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Securities acts and independent auditors : what did Congress intend? A research study

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Commission on Auditors' Responsibilities

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Research Study No. 2

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A research study prepared for the Commission on Auditors' Responsibilities

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Foreword

History is myth based on consensus, say the cynics. The intent of Congress in requiring an audit of annual financial statements by an independent public accountant has achieved the status of myth, but the consensus is lacking. The SEC and its staff have used the congressional decision to rely on independent auditors as evidence that Congress expected the public accounting profession to function as an arm of government. For example, it is contended that the independent auditor should immediately report violations of law to federal authorities. After all, Congress rejected a corps of federal auditors and federal licensing of auditors at the urging of independent auditors who testified before it. Would Congress have expected less from independent auditors than from government auditors?

Others have relied on the same evidence to support an opposite view. By rejecting federal auditors, Congress must have been aware that a confidential relationship between the auditor and management is essential for an effective audit. If the independent auditor is trusted by management, both can work together to achieve the best possible financial presentation. Casting the auditor as an agent of government would undermine the effectiveness of independent audits.

Faced with such contradictory interpretations, the Commission on Auditors' Responsibilities asked Professor Jeremy Wiesen to study the legislative history of the securities acts and to extract the auditor's roles and responsibilities as they were envisioned by Congress. His study should help to put to rest debates about the implications of the decision to favor independent auditors over federal auditors and similar discussions. However, no victor emerges in this particular argument because both sides have overstated the significance of the decision.

At a time when many of the issues considered by Congress in 1933 and 1934 are again the subjects of congressional hearings, Professor Wiesen's investigation of earlier legislation should add valuable perspective.

This is the second of four studies to be published from the background research for the Commission on Auditors' Responsibilities. The studies are not part of the commission's report, but the commission believes they contain useful material that warrants wide distribution.

Publication does not necessarily constitute endorsement or approval by either the AICPA or the commission. Authors of research studies are responsible for the content and recommendations.

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Preface

In November, 1977, the Senate Subcommittee on Reports, Accounting and Management (Metcalf Committee) wrote: "Prior to this subcommittee's inquiry, Congress had not made a thorough study of the independent auditing system established under the provisions of the Federal securities laws since they were enacted more than 40 years ago." The congressional consideration of auditors' duties in 1933-1934 is the subject of this monograph.

The nature and extent of the congressional consideration of auditing at the enactment of the securities acts should be considered by courts and the SEC when they apply the acts to auditors, and it should be examined by Congress before it adopts new legislation affecting auditors. The Commission on Auditors' Responsibilities was particularly interested in the subject as it related to the auditor's role in society.

I was greatly assisted on preliminary drafts of this study by the following members and staff of the Commission on Auditors' Responsibilities: Manuel F. Cohen, chairman until his death in June, 1977; Lee J. Seidler, deputy chairman; Henry R. Jaenicke, principal research consultant; Douglas R. Carmichael, research director; and, Patricia McConnell, project coordinator. Three accounting historians, Richard Brief and Barbara Merino of New York University, and Stephen A. Zeff of Rice University, provided helpful insights into the state of auditing in the 1930s. Conscientious research of legislative history was performed by three New York University research assistants: Stewart S. Karlinsky, Susan D. Lewis, and Floyd Tupper.

The text and footnotes of the final draft of this study were extensively edited for publication.

Special recognition must be given to the considerable efforts contributed by Richard Eng, a CPA and JD/MBA candidate at New York University, and my current research assistant. His auditing experience, meticulous research, and skillful draftsmanship were indispensable to the study's publication.

Jeremy Wiesen
New York, New York
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Introduction

Issues Presented

The principal purpose of this study is to examine the nature and extent of the responsibilities that Congress intended auditors to assume at the time of enactment of the Securities Act of 1933 (1933 act) and the Securities Exchange Act of 1934 (1934 act, and with the 1933 act, referred to herein as "the securities acts"). This subject is part of the broader topic of the independent auditor's role in society, which has been studied by the Commission on Auditors' Responsibilities (CAR) and is discussed in section 1 of its *Report, Conclusions, and Recommendations*.

Chapter 1 describes the significant lack of specific congressional intent regarding auditors' duties in 1933 and 1934. Chapters 2 and 3 discuss congressional intent that did exist at that time regarding auditors. The Conclusion discusses the impact which congressional expectations ought to have on auditors' duties under the securities acts.

Dr. Henry R. Jaenicke prepared a study for CAR in which he thoroughly discusses common law and statutes affecting auditors, including the principal provisions and court interpretations of the securities acts.[1] The matter of auditors' legal liability is closely related to their professional responsibilities, the subject of this paper. Note the following statement by one of the principal draftsmen of the 1933 act, William O. Douglas, in a coauthored article which describes the increased legal responsibilities of auditors under the 1933 act:

> To say the least the [1933] Act goes as far in protection of purchasers of securities as the plaintiff in *Ultramares Corp. v. Touche* unsuccessfully urged on the New York Court of Appeals to go in the protection of a creditor. The change which the court thought so "revolutionary" as to be "wrought by legislation" has been made. And the duty placed on experts such as accountants has not been measured by the expert's relations to his employer but by his service to investors.[2]

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1. H. R. Jaenicke, *The Effect of Litigation on Independent Auditors*, CAR Research Study No. 1, (New York: AICPA, 1977).
2. Douglas and Bates, "The Federal Securities Act of 1933," *Yale Law Journal* 43 (1933): 198. Douglas and Bates used the terms *accountant* and *auditor* interchangeably. This was a prevalent practice at the time the article was written.

Douglas and Bates point out in a subsequent part of the article that Congress did not "measure" the specific obligations of auditors in the language of the securities acts.[3] Courts and, in turn, the SEC and the regulated community of auditors should be concerned with the legislative intent (or purpose) behind the statutory provisions. In fact, the legislative history could be consulted even if the references and mandates to auditors in the securities acts were clear and unambiguous:

> It is often said that extrinsic aids may be considered only when a statute is ambiguous and not where the language is clear. But ambiguity is not uniformly insisted on as a prerequisite to the use of aids to construction. Thus it has been said that "Usually a court looks into the legislative history to clear up some statutory ambiguity . . . but such ambiguity is not the sine qua non for a judicial inquiry into legislative history," and that the "plain meaning rule . . . is not to be used to thwart or distort the intent of Congress by excluding from consideration enlightening materials from the legislative files."[4]

Two of the principal draftsmen of the securities acts, James Landis and Felix Frankfurter, advocated searching analyses of the history and purposes of legislation. Landis, in an article written prior to the enactment of the securities acts, stated: "Legislative history . . . affords in many instances accurate and compelling guides to legislative meaning."[5] Frankfurter, thirteen years after the enactment of the securities acts, made the same point:

> To be sure, laws can measurably be improved with improvement in the mechanics of legislation, and the need for interpretation is usually in inverse ratio to the care and imagination of draftsmen. . . .
>
> . . . Laws are not abstract propositions. They are expressions of policy arising out of specific situations and addressed to the attainment of particular ends.[6]

Methodology: Interpreting Legislative Intent

Legislative interpretation begins with an analysis of the meaning of the words of the statute, using various rules on interpretation that the courts have developed. An analysis of the language in the securities acts reveals little concerning the duties of auditors as shown in Dr. Jaenicke's research study. Further investigation requires study of various materials which courts term "extrinsic aids."

