for AICPA as Amicus Curiae at 42, Brief for Ernst & Ernst as Amicus Curiae at 5, *Arthur Anderson & Co. v. SEC*, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

80. See AICPA, *Accounting Principles Board Statement No. 4*, ¶¶ 10-16, 2 APB CCH ACCOUNTING PRINCIPLES 9,074 (1973).

81. *Id.*

82. *Id.*

83. See note 32 *supra* and accompanying text.

84. See notes 44-56 *supra* and accompanying text.

accounting profession has developed, various acceptable methods of reporting the same transactions have evolved.⁸⁵ It is therefore possible for independent accountants to apply those principles of accounting which will present a more favorable report.⁸⁶ Although acceptable, this practice would color the true financial position of an enterprise.

By applying specific GAAP, however, accountants are capable of presenting financial pictures which, although accurate and factual, would not be evident had alternative principles been applied. This practice has been strongly criticized by both the SEC and the AICPA.⁸⁷ A simple example illustrates this procedure. Two of the generally accepted accounting treatments of inventory costing are last-in-first-out and first-in-first-out methods (LIFO and FIFO).⁸⁸ Either method may be utilized in preparing financial statements, and yet both would present different accounting pictures. In a period of rising costs a FIFO application will reflect a higher inventory valuation than LIFO and affect presentation of balance sheets, income statements, and related schedules. The accountant, depending upon the financial picture desired, can apply either method to suit his needs. Further, as his needs change, alternative GAAP can be adopted.

This is not to suggest that the practice of choosing the "best" GAAP is entirely wrong. Many changes between equally accepted principles applied from one period to the next are warranted and in fact truthful.⁸⁹ Accounting principle changes are often adopted so as to reflect a more realistic evaluation and improved reporting. It is only those changes which are unwarranted and invoked for purposes other than "fair presentation" that Instruction H(f) seeks to prevent.⁹⁰

The Securities Act of 1933 is referred to as the "Truth in Securities" law. It is now apparent that, with regard to financial reporting, "truth" goes beyond mere compliance with the securities

85. See notes 9-11 *supra* and accompanying text.

86. See note 74 *supra*.

87. AICPA, Accounting Principles Board Opinion No. 20, 2 APB CCH ACCOUNTING PRINCIPLES 6,685 (1973).

88. The first-in, first-out method assumes that inventory is sold in the order of acquisition. FIFO accounting overstates profit in times of inflation and understates it in times of deflation. Last-in, first-out assumes that the inventory most recently acquired is the first sold. LIFO accounting reduces the impact of inflation on reported profits and taxes.

89. See pp. 250-51 *infra*.

90. See note 74 *supra*.

acts, Regulation S-X, and GAAP.⁹¹ Accounting procedures must serve the interests of all parties by providing unbiased, fair, and impartial accounting reports.

In recent litigation "truth" has been construed as relating to a general concept of "fair presentation." The SEC has emphasized that "fair presentation" goes beyond GAAP and that courts will not give complete absolution of any liability because of compliance with them.⁹² In *United States v. Simon*⁹³ the Second Circuit Court of Appeals affirmed the conviction of auditors on fraud charges for certifying statements that did not "fairly present" the financial position of an enterprise despite compliance with GAAP.⁹⁴ The courts look beyond the "esoteric accounting norms" to determine if financial statements fairly present the true financial picture to the "untutored eye of an ordinary investor."⁹⁵ John C. Burton, the former Chief Accountant of the SEC, has stated that the fair presentation has three elements: 1) financial results taken as a whole must present business results in a fashion such that users who have a general familiarity with the accounting model will be able to understand what happens to the reporting enterprise in a business sense; 2) a detailed knowledge of accounting should not be required of users to achieve this result even though general familiarity with the model is necessary; and 3) the basic impression given by financial statements should coincide with the business reality, or, in other words, "the message must be clear."⁹⁶

Instruction H(f) is an outgrowth of the SEC's goal to assure "fair presentation" and prevent the manipulation of accounting principles. Financial reports should present the true financial picture, and where more than one accounting principle applies, the most preferable method should be utilized in lieu of any other. However, the notion of preferability does not originate with Instruction H(f). It has had an impact on the accounting profession throughout the develop-

91. Hawes, *Truth in Financial Statements: An Introduction*, 28 VAND. L. REV. 1, 8 (1975). See note 5 *supra*, ¶ 189 at 9,099.

92. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

93. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

94. *Id.*

95. *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,574 (S.D.N.Y. May 29, 1974).

96. Address by John C. Burton, "Fair Presentation: Another View," The Baruch College of the City University of New York (Feb. 18, 1975).

ment of GAAP. Indeed, the principles themselves evolve from the SEC and AICPA objective of financial presentation utilizing the best methods of disclosure.

The AICPA and the SEC advocate departure from the consistent application of GAAP only when the effect is more meaningful financial disclosure.⁹⁷ Primarily due to economic growth in the 1960's, accountants were employed to appease investors with consistently improved financial position. Changes in principles were utilized to reflect higher income, increased earnings per share, and overall financial growth. The SEC responded to this activity by objecting to accounting changes so motivated. The Commission voiced its approval for accounting changes benefiting full and fair disclosure.⁹⁸

The AICPA also reacted to the problem of accountants appeasing investors through choice of method. It issued an exposure draft entitled "Accounting Changes," which proposed that:

There is a presumption that an accounting principle or method, once adopted, will not be changed as long as the pertinent events or transactions continue. The presumption that accounting changes will not be made may be overcome only when it is demonstrable that the change proposed is to a method which is generally accepted and which will provide more useful results than those furnished by the methods previously followed, considering the varying interests of the parties using the financial statements.⁹⁹

Thus, both the AICPA and the SEC identified the same problem. However, the AICPA and the SEC viewed the procedures for justifying accounting changes differently. This agreement was one of the factors that eventually led to the promulgation of Instruction H(f).

When the final draft of APB Opinion 20, entitled "Accounting Changes," was adopted in 1971, it placed the burden of justifying an accounting principle change on the management of the reporting enterprise. The presumption that an entity should not change accounting principles was overcome "only if the enterprise justifies the use of an alternative principle on the basis that it is preferable."¹⁰⁰

97. See notes 78 and 87 *supra*.

98. SEC Accounting Series Release No. 177 (Sept. 10, 1975).

99. See AICPA, Accounting Principles Board Opinion No. 20, ¶ 16, 2 APB CCH ACCOUNTING PRINCIPLES 6,685 (1973).

100. *Id.*

This test developed largely from belief that business planning and judgment often provide the justification for principle changes. As business conditions vary from time to time and such conditions affect businesses in different ways, one enterprise's management might base a preference for a particular principle based on economic factors and future expectations, while accounting judgment may not provide the criteria for making a preference.¹⁰¹ According to the AICPA, the role of the independent accountant in justifying an accounting principle change was to advise clients desiring to effect the change. "The auditor should evaluate a change in accounting principle to satisfy himself that: (a) the newly adopted accounting principle is a GAAP; (b) the method of accounting for the effect of the change is in conformity with GAAP; and, (c) management's justification for the change is reasonable."¹⁰² Thus, the obligation of the independent accountant was minimized, and liability was avoided if a change was reasonable.

The Commission looks to the independent accountant rather than the reporting enterprise to justify that a change in principle is the "preferable" alternative rather than merely a "reasonable" one. The SEC believes that independent accountants are best prepared to justify accounting changes due to their expertise in accounting practice. Therefore the SEC responded to APB Opinion 20 by adopting Instruction H(f) as it relates to interim reporting under Form 10-Q.¹⁰³ As adopted, the rule states:

The financial statements to be included in this report shall be prepared in conformity with the standards of accounting measurement set forth in Accounting Principles Board Opinion No. 28 and any amendments thereto adopted by the Financial Accounting Standards Board. In addition to meeting the reporting requirements for accounting changes specified therein, the registrant shall state the date of any change and the reasons for making it. In addition, in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants shall be filed as an exhibit indicating whether or not the change is to an alternative principle which in his judgment is preferable under the

101. Brief for Coopers & Lybrand as Amicus Curiae at 18, *Arthur Anderson & Co. v. SEC*, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

102. AICPA, *Statement on Auditing Procedure No. 53* (1972). *Statements on Auditing Procedure Nos. 33-54* were codified in 1972 in *Statement on Auditing Standards No. 1*.

103. [1976] 3 FED. SEC. L. REP. (CCH) ¶ 31,031.

circumstances; except that no letter from the accountant need be filed when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such change.¹⁰⁴

The Effect of Instruction H(f)

The purpose of Instruction H(f) is to regulate changes of accounting principles in quarterly financial statements. The effect of the rule is threefold. First, it adopts Opinion 28, entitled "Interim Financial Reporting," as pronounced by the APB and amended by the FASB.¹⁰⁵ Opinion 28, like Form 10-Q, concerns financial reports prepared between fiscal periods. Secondly, the rule declares the SEC's position on preferability and justification of accounting changes. Finally, it reaffirms the SEC's acknowledgement of the FASB as the authoritative source for GAAP applied to interim financial statements. In addition to the effects of the original pronouncement, the impact of the rule was expanded by subsequent interpretations by the SEC.¹⁰⁶

1. Adoption of APB Opinion No. 28

In Opinion No. 28 the APB recognized the usefulness of interim financial reports for investors to aid in making business decisions.¹⁰⁷ However, in the past a lack of uniform standards for their preparation had existed. Accordingly, the pronouncement served to "clarify the application of GAAP and reporting practices" applied in interim period reports.¹⁰⁸ The opinion covers two specific areas. It outlines the application of accounting principles in interim reports, and it indicates types of disclosure necessary for meaningful presentation of financial data by publicly traded companies. As applied to Instruction H(f), the pertinent parts of Opinion 28 relate to its position on accounting changes.¹⁰⁹

Opinion 28 requires that an accounting change in interim statements be reported in the period in which the change is adopted,

104. *Id.*

105. AICPA, Accounting Principles Board Opinion No. 28, 2 APB CCH ACCOUNTING PRINCIPLES 6,781 (1973).

106. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976); Letter from SEC to Auditing Standards Executive Committee (Apr. 30, 1976).