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3. See chap. 1, n. 55 and chap. 3, n. 7.
4. J. Sutherland, *Statutes and Statutory Construction*, 4th ed., vol. 2A (Chicago: Callaghan and Co., 1972), sec. 48.01.
5. Landis, "A Note on 'Statutory Interpretation'," *Harvard Law Review* 43 (1930): 889.
6. Frankfurter, "Some Reflections on the Reading of Statutes," *Columbia Law Review* 47 (1947): 528 and 533.

Sutherland, in his treatise on statutory interpretation, groups extrinsic aids into three chronological categories:

> (a) pre-enactment history, i.e., pertinent circumstances and events leading up to the introduction of the bill in the legislature, (b) enactment history, covering all actions taken during legislative consideration of the bill, including statements about it, and (c) post-enactment history.[7]

Enactment history often provides the greatest resources for deciphering legislative intent. These materials include reports of legislative committees, transcripts of committee hearings and legislative debates, reports of committees and commissions outside the legislature, executive messages, and the views of draftsmen. Some are considered to be more authoritative than others. For example, congressional reports are said to have the greatest authority, while legislative debates, the least, since debates may only show individual views and motives. This study can not make such fine distinctions because of the lack of significant information in the more important resources. Therefore, legislative hearings have been generously cited, and the views expressed by influential congressmen have sometimes been ascribed to Congress itself.

Social and economic conditions are informative sources of pre-enactment history. Sutherland states:

> The events occurring immediately prior to the time when an act becomes law comprise a most instructive source for information indicative of what the legislature intended it to mean. . . . [The history of events] consists chiefly in statements by various parties as to the nature and effect of the proposed law and statements or other evidence as to evils requiring legislative relief. Contemporary history also includes information concerning the activities of pressure groups, economic conditions in the country . . . , prevailing business practices, and the prior state of the law. . . .[8]

Such materials are useful in the analysis of congressional intent regarding auditors' duties because of the paucity of the important types of enactment history resources.

Post-enactment history includes an analysis of legislative inaction. There is disagreement about its significance:

> A number of decisions have held that the acquiescence of the legislature through inaction following a contemporaneous and practical interpretation is evidence that the legislature intends to adopt such interpretation. But legislative inaction has also been called a "weak reed upon which to lean" and a "poor beacon" to follow in construing a statute.[9]

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7. J. Sutherland, *Statutes and Statutory Construction*, vol. 2A, secs. 48.04-48.18.
8. Ibid., sec. 48.04.
9. Ibid., sec. 49.10.

In the case of legislation that creates a regulatory agency (such as the SEC), interpretations by the agency of the statute are afforded some weight if not objected to by the legislature:

> Interpretive regulations by officers, administrative agencies, departmental heads and others officially charged with the duty of administering and enforcing a statute, and their practices which reflect the understanding they have of provisions they are charged to carry out, have great weight in determining the operation of a statute.[10]

The limits of this proposition are discussed in the Conclusion.

10. Ibid., sec. 49.05.

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The Lack of Congressional Intent Regarding Auditors

Congressional Consideration of the Securities Acts

Landis provided the following description of Frankfurter's request for help in drafting the bill that became the 1933 act:

> It was a Thursday in early April and my next classes [as Professor of Legislation at Harvard Law School] were scheduled for the following Monday. Frankfurter, however, thought that the job could be done over that weekend. We consequently left on the night train for Washington. . . .
>
> . . . After a brief session with Frankfurter, where we determined to take as the base of our work the English [British] Companies Act with which [Benjamin] Cohen was very familiar, Cohen, Corcoran and I set to work. . . . By late Saturday night we had a draft of the bill in reasonable shape.[1]

This vignette is a colorful depiction of what one researcher called the "atmosphere of crisis"[2] in which the 1933 act was created. Such descriptions are somewhat hyperbolic, however, as Landis states in the quote concluding this chapter.

In the first place, Congress had considered securities legislation prior to 1933-4. In 1919 Representative Taylor of Colorado introduced a bill fashioned from the British Companies Act, and in 1920, the Vol-

1. Landis, "The Legislative History of the Securities Act of 1933," *George Washington Law Review* 28 (1959): 33-34.
2. R. Chatov, "The Collapse of Corporate Financial Standards Regulations: A Study of SEC-Accountant Interaction" (Ph.D. Dissertation, University of California, Berkeley, 1973), p. 157. The dissertation, in a slightly edited form, has been published under the title *Corporate Financial Reporting: Public or Private Control*, (New York: Free Press, 1975).

stead Bill was introduced, modeled after New York State's Martin Fraud Act; both bills died in committee.[3] In 1922, Representative Denison of Illinois introduced a bill to prevent fraud in the sale of securities through the mails or agencies of interstate commerce. This bill fared better than the Taylor bill, but it never passed the Senate. Subsequently, a similar bill was introduced by Representative Sabath, and the Denison bill was reintroduced (as the LaGuardia bill), but both were dead issues by 1933. In addition, there was the Uniform Sales of Securities Act, drafted by thirty-eight state securities commissioners. Huston Thompson, a lawyer for the American Institute of Accountants and one of the drafters of the 1933 act, provided the following insight about the proposed 1933 act at the 1933 Senate hearings: "We have taken [the registration] requirements from the Uniform Sales of Securities Act, and also from the Taylor bill."[4]

In the second place, the congressional testimony, submissions of statements, and committee reports that accompany the securities acts fill an eleven-volume set.[5] Although specific conclusions cannot be drawn from the fact that this congressional "record" would probably outweigh the written record of many other pieces of legislation, the fact that the record is not insubstantial is some evidence of congressional diligence.

In the third place, the design of the securities acts made them more than temporary regulation. This is true of the contemporaneous legislation in the 1930s that created the Federal Communications Commission (1934), the Tennessee Valley Authority (1934), the Federal Deposit Insurance Corporation (1933), and the Social Security Administration (1935). The securities acts are unlike other New Deal programs that were merely continuations of the anti-Depression policies created during the Hoover administration.[6] Finally, Congress employed very skilled lawyers to draft the securities acts.

On the other hand, justifiable criticism of the securities acts supports the proposition that they were not a result of diligent congressional consideration. Securities lawyers have noted the deficiencies in

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3. E. T. McCormick, *Understanding the Securities Act and the S.E.C.*, (New York: American Book Co., 1948), p. 15; and the statement of Huston Thompson, U.S., Congress, Senate, Committee on Banking and Currency, *Hearings on S. 875*, 73d Cong., 1st sess. (1933), pp. 69-74 [hereinafter cited as 1933 Senate Hearings].
4. 1933 Senate Hearings, p. 96. However, the 1933 act adopted a policy of disclosure, whereas the state laws granted the government substantial powers to pass on the merits of securities offerings.
5. J. S. Ellenberger and E. P. Mahar, *Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934* (S. Hackensack, N.J.: Fred B. Rothman & Co., 1973).
6. See P. Studenski and H. E. Kroos, *Financial History of the United States* (New York: McGraw-Hill, 1952), p. 382.

a scheme which has one statute that heavily regulates disclosure when securities are issued (the 1933 act) and another statute, almost totally unconnected, that regulates the disclosure of information by public companies (the 1934 act).[7] As a result of recommendations in the SEC's "Wheat Report," the SEC has reduced certain disclosure requirements under the 1933 act while increasing 1934 act obligations.[8] In 1978, Congress will be asked to consider adoption of the American Law Institute's Federal Securities Code, which would, in effect, integrate the securities acts. The flexibility of the acts, as demonstrated by the SEC's recent shift in emphasis, is also a factor that indicates the absence of strong, original congressional intent.

Securities analysts and economists have also criticized the securities acts: They complain of the uselessness of some of the information the SEC requires to be disclosed and of the SEC's prohibition against disclosure of more relevant information. This criticism led to the formation in 1976 of the SEC's Advisory Committee on Corporate Disclosures, which recently issued its report.

Congressional committees were informed in 1933 and 1934 that historical cost information might not be very useful to investors,[9] but Congress did not attempt to understand the problem in depth nor try to solve it. Professor Homer Kripke has suggested a reason for this indifference in 1933-4: "There is no history showing that the persons responsible for the draftsmanship of the Securities Act of 1933 were experienced in securities selection or in the securities markets. . . ."[10] Even the less subtle topic of the investor's need for earnings statements for three years, rather than earnings statements for just one year, had to be explained at the 1933 Senate hearings by a prominent accountant, but the senators were not overwhelmed by the accountant's insight, as is described later in this chapter.[11]

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7. The principal activating force for this criticism was an article by Milton Cohen, " 'Truth in Securities' Revisited," *Harvard Law Review* 79 (1966): 1340. It should be noted that in his 1933 message to Congress regarding the 1933 act, President Roosevelt referred to his plans for a second securities act dealing with "all property dealt in on exchanges." *H. Rep. No. 85*, 73d Cong., 1st sess. (1933).
8. U.S. Securities and Exchange Commission, *Disclosure to Investors–A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts* (New York: Commerce Clearing House, 1969).
9. See chap. 2, n. 23.
10. H. Kripke, "An Unusual Opportunity for Rethinking Concepts on a Fundamental Level," *New York Law Journal*, December 13, 1976, p. 27, col. 2. For another description of the work of economists in this area, and its impact on the work of the SEC, see an address by Commissioner Sommer titled "Required Disclosure in the Stock Market: The Other Side," September 27, 1973, in Wiesen, *Regulating Transactions in Securities* (St. Paul, Minn.: West Publishing Co., 1975), p. 311.
11. 1933 Senate Hearings, pp. 55-67.

Congressional Consideration of the Role of Auditors Under the Securities Acts

The testimony of Colonel Carter, president of the New York State Society of Certified Public Accountants, before the Senate Banking and Currency Committee in 1933 was of great importance to public auditors.[12] He influenced Congress to abandon the idea of government auditors in favor of auditing by the private sector's "public" auditors. The SEC, in an accounting series release (ASR), referred to Carter's role at the hearings as that of "a representative of the accounting profession," and stated that the Senate committee revised the bill in accordance with Carter's "suggestions."[13] In fact, the SEC implied that the committee was convinced by Carter's persuasion, and persons generally recall the episode in that way.

In that ASR the SEC characterized Carter's testimony at the 1933 Senate hearings as part of a thorough investigation by the Senate committee of what the role of the auditor under the 1933 act would be:

> The Committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public. The Committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.[14]

This statement belies that Senate committee's lack of knowledge of, and its disinterest in, the work of auditors.

Carter's testimony significantly influenced the Senate committee to change a major provision of the 1933 act, from requiring issuers of securities to be audited by government auditors to requiring those audits to be done by the private sector. That decision was made quite easily because the committee had not thoroughly explored the mechanics of the proposed government audit process, it did not possess a basic knowledge of public auditing, nor did it have a sophisticated understanding of the purposes of financial statements as displayed by Carter's discussions on the need for three-year comparative financial statements.

The testimony that most pointedly displays the committee's lack of knowledge about auditors' work is the following:

> SENATOR GORE: How many public accountants do you think would be available for this service?

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12. Ibid.
13. U.S. Securities and Exchange Commission, *Independence of Certifying Accountants*, ASR no. 81 (December 11, 1958), p. 1.
14. Ibid.

MR. CARTER: There are approximately 15,000 certified public accountants in the United States today qualified under the laws of the various States:

SENATOR BARKLEY: How many in your organization?

MR. CARTER: Two thousand.

SENATOR BARKLEY: Is there any relationship between your organization with 2,000 members and the organization of controllers represented here yesterday with 2,000 members?

MR. CARTER: None at all. We audit the controllers.

SENATOR BARKLEY: You audit the controllers?

MR. CARTER: Yes; the public accountant audits the controller's account.

SENATOR BARKLEY: Who audits you?

MR. CARTER: Our conscience.

SENATOR BARKLEY: I am wondering whether after all a controller is not for all practical purposes the same as an auditor, and must he not know something about auditing?

MR. CARTER: He is in the employ of the company. He is subject to the orders of his superiors.

SENATOR BARKLEY: I understand. But he has got to know something about auditing?

MR. CARTER: Yes.

SENATOR BARKLEY: He has got to know something about bookkeeping?

MR. CARTER: But he is not independent.

SENATOR REYNOLDS: Let me ask you this question, Colonel. These companies are going to arrive at these figures through their special auditors. All right. Now you want the members of your organization to check up on their figures?

MR. CARTER: As we do in many cases of industrial companies every year.[15]

Further questioning of Carter showed that some of the committee members were not absorbing all of his testimony. The committee had to be informed twice that 85 percent of New York Stock Exchange (NYSE) companies had independent audits.[16] After the testimony quoted above, committee members repeated questions they had previously asked about the British Companies Act[17] and the nature of the auditor's opinion in the United States.[18]

At the 1933 Senate hearings the committee also displayed a lack of patience with the subject of auditing. At one point the committee was engaged in a meaningful discussion of the purpose of having an independent audit, but the committee chairman stated: "Let us proceed, Colonel Carter. We would like to get through with this."[19] Carter's testimony had at that point filled less than eight large-type pages, but had begun to develop very practical proposals about financial statements and a discussion of the purposes of the bill. Carter obeyed the chairman's directive: After one more page of testimony on the efficacy

15. 1933 Senate Hearings, p. 58.
16. Ibid., pp. 56, 60.
17. Ibid., pp. 57, 61-62.
18. Ibid., pp. 56-57, 59-60.
19. Ibid., p. 62.

of financial statements, Carter left the topic and concluded his testimony with a discussion of securities salesmen's commissions.