107. AICPA, Accounting Principles Board Opinion No. 28, ¶ 6, 2 APB CCH ACCOUNTING PRINCIPLES 6,781 (1973).

108. *Id.* ¶ 1.

109. *Id.* ¶ 8.

in accordance with APB Opinion 20.¹¹⁰ In turn, Opinion 20 defines the types of accounting changes and methods of reporting them.¹¹¹ Included in Opinion 20 is the APB's position of preferability, which requires that a change in accounting principle be justified as preferable by the enterprise proposing the change.¹¹² The SEC, however, adds to its adoption of Opinion 28, and thereby Opinion 20, by requiring additional justification by the independent accountant.

2. The SEC Preferability Position

The SEC's position on preferability is the second effect of Instruction H(f). When a reporting entity employs a change in accounting principle, its adoption must be recognized by the independent accountant as a preferable application. The rule, in effect, supplements the FASB's position that the enterprise justify a change by requiring the accountant's justification in addition. Changes in accounting principles which are the subject of the preferability rule occur in three situations: (1) where a new authoritative pronouncement expresses preferability for one GAAP and rejects the acceptability of another; (2) where an accounting rule identifies as preferable under a given set of circumstances a particular GAAP; and, (3) where one acceptable accounting principle is substituted for another equally acceptable method.¹¹³

The pronouncement by an authoritative body such as the FASB, which either creates an accounting principle, designates a principle as preferable, or rejects a principle as no longer acceptable, is sufficient justification for an accounting change.¹¹⁴ The change is completed merely by conforming financial statements to the new GAAP. Such changes present no problem under Instruction H(f), and a letter by the accountant stating preferability is not required.

An accounting principle change also results where circumstances have occurred that require the application of a specific accounting principle.¹¹⁵ If the required application has not pre-

110. *Id.* ¶¶ 24-25.

111. AICPA, Accounting Principles Board Opinion No. 20, 2 APB CCH ACCOUNTING PRINCIPLES 6,685 (1973).

112. *Id.* ¶¶ 15-16.

113. Brief for Coopers & Lybrand as Amicus Curiae at 14, Brief for AICPA at 42, *Arthur Anderson & Co. v. SEC*, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

114. *See* p. 241 *supra*.

115. In its brief as amicus curiae, Coopers & Lybrand suggested the following as an example:

[B]oth percentage of completion and completed contract methods of accounting may be acceptable for a particular construction contract, but

viously been applied, the statements must reflect a change to the preferable principle. Since recognition of the situation identifies the preferred principle, there is no preferability problem. Because such circumstances are identified through the AICPA committees, it appears that no letter of preferability need be filed.

The third type of accounting change occurs when more than one GAAP applies for which there is no criteria for determining preferability.¹¹⁶ It is in this situation that Instruction H(f) has its greatest impact. An absence of any authoritative guide for determining preferability results from the existence of differing opinions as to which principle is preferable. A decision of preferability in such circumstances is most difficult. For example, two generally accepted accounting principles for inventory costing are the LIFO and FIFO methods.¹¹⁷ Both would be legitimate choices in varying circumstances, but without extrinsic information neither could be characterized as more suitable for accounting presentation. Other illustrations include changes in methods of depreciation, accounting for long term construction contracts, and methods of accounting for research and development expenses.¹¹⁸ In such situations an accountant is expected under Instruction H(f) to make a judgment as to the preferable method.

3. FASB Authority under Instruction H(f)

The third effect of the original pronouncement in ASR No. 177 is that it reaffirms the authority of the FASB. When that body finds it necessary to prescribe or reject application of specific accounting principles, no letter of preferability is required. The SEC thereby recognizes both former and future pronouncements of the FASB and reaffirms the statement in ASR No. 150 that, "principles, standards and practices promulgated by the FASB and its statements and interpretations will be considered by the Commission as having substantial authoritative support."¹¹⁹ Furthermore, the statement is consistent with the AICPA Rules of Conduct, which also require

after the percentage of completion method is adopted for a particular transaction, a lack of dependable estimates may suggest that a change to the completed contract method is preferable as a matter of accounting practice. See Accounting Research Bulletin No. 45 (1955).

Brief for Coopers & Lybrand as Amicus Curiae at 14, Arthur Anderson & Co. v. SEC, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

116. See note 64 *supra*.

117. See note 88 *supra*.

118. L. RAPPAPORT, *supra* note 11, at 3.3.

119. See note 55 *supra*.

application of the principles promulgated by the FASB and its predecessors.¹²⁰

4. SEC Interpretations of Instruction H(f)

The impact of Instruction H(f) upon the accounting profession goes beyond the determination of preferability when a client invokes an accounting principle change. In interpreting the rule the SEC has further limited professional accountants. The Commission stated in its Staff Accounting Bulletin No. 6 that if one client of an accountant or accounting firm changes applications of GAAP and a letter of preferability is filed, the SEC would not permit other clients to effect changes to other equally acceptable principles where circumstances are similar.¹²¹ Thus a statement of preferability for one client is a statement for all similar clients. Although the Commission recognizes that unusual cases may warrant accounting principle changes in different directions for different clients, it expects that sufficient justification for the change exist in such circumstances.¹²²

In sum, Instruction H(f) is the SEC's attempt to prevent unwarranted accounting principle changes invoked to facilitate portrayal of an improved financial picture of an enterprise. The commission seeks to permit accounting changes only where such change serves as an improved method of reporting in furtherance of the FASB's and its own objective of full disclosure and fair presentation. Although the primary effect of the regulation is to require an independent accountant's statement of preferability when accounting principle changes are made, Instruction H(f) also acts to limit changes in different directions by different clients of an accountant. It is this latter effect, together with the accounting profession's claim that inadequate standards for determinations of preferability exist, which make the rule controversial and subject to attack as unnecessary, vague, and arbitrary.

IS INSTRUCTION H(f) NECESSARY?

The effect of Instruction H(f) may appear to be slight. Letters of preferability when accounting principle changes are made serve the interest of full disclosure and fair presentation. Yet the regulation, in its enforcement, has been subject to much criticism.¹²³ Instruction H(f) requires independent accountants to declare preferability

120. 2 CCH AICPA Prof. Stands. ET §§ 202.01, 203.01 (1974).

121. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976).

122. *Id.*

123. *See note 79 supra.*

between equally acceptable and equally appropriate accounting principles. In Staff Accounting Bulletin No. 6 the Commission stated:

[if] the registrant was formally using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable under the circumstances.¹²⁴

The accounting profession contends that the new regulation departs from FASB requirements for situations in which more than one GAAP may be applicable¹²⁵ and that the SEC provides insufficient criteria to enable accountants to conform to the rule's requirements.¹²⁶ Further, the SEC's limitation on accounting changes for similar clients is claimed to be improper and unduly restrictive.¹²⁷ Thus, in analyzing the expedience of Instruction H(f) three questions must be answered: (1) does Instruction H(f) serve its purpose? (2) Does the SEC unduly restrict accountants by adopting a rule and interpretations thereof which are vague and with which compliance is impossible? (3) Is the rule vague, arbitrary, and capricious and hence violative of the Administrative Procedure Act?

Does Instruction H(f) Serve Its Purpose?

The SEC believes that independent accountants should bear responsibility in a determination of preferability;¹²⁸ Instruction H(f) is designed to create that responsibility. Prior to the adoption of Instruction H(f) independent accountants were not required to make judgments of preferability between alternative generally accepted accounting principles. The FASB had put a burden upon the reporting enterprise to justify a principles change.¹²⁹ The FASB determined that it was not possible to develop effective criteria for determining preferability between equally acceptable GAAP on

124. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976).

125. AICPA, Accounting Principles Board Opinion No. 20, 2 APB CCH ACCOUNTING PRINCIPLES 6,685 (1973); AICPA Statement on Auditing Standards No. 5 ¶ 9 (1975).

126. See note 79 *supra*.

127. *Id.*

128. SEC, Accounting Series Release No. 177 (Sept. 10, 1975).

129. AICPA, Accounting Principles Board Opinion No. 20, 2 APB CCH ACCOUNTING PRINCIPLES 6,685 (1973).

their merits.¹³⁰ It concluded that where more than one GAAP applies, an expression of preferability by the accountant is unnecessary. Rather, such determinations should be made by the reporting enterprise and hence be based upon business judgments and future plans of the entity.¹³¹ Further, preferability determinations by independent accountants on the merits of alternative principles were deemed by the FASB to be inappropriate. As that body stated:

Specifying the circumstances in which one accounting principle should be selected from among alternative principles is the function of bodies having authority to establish accounting principles. When criteria for selection among alternative accounting principles have not been established to relate accounting methods to the circumstances, the auditor may conclude that more than one accounting principle is appropriate in the circumstances.¹³²

The independent accountant's role is thus one of ensuring that accounting principle changes are reasonable and that they conform to GAAP;¹³³ in other words, to ensure the objective of full disclosure and fair presentation in financial reporting.