The choice of that subject, to which Carter was directed by the committee, may be also indicative of the reason so little attention was placed on the work of auditors. Congress may have been more concerned with the institutions directly involved with the functioning of the securities markets than it was in the quality of corporate disclosures. This relative degree of concern was displayed at another session of the 1933 Senate hearings, at which some senators had difficulty understanding why the 1933 act was so unrelated to stock exchange transactions.[20]

At the 1934 Senate hearings, on the topic of the qualifications of auditors, Robert E. Healy, chief counsel of the Federal Trade Commission (FTC), testified that he "hope[d] the day [would] come" when accountants would be more strongly regulated by the federal government. Senator Kean asked emphatically whether accountants ought to be licensed by the federal government. Healy began his brief answer by reminding the committee that he had already answered the question, but "some of the committee were busy with something else." He stated that it might be a good idea, and along with it, accountants should perhaps report to shareholders, rather than to directors, all of which might give accountants "a dignified position of responsibility under Federal laws." Healy, in an attempt to provoke a response, suggested that the answer would be a matter of public and congressional "sentiment." The chairman responded: "We have enough to deal with now without going into outside questions. The complaint about this bill is that it goes too far."[21]

It is not too surprising that congressional consideration of auditing and auditors was not extensive concerning the 1934 act and the 1934 amendments to the 1933 act. Congressional interest in the subject may have been dissipated when the 1933 act made accountants a specific target of liability and set the standard at mere negligence, as discussed below.

At the 1934 Senate hearings some congressmen showed that they had not absorbed the prior year's testimony. For example, on the subject of audit costs, Senator Kean asked the same questions in 1934 as he had asked in 1933; however, he did not question George O. May, a prominent spokesman for the accounting profession, in 1934 why his answer differed significantly from Colonel Carter's testimony in 1933.[22]

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20. Ibid., pp. 72-74.
21. U.S., Congress, Senate, Committee on Banking and Currency, *Hearings on S. Res. 84, and S. Res. 56, and S. Res. 97*, 73d Cong., 2d sess. (1934), p. 7616 [hereinafter cited as 1934 Senate Hearings].
22. Compare 1933 Senate Hearings, p. 60, with 1934 Senate Hearings, p. 7182.

The failure of Congress to be more informed about auditing might be attributed, in part, to the absence of a unified national organization of accountants. In 1933-4 there were two opposing professional groups, the American Society of Certified Public Accountants and the American Institute of Accountants (the AIA, now the AICPA). A weak institutional framework resulted from the competition between them.[23] However, the profession was represented by leading persons who submitted statements to, or testified before, Congress, including Colonel Carter, representing the New York State Society of Certified Public Accountants; George O. May, on behalf of the AIA's Special Committee on Cooperation with Stock Exchanges; and John L. Carey, who was secretary of the AIA.[24]

Congress could have been more informed on auditing by carefully studying national bank and railroad audits, and by studying auditing-related literature. The information which was available on auditing in 1933-4 is described below. Furthermore, congressional committees could have examined various proposals that had been previously made in Congress regarding the federal licensing of auditors (described in chapter 3).

Regulation by Disclosure

The securities acts, especially the 1933 act, represent a grand attempt at regulation by disclosure rather than by prohibition. As described above, Congress was familiar with state "Blue Sky" laws which prohibited the sale of securities deemed to be unfair by an executive of the state government.

Congress appears to have been more conscious of choosing regulation by disclosure in 1933-4 than in the 1960s and 1970s when it has adopted disclosure as the method to regulate many types of business activities and conduct. A recent congressional bill, which became the Foreign Corrupt Practices Act of 1977, was said to employ a novel regulatory approach because it prohibited certain activities rather than merely requiring them to be disclosed. The staff of the Senate Banking, Housing and Urban Affairs Committee stated in the report accompanying the bill that they "carefully weighed" the arguments on both sides of "prohibition vs. disclosure."[25]

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23. The "feud," and its effects, are described throughout Chatov, "Corporate Financial Standards Regulations."
24. The testimony of Carter and May is documented extensively in this paper. Carey's statement is included in U.S., Congress, House, Committee on Interstate and Foreign Commerce, *Hearings on H.R. 7852 and H.R. 8720*, 73d Cong., 2d sess. (1934), pp. 652-654.
25. See U.S., Congress, Senate, Congressional Record 122 (1976): 6977, regarding S. 3418, 94th Cong., 2d sess. (1976).

Congress rejected two direct methods of regulating auditing—employment of federal auditors and federal licensing of auditors. However, as discussed in chapter 2, Congress did not consider them extensively. Considered even more briefly was regulating " . . . how [companies should] keep their books,"[26] even though Congress had in fact authorized such close regulation of utilities and railroads prior to 1933.[27] In both of the securities acts, Congress delegated significant authority over auditors and auditing to the administrative agency that would supervise the act.

The State of Auditing in 1933-4

Independent auditing was in a period of transition in the early 1930s, moving from relative unimportance and comparatively few written rules, to becoming a requirement for public companies and a profession with some significant written guidelines. This development of auditing appears to have been more a result of the efforts of the NYSE, which began most earnestly in 1932, than the enactment of the securities acts, as described by SEC Commissioner Sommer in a 1974 speech:

> We are now in the midst of the third formal effort to develop in a systematic fashion a body of accounting principles. Prior to the commencement of the first such formal effort, there had been considerable discussion of the desirability of developing some systemization of accounting principles and auditing practices. This manifested itself in somewhat fragmentary fashion in bulletins issued by the Federal Reserve Bank in 1917 and 1929. Largely under the leadership of George O. May, then the managing partner of Price, Waterhouse & Co., liaison was established between the principal accounting organization and the New York Stock Exchange, the principal securities market in the United States, looking toward the development of accounting and auditing standards for companies listed on that Exchange. This eventuated in 1934 in a document entitled *Audits of Corporate Accounts* which unquestionably had profound impact upon the development of accounting principles. Given its origin, of course, this publication was strongly shareholder oriented. Among other things, this introduced the terms "accepted principles of accounting" and "accounting principles," established a standard form of auditing report and incorporated in it the term "present fairly" and eliminated the words "we certify" in favor of "in our opinion."[28]

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26. 1933 Senate Hearings, p. 219 (discussion between Senator Byrnes and Mr. Healy; quoted statement is by the latter).
27. W. A. Staub, *Auditing Developments During the Present Century* (Cambridge, Mass.: Harvard University Press, 1942), pp. 15-25.
28. "The American Experience with Accounting Principles," address by Commissioner A. A. Sommer, London, England, Dec. 11, 1974 (Washington, D.C.: Securities and Exchange Commission), pp. 1-2. The third effort to establish accounting principles referred to in the quote is the formation of the Financial Accounting Standards Board (FASB). Note that for the purposes of this paper Sommer is referring to auditing standards as much as to accounting principles. As described elsewhere, the FRB

The fact that accounting and auditing were in a state of change in 1933-4 makes it difficult to gauge congressional intent on the topic and suggests that Congress may have had difficulty focusing on this moving subject.