Instruction H(f) is in direct contrast to the FASB's position on preferability. At the time of its adoption the SEC interpreted APB Opinion 20 as requiring that independent accountants be satisfied that changes in accounting principles were to preferable applications.¹³⁴ After adoption of Statement 53 by the CAP, the SEC determined that the accounting interpretation of APB Opinion 20 was inappropriate.¹³⁵ Through Instruction H(f), the SEC therefore puts the burden of determining preferability upon the independent accountants. The SEC believes that the reporting enterprise satisfies its burden of justifying an accounting change under Opinion 20 "only if it has convinced its independent public accountant that the change will result in improved reporting, and hence in the judgment of the independent accountant the new principle is preferable under the circumstances."¹³⁶

130. *Id.* at ¶¶ 15 and 16.

131. AICPA, Statement on Auditing Procedure No. 53 (1972).

132. AICPA, Statement on Auditing Standards No. 5 ¶ 9 (1975).

133. *Id.*

134. Brief for Defendant at app. pt. 2, *Arthur Anderson & Co. v. SEC*, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

135. *Id.*

136. ASR No. 177 contains the following paragraph with respect to the adoption of Instruction H(f):

Rule H(f) accomplishes its objective in that conceptually it will help assure that accounting changes are to preferable applications. Independent accountants will look to management's motives for changes and declare their intentions as justified. The management and accountant will study business conditions and will base preferences for particular GAAP on their perceptions of the economic situations and expectations for the future. In this context the independent accountant serves to assure that the motives for the change are realistically based upon business planning and judgment rather than on merely presenting an improved financial picture. In this sense the accountant's assurance of fair presentation is made without a judgment of alternative principles on their merits. Thus the effect of Instruction H(f), in this respect, coincides with the effect of APB Opinion 20 and its interpretation by the AICPA.

The regulation as interpreted, however, appears to also require a preferability determination on the merits of alternative principles.¹³⁷ This factor enlarges the FASB view, which places such determination with bodies that have the authority to establish accounting principles.¹³⁸ Such decisions are beyond the scope of an independent accountant's authority. The FASB has been designated as the current standard-setting body of the accounting profession. Its inability to make determinations of preferability leads to its recognition of situations where equally acceptable principles apply.

Consequently, the effect of Instruction H(f) is to force arbitrary decisions by accountants, on the merits of principles, based upon

In connection with accounting changes, a letter from the registrant's independent public accountant is required to be filed in which the accountant states whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A number of accountants objected to this requirement on the grounds that no standards exist for judging preferability among generally accepted accounting principles and that authoritative accounting principles only require that management justify that a change is to a preferable method. The Commission believes that professional accounting judgment can be applied to determine whether an alternative accounting principle is preferable in a particular set of circumstances. Since a substantial burden of proof falls upon management to justify a change, the Commission believes that the burden has not been met unless the justification is sufficiently persuasive to convince an independent professional accounting expert that in his judgment the new method represents an improved method of measuring business operations in the particular circumstances involved.

137. See Letter from SEC to Auditing Standards Executive Committee (Apr. 30, 1976).

138. AICPA, Accounting Principles Board Opinion No. 20, 2 APB CCH Accounting Principles 6,685 (1973).

personal judgment and bias. Absent any provisions of specific criteria, by an authoritative body, upon which such determinations can be made, preferability decisions on the merits of principles cannot be made. Unless sufficient guidelines are provided for independent accountants to aid in preferability determinations, Instruction H(f) will not have served its purpose.

Is Instruction H(f) Unduly Vague?

It is a fundamental requirement of due process that a regulation which establishes a standard of conduct do so with sufficient clarity.¹³⁹ The purpose behind this rule of law is simple: persons subject to the regulation should know what is expected of them.¹⁴⁰ A statute or regulation worded "in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential element of due process of law."¹⁴¹ The SEC has been criticized as having failed to offer sufficient criteria for determining preferability under Instruction H(f).¹⁴²

The original pronouncement of Instruction H(f) in ASR No. 177 included only slight reference to the criteria to be followed in determining preferability. The Commission stated that professional accounting judgment can determine the merits of a proposed principle change. Accordingly, the SEC's test for determining preferability was whether the "new method represents an improved method of measuring business operations in the particular circumstances involved."¹⁴³ It soon became apparent, however, that such criteria was insufficient for preferability determinations. This was particularly true in those cases in which alternative principles were acceptable.

In April of 1976 the SEC responded to requests by the accounting profession for criteria with which to determine preferability in cases for which equally acceptable alternatives exist.¹⁴⁴ The Commission disagreed with the argument that specific rules of determination were necessary. Rather, the SEC noted that the training of a professional accountant provides the skill and judgment

139. *Connally v. General Constr. Co.*, 269 U.S. 385 (1926).

140. *Id.*

141. *Id.*

142. *See note 79 supra.*

143. *See note 136 supra.*

144. Letter from SEC to Auditing Standards Executive Committee (Apr. 30, 1976).

needed to make such determinations.¹⁴⁵ The SEC's test therefore declared that "one of the fundamental professional responsibilities of an independent accountant is to apply his skills and trained judgment to determine whether the circumstances are fairly accounted for within the accounting model."¹⁴⁶

According to the former Chief Accountant of the SEC, the concept of "fair presentation" embodies the accountant's use of professional judgment in appraising alternative accounting principles.¹⁴⁷ This use of professional judgment, it is believed, can present the most meaningful financial picture. The SEC further notes that determinations of preferability should not be based upon preferences between alternative principles alone. The accountant should consider all relevant factors and the management's justification for change in making his determination.¹⁴⁸

The SEC's test of preferability of accounting principles is thus centered on whether the circumstances will be "fairly accounted for within the framework of the accounting model."¹⁴⁹ The key to the SEC test, however, is the limitations of the "accounting model" imposed upon changes of principles. The term "accounting model" is itself criticized as being unduly vague. As noted by the former Chief Accountant of the SEC, the term is not easily defined, and although attempts at definition have been made, no one definition has received universal approval.¹⁵⁰ Rather, "accounting model" is a variable term. It changes with the passage of time, based upon "a changing consensus of business realities, upon a FASB study of the conceptual nature for financial reporting, or even upon divine revelation."¹⁵¹ Five factors, however, have been offered by the former Chief Accountant as reasonable guidelines for its definition.¹⁵² It is also

145. *Id.*

146. *Id.*

147. Address by John C. Burton, "Fair Presentation: Another View," The Baruch College of the City University of New York (Feb. 18, 1975).

148. *See* note 136 *supra*.

149. *Id.*

150. *See* note 147 *supra*.

151. *Id.*

152. The five parameters noted in Burton's speech were:

(1) Business results are presented in a set of articulated financial statements of which the income statement is primary.

(2) Income is measured by an averaging approach (called matching) which is designed to show the long run average net cash inflow at the current level of activity.

(3) The current level of activity is measured by recognizing revenue on the basis of work done and the legitimization of the value of that work by an arms' length transaction with an outside party.

apparent that elements of "fair presentation" have an important impact upon any definition.

The accounting profession is dissatisfied with the SEC test of preferability.¹⁵³ It specifically objects to the use of terms such as "accounting model" which offer no standard of conduct, vary with the passage of time, and offer little certainty. Thus the professionals believe that no criteria is available to implement the rule and that the rule fails the due process vagueness test.

The SEC interpretation in Staff Accounting Bulletin No. 6, which limits changes among various clients of a single accountant, is also criticized as being unreasonably vague. For reasons similar to those argued against the SEC test of preferability, the interpretation is claimed to provide insufficient criteria for its implementation. In the Bulletin No. 6 statement the SEC declared that where circumstances are "similar" the SEC would not allow changes in different directions by different clients. In "unusual cases," however, with "substantially different" circumstances, changes in opposite directions would be permitted.¹⁵⁴

The success of Instruction H(f) as a true preferability rule depends upon sufficient criteria to implement its provisions.¹⁵⁵ Without guidelines, the determinations of preferability between alternative practices will be made by subjective judgment and personal bias. The accounting profession contends that the regulation is unduly vague. The SEC asserts that accounting judgment can be used to implement the rule. Within the framework of the "accounting model," the SEC believes that preferability determinations are possible. The merits of both positions are sound.

On the one hand, the accounting profession is warranted in seeking an objective test. The impact of decisions of preferability upon the client involved in the immediate situation and upon all clients of the accountant is great.¹⁵⁶ Such an impact should not be

(4) Asset valuations are generally based on historical monetary costs incurred in arms' length transactions. Increases in value are recognized only when a transaction occurs, while decreases are recognized when there is a reduction in the value of assets for the purposes they are held.

(5) Business substance rather than legal form must predominate in the analysis of transactions and the determination of the accounting to be followed for them.

153. See note 79 *supra*.

154. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976).

155. See note 79 *supra*.

156. *Id.*

made on the basis of subjective criteria. Furthermore, the absence of objective and uniform criteria will result in a proliferation of standards followed by different accountants making preferability decisions. The final argument is that determinations between alternative principles on their merits is a task of bodies with authoritative support, such as the FASB and the SEC.¹⁵⁷ If determinations between equally acceptable principles are to be made, criteria should be offered for making them.

The SEC may yet be warranted, however, in choosing not to set specific standards for making determinations. Just as GAAP change, specific criteria for preferability determinations should also change in response to varying economic changes, varying social changes, new knowledge, and improved technology. Specific criteria, even if set by the SEC, could therefore be no more objective than the present criteria offered.