At the 1933 Senate hearings Colonel Carter depicted independent auditing as a profession that was ubiquitous, but, as noted above, congressmen seemed to have little understanding of the subject. Healy, who as chief counsel at the FTC was to have an important role in administering the 1933 act, revealed to Congress, without apology, his lack of knowledge of auditing:

> THE CHAIRMAN: Now, Judge Healy, suppose an independent auditing concern, a certified public accountant, were to submit to you a statement regarding one of these concerns that was applying for registration for the purpose of selling their securities, would that accounting concern take the books of the corporation, without going into the question of the value or the write-up or anything of that sort. Would they just confine themselves to the books of the company in making their statement?
>
> MR. HEALY: It is very difficult for me to answer that question, of course, because I do not know what they do.[29]

Nine leading accounting firms, in a letter to the NYSE in 1933, implied that little was known about auditing:

> We fully recognize the importance of defining the responsibility of auditors and of bringing about a proper understanding on the part of the investing public of the scope and significance of financial audits, to the end that their importance should not be underrated nor their protective value exaggerated in the minds of investors.[30]

This was a convenient argument to present to Congress in 1933-4 as a reason for not imposing great liability on auditors. However, such disparagement of auditing was considered necessary by some accountants because other contemporaries described auditing as a precise science, as is discussed in chapter 2. Of course, the public still has significant misconceptions about auditing.[31]

There is some evidence that in 1933-4 auditing was in a more highly developed state, and more was known about it, than the foregoing information reveals. This can be seen in W. A. Staub's [managing

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bulletin, *Verification of Financial Statements* (Washington, D.C.: U.S. Government Printing Office, 1929), and the pamphlet *Audits of Corporate Accounts* (New York: AIA, 1934), were concerned with the rules of auditing.

29. 1933 Senate Hearings, p. 218.
30. This letter was printed in American Institute of Accountants, *Audits of Corporate Accounts*, which also contains the correspondence between the AIA's Special Committee on Cooperation with Stock Exchanges and the NYSE's Committee on Stock List from 1932-1934.
31. For example, the Commission on Auditors' Responsibilities found that many financial statement users have the erroneous conception "that the financial statements are the representations of the auditor rather than of management." CAR, *Report of Tentative Conclusions* (New York: AICPA, 1977), p. 76.

partner of Lybrand, Ross Bros. & Montgomery] description of the standardization process that auditing was undergoing for NYSE-listed companies before the NYSE-AIA collaboration began in 1932:

> One of the most helpful influences in furthering the practice of having published financial statements accompanied by certificates of independent public accountants was that exerted by the New York Stock Exchange. *As the culmination of informal activity in this direction for some years*, the president of the Exchange on January 6, 1933, made an announcement that since April of 1932 all corporations applying for listing of their securities had been asked to include in their listing agreements an undertaking that future annual financial statements, published more than three months after the agreement, would be audited by independent public accountants and accompanied by a certificate of such accountants, setting forth the scope of the audit and qualifications, if any, made by them in respect thereto, and that the Committee on Stock List had considered many reasons advanced why this procedure should not apply in particular cases but had made exceptions only in the case of certain railroad companies. . . .
>
> *Especially from the time that Mr. J. M. B. Hoxsey became executive assistant to the Stock List Committee of the Exchange during the 1920's*, the Exchange had been doing its utmost to encourage the preparation of financial statements published by listed corporations on the basis of sound accounting principles. The support of the Exchange in this way, which antedated the enactment of the securities acts, was most helpful to accountants in their efforts for improvement in corporate accounting practice. The services of Mr. Hoxsey, representing the Exchange, in accounting conferences with the officers of listed corporations, with the independent accountants examining the statements of such corporations, and with the Committee of the American Institute of Accountants on Cooperation with Stock Exchanges, were of the greatest value in furthering the recognition and adoption by corporations of sound accounting principles and the improvement in form and content of published statements (emphasis supplied).[32]

Accounting historians provide additional reasons for characterizing auditing as being in a relatively developed state in 1933-4.[33] They cite the quality of Robert H. Montgomery's formidable work *Auditing Theory and Practice*, first published in 1912, and in its fourth edition by 1933.[34] As further evidence that modern auditing was observable in the United States at the beginning of the twentieth century, historians cite publication in 1905 of Dicksee's *Auditing: A Practical Manual for Auditors* (edited by Montgomery).[35]

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32. Staub, *Auditing Developments*, pp. 14-15. President Whitney's announcement on January 6, 1933, is contained in *Audits of Corporate Accounts*, p. 14.
33. In 1976 the author consulted Professors Richard Brief and Barbara Merino of the Schools of Business, New York University, and Professor Steven A. Zeff of the School of Business, Tulane University.
34. R. H. Montgomery, *Auditing Theory and Practice* (New York: Ronald Press, 1912). The second edition was published in 1923 and the third in 1927.
35. L. R. Dicksee, *Auditing: A Practical Manual for Auditors*, First American Ed., edited by R. H. Montgomery (New York: Ronald Press, 1905).

It is difficult to reconcile the conflicting evidence about the state of the art of auditing in 1933-4 because of the absence of significant empirical evidence of what auditors were in fact doing. William Werntz, chief accountant at the SEC in the 1930s, made the following observation in 1939 about the difficulty in studying actual audit procedures:

> In contrast to the time we [at the SEC] have spent on accounting principles, there have been few cases before us involving the question of whether a reasonable audit was made. This is perhaps due to lack of information, in the normal case, as to the audit procedure followed. The cases that do appear come to us after the horse had been spirited from the barn. . . .[36]

Even though most auditors had probably studied Montgomery's auditing book, there is no evidence that accountants outside of Montgomery's firm were following it in practice. The framework of auditing, as we know it, seems to have been present, but there was apparently significant variability in its application from firm to firm.[37]

Barr and Koch, high-ranking accountants with the SEC, analyzed the state of auditing in 1934 and reported that "little authoritative literature existed which clearly indicated the type of auditing procedures normally employed by certifying accountants."[38] Their article cited the McKesson & Robbins case to support that observation. The SEC found in that 1939 case that physical inspection of inventories, and direct correspondence with debtors to confirm amounts reported as accounts receivable, were generally recommended and frequently employed, but they were not required procedures of the accounting profession.[39] Staub, in the 1940 Dickinson lectures at Harvard, stated: "Although the confirmation practice was gradually coming into greater use, it certainly could not be said up to 1939 that it was an essential auditing procedure in the absence of which the auditor would not give an unqualified certificate."[40]