It appears that the independent accountant may realistically evaluate all relevant data in making a preferability determination without a specific set of rules. In light of the SEC's directive that changes must be in the interest of improved financial reporting and fair presentation within the accounting model, the accountant's task, though formidable, is not impossible. The enterprise's justification for a change will necessarily be an important determinant. This justification would be based partly on the effect of a change upon other clients in a similar situation. When viewed in conjunction with the facts and circumstances behind a proposed change, a determination on the merits of alternative principles would not necessarily be in derogation of the authoritative bodies which establish GAAP. These bodies have found it impossible to declare which GAAP is more acceptable on merits alone. They do not, however, consider outside factors when developing the GAAP, but instead establish their acceptability solely upon their merits.

Is Instruction H(f) Arbitrary and Capricious?

Actions taken by the SEC in exercise of its statutory power are governed by the Administrative Procedure Act.¹⁵⁸ Under its provisions a court shall find unlawful any agency regulations which it finds to be "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law."¹⁵⁹ In testing an agency regulation under such a standard, the objective is to determine

157. AICPA, Statement on Auditing Standards No. 5 ¶ 9 (1975).

158. 5 U.S.C. § 706 (1970).

159. See note 58 *supra*.

whether the agency has acted to eliminate arbitrariness and irrational consequences in its application.¹⁶⁰ Instruction H(f) has been attacked as arbitrary and capricious.¹⁶¹

The arbitrariness controversy concerns an SEC position taken in Staff Accounting Bulletin No. 6 which interprets the preferability rule. The Bulletin No. 6 statement declares:

Where the factual circumstances surrounding the accounting changes are similar, the staff would not expect an accounting firm to accept accounting changes in both directions by different clients. In unusual cases, however, substantially different factual circumstances may exist in different client situations which would make it possible for the accountant to conclude that switches in opposite directions may each be preferable under all the particular circumstances.¹⁶²

By preventing accounting changes in different directions the SEC hopes to further deter unwarranted accounting principle changes. Without such provision, enterprises could change principles at will and would be limited only by a need for an accountant's letter of preferability. Conceivably the frequency of preferability statements would be unlimited. Accountants would likely base their decisions solely upon the needs of clients and management justification. The addition of Bulletin No. 6, however, necessitates the careful consideration of the complete merits of an accounting change. The impact of a statement of preferability, particularly upon similar clients, will deter unwarranted declarations of preferability. The effect of this Bulletin therefore serves to further assure that accounting changes will reflect improved methods of financial reporting.

The criticism of the interpretation of Instruction H(f) in the Bulletin is best illustrated by an example of its effect. Assume that an independent accounting firm, XYZ, has three clients, A, B, and C, all of whom are subject to securities laws and operate similar businesses. Assume in addition that XYZ also services clients D and E, who, although subject to securities law, do not operate enterprises similar to A, B, and C. In the first case, clients A, D, and E have consistently followed the LIFO method and clients B and C the FIFO method of inventory costing. Clients A and B both desire to change

160. *Id.*

161. *See note 79 supra.*

162. SEC, Staff Accounting Bulletin No. 6 (Mar. 1, 1976).

accounting principles to the principle practiced by the other. If *A* and *B*, although engaged in similar business, can show that "substantially different" circumstances surround their decisions to change principles, the SEC would permit both to adopt opposite practices.

However, should the circumstances surrounding their proposed changes be "similar," the SEC would not expect the accountant to comply with both *A*'s and *B*'s plans. Despite the fact that both LIFO and FIFO are GAAP and that business plans may justify their adoption, one principle must be declared preferable. Thus a change by one of the clients would be prevented. Furthermore, assuming the LIFO method is declared preferable, client *A* would be obligated to continue its application. This would be the case despite the permitted use of FIFO by client *C*, who desires to make no change in his past practice. In addition, clients *D* and *E* are unaffected by these changes and may at a later date adopt the FIFO application.

In a second case, all clients of *XYZ* practice the LIFO method of inventory costing. Client *A*, upon sound considerations, desires to adopt the FIFO principle. In order to permit such change the accountant must declare the FIFO method preferable. Other clients, although permitted to continue the application of LIFO, must either change their practices or present their financial reports using a less preferable accounting application.

A further criticism of the Bulletin interpretation involves the effect it will inevitably have upon the practices of accountants.¹⁶³ Independent accountants, by expressing opinions on preferability, will be increasingly restricted in approving accounting changes by their clients. Furthermore, requiring that a firm make such determinations allocates to the accountant a rule-making authority with regard to clients.¹⁶⁴ This effect may eventually result in "accountant shopping." As different accounting firms choose differing positions of preferability, clients will shop for those firms whose practices coincide with their own.