As described above, the existence of two competing professional organizations of accountants in 1933-4 constituted a weak institutional framework. This also may have contributed to a lag between auditing theory and actual auditing practice. The absence of information about auditing practices hindered the profession's spokesmen before Con-

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36. W. W. Werntz, "What Is Expected of the Independent Auditor: From the viewpoint of the Investor," an address delivered at the annual meeting of the American Institute of Accountants, September 21, 1939 (Washington, D.C.: Securities and Exchange Commission), p. 2.
37. This was the consensus opinion of the three accounting historians referred to in n. 33 above.
38. Barr and Koch, "Accounting and the S.E.C.," *George Washington Law Review* 28 (1959): 186. Andrew Barr was the chief accountant at the SEC for many years. Elmer Koch was a financial accountant at the SEC at the time the article was written.
39. U.S. Securities and Exchange Commission, *In the Matter of McKesson & Robbins*, ASR no. 19 (December 5, 1940), contained a summary of the SEC's two-part report.
40. Staub, *Auditing Developments*, p. 52.

gress and was detrimental to the ability of Congress to have specific expectations about auditor services.

Healy, speaking in 1937 as an SEC commissioner, reflected on the state of accounting and auditing after the securities acts were adopted:

> I recall the advent of the Securities Act of 1933, the Securities Exchange Act of 1934, the creation of the Securities and Exchange Commission in 1934, and the Public Utility Holding Company Act in 1935. I recall the writing of the forms and regulations for the registration of securities, the disappointments attending our search for well established accounting standards, *the difficulty even of finding a definition for the word "audit,"* the weeks of arguments as to what should be required in a form and what omitted, *the difficulty of deciding what an accountant's certificate ought to contain*, the cooperation and contributions of accountants, some with axes to grind and others without (emphasis on portions directly related to auditing).[41]

Congressmen may have been in the same position as all U.S. citizens: According to a 1932 *Fortune* article, certified public accountants "walk in the shadow of virtual anonymity."[42]

Congressional Expectations Regarding the SEC and the Accounting Profession

Congress may have adopted the securities acts without specific expectations about auditor duties because it relied on the SEC (or the FTC when it adopted the 1933 act) and the two professional associations of accountants (even though they were feuding) to develop accounting and auditing requirements.

Landis, in a private communication, referred to the delegation of authority to the SEC in the following way: "We ought eventually to move toward some uniformity in accounting, but it will be obviously a long time before that can be done. . . ."[43] Chatov's research confirms this statement, although he is more concerned with accounting principles than with auditing standards:

> What were the specific ideas in the minds of the creators of the [securities] Acts with respect to the treatment of accounting principles and setting up the rules for financial reporting? . . . Benjamin Cohen's [another of the acts' draftsmen] recollection of the event was that the ultimate idea was to get power into the Commission.

41. R. E. Healy, "The Next Step in Accounting," an address delivered at the annual meeting of the American Accounting Association (December 27, 1937), p. 2.
42. "Certified Public Accountants," *Fortune* 5 (1932): 63.
43. Letter from Landis to Renn, March 26, 1934, on file with the James M. Landis Papers, Harvard Law Library.

. . . Congress had given the new Commission extensive rulemaking authority, rather than impose statutory requirements which would have been impossible to fulfill, since generally accepted principles of accounting were a myth rather than a reality.[44]

This analysis is supported by a dialogue at the 1933 Senate hearings between Huston Thompson and Senator Steiwer:

SENATOR STEIWER: . . . I have just provided myself with the listing requirements of the New York Stock Exchange, which I had not been familiar with, and apparently, from a superficial reading of their listing requirements, they are more far-reaching as to the information necessary to be furnished than the bill now presented to this committee.

MR. THOMPSON: I might say that in a sense we were trying not to have this bill too long. I think it is only about 30 pages, while the British Companies Act is over 300 pages. But we do have a provision in the bill which permits the Commission to set up rules and regulations which will have the effect of law. In those rules and regulations we expect them, in drafting their forms, to go more into detail with regard to requirements.

SENATOR STEIWER: All right.[45]

The extent to which Congress delegated authority over auditing to the SEC is a subject of some controversy.[46] There is agreement that the SEC has indirect control over auditing because of its authority to (*a*) prescribe " . . . the methods to be followed in the preparation of accounts";[47] (*b*) prevent false or misleading statements;[48] and (*c*) require certain financial statements to be certified by independent public or certified accountants.[49]

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44. Chatov, *Corporate Financial Standards Regulations*, pp. 183-184.
45. 1933 Senate Hearings, p. 72.
46. In the first place, there is a difference of emphasis in the way commentators approach the issue. Strother emphasizes that neither of the securities acts "expressly authorize[s] the Commission to prescribe the standards by which an independent public accountant is to conduct the examination underlying his report." "The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards," *Vanderbilt Law Review* 28 (1975): 224. The emphasis of Carmichael and Willingham is on the SEC's power: "The SEC has the authority to make detailed prescriptions of accounting principles and auditing standards. . . ." (D. R. Carmichael and J. J. Willingham, *Auditing Concepts and Methods*, 2d ed. [New York: McGraw-Hill, 1975], p. 23). Secondly, it is presently unclear to what extent rule 2(e) of the SEC rules of practice permits the SEC to disqualify from appearing and practicing before it those accountants who do not possess the requisite qualifications. The rule is being challenged in Touche Ross & Co. v. SEC, 76 Civ. 4489 (S.D.N.Y. 1976).
47. Section 19(a), Securities Act of 1933 and section 13(b), Securities Exchange Act of 1934. These sections also permit the SEC to prescribe "the form . . . in which required information shall be set forth" and "the items or details to be shown in the balance sheet and earnings statement. . . ."
48. The goal of full and fair disclosure is the crux of the 1933 act as stated in the act's preamble and is the leading object of the various antifraud provisions of both the securities acts.
49. Securities Act of 1933, sched. A, items (25)-(26), and Securities Exchange Act of 1934, secs. 12(b)(1)(J)-(K), 13(a)(2). Other provisions of the acts appear to grant the SEC the authority to define independence and to determine whether an auditor is independent.

Confusion between Auditing and Accounting

It is difficult to assess some of the extrinsic evidence relevant to auditors' duties in 1933-4 because it simply refers to the rules and standards of accounting. The distinction between accounting principles and auditing standards appears to have been less clear then than it is today. The frequent use of the term *accounting* at congressional hearings could indicate congressional indifference to specific auditor duties, conscious assignment of that topic to a lesser status, or confusion between accounting and auditing. Staub, in a 1941 speech, described the subtlety of the distinction at that time:

> Auditing has been sometimes described as the analytical phase of the accountant's work and accounting *per se* as the synthetic phase. In practice the line between the two often becomes very dim; in fact, that line is frequently not apparent at all because of the overlapping of the two phases.[50]

Commentators in the 1930s indicated that accounting principles were of greater interest to the fledgling SEC than were matters concerning auditing. Werntz, speaking in 1939, stated: "It is perhaps true that the attention which events have directed toward standardizing accounting principles has resulted in less attention to audit problems."[51] Staub indicated that, after the McKesson & Robbins case in 1940, the term "audit" was at the center of conversations about accounting.[52]

Chatov claims that accountants helped Congress to confuse the distinction between accounting and auditing in order to aid their goal of keeping accounting and auditing rulemaking in the private sector. He characterizes the following description of the problem by John L. Carey as "somewhat generous": "The accountants may have taken advantage of some of the confusion in . . . the distinction between uniform accounting and standard audit requirements."[53]

The Absence of Specific Funding by Congress

It has been argued that Congress evinced an original, and continuing, policy against the SEC's development of auditing standards by not having provided, or at least earmarked, sufficient funds for that pur-

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50. Staub, *Auditing Developments*, p. 4.
51. W. W. Werntz, "What is Expected of the Independent Auditor," p. 7.
52. Staub, *Auditing Developments*, p. 5.
53. See e.g., Chatov, *Corporate Financial Standards Regulations*, p. 53, citing J. L. Carey, *The Rise of the Accounting Profession*, vol. 1 (New York: AICPA, 1969-70), p. 133.

pose.[54] Also, prior to enactment of the securities acts, when Congress was considering requiring federal audits, it expected to fund them merely from registration fees, as is discussed in chapter 3.

Conclusion

Landis stated: "The experience of many years and of many nations is epitomized in the provisions of the Securities Act. . . . The Securities Act embodied little that was novel in conception, nor did it emanate from a Congress that for the first time had been called upon to consider the problem of security regulation."[55] However, as other draftsmen of the securities acts indicated, Congress did not consider extensively specific auditor duties:

> . . . Many uncertainties remain—some necessarily so. May an accountant rely upon an appraiser's certificate, where it does or where it does not contain qualifications? May he rely upon an officer's certificate of inventory? In a financial statement, what falls within the realm of fact, what within the realm of opinion?[56]

54. Chatov, *Corporate Financial Standards Regulations*, pp. 418-419.
55. J. M. Landis, "Liability Sections of Securities Act Authoritatively Discussed," an address before the Eleventh Annual Fall Conference of the NYS Society of CPAs held in New York City, October 30, 1933, appearing in *The American Accountant* 18 (1933): 330.
56. Douglas and Bates, "The Federal Securities Act of 1933," *Yale Law Journal* 43 (1933): 198.

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General Congressional Expectations

High Expectations

Several of the specific congressional expectations discussed in chapter 3 indicate that Congress may have had high expectations of the services auditors would perform when it adopted the securities acts. General support for a high level of congressional expectations of auditors' duties can be grouped into the categories that follow.

Reliance on Financial Statements

Section 11 of the 1933 act places greater responsibilities on accountants for the accuracy of the financial statements in registration statements than it places on other "participants" in registered securities offerings, other than the issuer.[1] Accountants "expertise" sections of registration statements, unlike directors, underwriters, and officers who sign the registration statement. Participants (except the issuer) who are *not* "experts" do not need to "investigate" the "expertised" parts of the registration statement. For example, directors and underwriters can rely on the auditors' work to the extent that it leads to certification of the financial statements, if the nonexpert "has no reasonable ground to believe and did not believe" that the statements were untrue.[2]

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1. Section 11 refers to "accountants," but the responsibilities generally pertain to auditors.
2. Section 11(b)(3)(C). As to accountants, the expertised part of a registration statement is the certified financial statements. See Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

This duty of "negative assurance" placed on the nonexpert for the expertised parts of the registration statement was a result of congressional amendment of section 11 in 1934. This amendment changed the provisions of the statute which had imposed a positive duty of "belief" in the truth of the statements. In 1934 Congress also changed the standard for review by nonexperts of nonexpertised parts of the registration statement from that of a "fiduciary" to that of a "prudent man in the management of his own property."[3]

Professor Folk's analysis of the legislative history of these changes was that "neither amendment intended or effected a change of substance." Folk contended that the effect of the amendments on auditors' responsibilities was clearly limited because a major reason for them was that "section 11 in its original form terrified the investment community."[4] Still, any reduction of responsibility of nonexperts under section 11, especially regarding the financial statements, can be viewed as an increase in the responsibility of experts to some degree.

Auditors must make a "reasonable investigation" of their expertised parts of 1933 act registration statements.[5] This is formidable when compared to the British Companies Act. "Section 11 broke new ground by making experts liable for their misstatements; the English statutes did not incorporate this development until the Companies Act of 1948," and "section 11 goes beyond the 1948 Act in specifically mandating a reasonable investigation by an expert and extending his liability to misleading omissions."[6]

George O. May, senior partner of Price Waterhouse & Co. and a leading accounting spokesman in his role as chairman of an important AIA committee, characterized holding accountants liable for "untrue statements of a material fact" or omissions as an "unduly drastic measure":

> The question that should really be put to the accountant is not whether the balance sheet is true, but whether it is fair—fair in the accounting principles on which it is based; fair in the way in which those principles are applied to the facts; and fair in the way in which the results are presented. These are matters of opinion. . . .
>
> . . . Balance sheets, and profit and loss accounts are not, of course, covered in the form of statements of fact; but a description with an amount set opposite it is fairly capable of being judged as a statement of fact. The

3. Section 11(c).
4. Folk, "Civil Liabilities Under the Federal Securities Acts: The BarChris Case," *Virginia Law Review* 55 (1969): pp. 18-19. A second part of the article appears in the same volume at pp. 199-271. Folk also states: "The present negative test of no reasonable ground was substituted in 1934 for the original affirmative standard of reasonable ground to believe, but this change was said to be only a concession to the terror psychology of the investment community" (Ibid., p. 28).
5. Section 11(b).
6. Folk, "Civil Liabilities Under the Federal Securities Acts," pp. 14-16.

> common heading: "Land, buildings, plant and machinery, at cost," with a figure set opposite, seems at first blush to be a simple statement of fact; but in practice, what is fairly to be regarded as cost will often be a difficult matter of opinion, and always the question remains whether any, and if so, what amplification of the heading is necessary to make the statement not misleading.[7]

May directly informed Congress that accounting, including the auditing process, involved "matters of opinion," as discussed below. These remarks somewhat tempered congressional expectations of auditors' duties vis-à-vis other participants in the issuance of securities.