The impact desired by the SEC in Bulletin No. 6 would be best served by a clarification of the "unusual," "similar," and "substantially different" circumstances pronounced therein. Specific criteria for their determination should be provided. Many objections to Instruction H(f) would be eliminated by a narrow view of "similar"

163. See note 79 *supra*.

164. It is noted by Coopers & Lybrand that such would create different sets of accounting rules for different sectors of the business community.

circumstances and a broad view of "unusual" and "substantially different" circumstances. First, this criteria would serve the purpose of Instruction H(f). Determinations of preferability would continue to have a potential effect beyond the single client who proposes a change. Statements of preferability would therefore be based on more than the enterprise's motive for change. Second, the criteria would clear any lack of specific implements of the Bulletin position. Finally, such view succeeds in creating potential limitations on other clients while eliminating arbitrary submission to preferability positions. "Similar" circumstances would be found only where closely parallel situations warrant similar application of accounting principles. Yet, "unusual" cases could be readily found where consistent applications of principles among various clients is unnecessary.

CONCLUSION

The SEC's authority to enact Instruction H(f) is unquestioned. As examined, Congress has empowered the Commission to both require the filing of reports by regulated companies and to regulate accounting disclosures in them. Accordingly, while typically regulated by the FASB, accounting principles and practices may be affected by act of the SEC. Although the Commission has consistently relied upon the AICPA for establishment of generally accepted accounting principles, it has not exempted itself from disagreeing with AICPA findings. Where it has expressed an opinion, the SEC's position is preemptive of the AICPA standards. Thus the fact that Instruction H(f) is contrary to the AICPA's interpretation of APB Opinion 20 does not affect its applicability for registered enterprises. It is not an act beyond the scope of SEC authority. Hence, unless fatal in construction, the regulation cannot be questioned.

The construction of rule H(f) directly relates to its desired effect. Both the AICPA and the SEC seek by their actions to insure that financial statements will present a true picture of the economic character of an enterprise. To aid in achieving this goal, generally accepted accounting principles are developed to provide a uniform system of accounting practices which can consistently be applied in financial statement preparation. However, disagreement as to methods which will provide the most truthful disclosure has led to the AICPA's and the SEC's recognition of several equally acceptable practices. Instruction H(f) is the SEC's attempt to prevent manipulation of applicable principles to the advantage of more favorable financial pictures. To this end, however, the Commission must

require a statement of preferability among equally acceptable and appropriate accounting principles.

The position taken by the accounting profession that preferability is indeterminate among equally acceptable principles is not without merit. The FASB has not attempted, and the SEC has neglected, to provide specific criteria to aid the independent accountant in his determination of preferability based on the merits of GAAP. The FASB notes that such determinations are beyond the authority of independent accountants. The SEC, however, believes that preferability determinations should be made in consideration of surrounding circumstances and not merely on the merits of alternative principles. The accounting profession's criticism ignores the SEC's desire for consideration of the total factors involved in adopting a particular practice.

The SEC's position in Bulletin No. 6 may, in fact, be violative of due process. As noted, it restricts the use of GAAP by certain clients on the mere basis that they are in "similar" situations. Further, there is no offer of criteria with which to determine when "similar" situations exist. In addition, the effect of an accountant adopting one practice for all "similar" clients may result in accountant shopping by enterprises seeking to adopt specific principles. Yet, the considerations which serve as the basis for the position taken in Bulletin No. 6 have merit. Without such limitations the impact of Instruction H(f) is greatly diminished. Preferability statements would have no effect beyond the client involved, and conflicting statements of preferability could be made for clients depending upon desired results. This is what Instruction H(f) seeks to prevent.

The SEC's objective in promulgating Instruction H(f) may be achieved without the stringent application of Bulletin No. 6. As noted by one of the larger accounting firms, the SEC should recognize that based upon legitimate business factors, preferences for particular accounting principles may vary among similar enterprises without affecting a "fair presentation" of their financial situation.¹⁶⁵ Thus, the term "similar" in Bulletin No. 6 should only encompass the situation in which the nature of the enterprise and its aims and business expectations all coincide. On the other hand, "substantially different" circumstances should be recognized by a showing of dissimilar business goals, plans, and expectations, in addition to the different natures of the enterprises. Such interpretation would not affect the impact of Instruction H(f) beyond the fact

165. Brief for Coopers & Lybrand as Amicus Curiae at 20, Arthur Anderson & Co. v. SEC, Civil No. 76c-2832 (N.D. Ill. Sept. 3, 1976).

that a preferability statement would not be as restrictive. The potential finding of "similar" circumstances by the SEC, with present or future clients of the accountant, would help insure that preferability statements are not randomly made. Enterprises of a specific nature often have similar goals and expectations. Further, by denoting specific criteria for finding "similar" situations, due process attacks are minimized and accountant shopping is diminished. Instruction H(f) will help assure that the adoption of an accounting principle change occurs only where it will improve the full and fair disclosure of the registrant.