Expectations of Investors

Carter's and May's statements to Congress, that financial statements were matters of opinion, were factors that evidence low congressional expectations of auditors' duties. However, Carter and May also informed Congress that the public was not fully aware of this fact about accounting and believed financial statements, especially when accompanied by an auditor's report, offered greater protection than was possible.

Carter stated the following at the 1933 Senate hearings: "I think the impression generally prevails that one who reads a balance sheet and an income statement regards the figures in such a statement as a defensible definitely ascertainable fact. . . ."[8] Carter then reiterated the point: "Investors are too prone to regard balance sheets and income accounts as positive and indisputable statements of fact. . . ."[9] Also, as discussed below, congressmen and others spoke with high esteem of the work of the large accounting firms.

These assertions might seem unrealistic in light of the market crash four years earlier. However, the public apparently realized that frenzied speculation had been a major factor of inflated securities prices.[10]

Congress may have intended that required auditor performance be set by the courts at the level of investor expectations in 1933-4, which was high, or at a lower "floating" level if the profession was better able to explain to investors the limitations of its work (which, apparently, it still has not). The Conclusion of this study further explores the possibility that Congress had a "flexible" intent regarding auditors' duties and discusses the permissibility of such unspecific legislative intent.

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7. G. O. May, *Twenty-five Years of Accounting Responsibility: 1911-36*, vol. 2 (New York: American Institute Publishing Co., 1936), pp. 81-83. The quote comes from an address by May before the Illinois Society of Certified Public Accountants in Chicago, Ill. on December 6, 1933, and also appears in *Journal of Accountancy* 57 (1934): 9-23.
8. U.S., Congress, Senate, Committee on Banking and Currency, *Hearings on S. 875*, 73d Cong., 1st sess. (1933), p. 56 [hereinafter cited as 1933 Senate Hearings].
9. Ibid., p. 62.
10. G. Previts and B. Merino, *Accounting in America*, chap. 6 (publication forthcoming).

Expectations Regarding the SEC and the Accounting Profession

The SEC's statutory authority over auditing has been discussed in chapter 1. Congress may have had high expectations of auditors' duties by creating the SEC. Chatov quotes Frankfurter as stating that "the evolution of model financial accounting methods, with which the Commission is now charged, is well calculated to have far-reaching beneficial effects on American corporate practices."[11] Chatov asserts that Frankfurter led Congress to believe that the SEC would develop extensive accounting rules.[12]

Congress might have expected that even if the SEC did not promulgate "model financial accounting methods," the private sector would. As shown above, by 1933 the AIA had made some progress in that direction in collaboration with the NYSE.

Furthermore, the SEC's review of registration statements and other filed documents (even for limited purposes), and the greater dissemination of financial statements pursuant to the new acts, could have been expected to provide the empirical data that were necessary for the creation of auditing standards by the SEC or the private sector. George Cochrane, a partner of Haskins & Sells, in a 1950 speech to the Institute of Chartered Accountants in England, described this effect of disclosures that resulted from the passage of the securities acts: "Consideration by the commission's staff, of the accounting principles used by companies filing reports and of the audit procedures undertaken by the independent accountant in such cases, has led to a much wider knowledge of what is and is not being done by corporations and accountants."[13]

Advancement in Auditing Techniques

The rapidly developing state of auditing in 1933-4 was described in chapter 1. There does not appear to be any evidence that Congress anticipated a significant increase in the complexity of business. Therefore, Congress could have deduced that greatly improved auditing services were inevitable.

In the 1880s the first "chartered" accountants from Great Britain arrived in the United States.[14] A *Fortune* article observed that the great

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11. R. Chatov, "The Collapse of Corporate Financial Standards Regulations: A Study of SEC-Accountant Interaction" (Ph.D. Dissertation, University of California, Berkeley, 1973), p. 193. The dissertation in a slightly edited form has been published under the title *Corporate Financial Reporting: Public or Private Control* (New York: Free Press, 1975). Chatov relies on a September, 1934, *Fortune* article, which cannot be located as cited.
12. Id.
13. G. Cochrane, "The Auditor's Report: Its Evolution in the U.S.A.," *The Accountant* 123 (1950): 448-460.
14. Previts and Merino, *Accounting in America*, chap. 3. The authors note that there were public accountants in the United States in the 18th century; but, not until the British chartered accountants arrived was there a "recognized" professional group.

progress in public accounting by 1932 had occurred in those mere fifty years.[15] Staub, drawing from his professional experience, also described the significant development of auditing in that period.[16] While Congress was considering the securities act, the NYSE imposed a requirement that the scope of audits be as extensive as those required for loans by nonlisted companies in the 1929 version of the Federal Reserve Board (FRB) Bulletin, *Verification of Financial Statements*, and the new accountant's report designed by the NYSE immediately filtered down to other companies.[17]

Low Expectations

Business was less complex, and auditing less sophisticated, in 1933-4 than it is today. Therefore, it might be contended that Congress had low expectations of auditor duties. However, the following two topics, presented to Congress in 1933-4, lend greater support to that proposition.

Disparagement of Accounting and Auditing

When Congress was informed that accounting was a profession concerned merely with "opinions," it may have expected that auditing would develop little. May submitted the following memorandum to Congress in 1933:

> In so far as accounting information is concerned, it seems to me fundamentally important to recognize that the *accounts* of a modern business are *not entirely statements of fact*, but are, to a large extent, expressions of opinion based partly on accounting conventions, partly on assumptions, explicit or implicit, and partly on judgment (emphasis supplied).[18]

May indicated that one of the main draftsmen of the 1933 act understood this point. In a letter to Landis in 1933, May wrote:

> I was particularly pleased to note your recognition of the undoubted fact that accounts are expressions of opinions. This seems to me to be the only sound starting point for any regulations relating to accounts or accountants. I agree with you that, in the past, efforts have frequently been made to represent accounts as being statements of fact to a greater extent than they can possibly be, and no doubt accountants must assume a part of the responsibility. However, some accountants, including myself, have for years been very insistent on the opposite view, and I think that academic authorities have had more influence than accountants.[19]

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15. "Certified Public Accountants," *Fortune* 5 (1932): 95.
16. W. A. Staub, *Auditing Developments During the Present Century* (Cambridge, Mass.: Harvard University Press, 1942), particularly at pp. 9-15.
17. Cochrane, "The Auditor's Report," pp. 452-453.
18. "Memorandum Regarding Securities Bill-H.R. 4314 (1933)," in May, *Twenty-five Years*, vol. 2, p. 49.
19. Letter to the Hon. James M. Landis, November 2, 1933, in May, *Twenty-five Years*, vol. 2, p. 64.

Colonel Carter emphasized at the 1933 Senate hearings that the auditor's report accompanying financial statements only contained an opinion: "[An opinion] is all [independent accountants] can give; that is all they can give. That is all anyone can give as to a balance sheet."[20] Carter objected to a provision in the proposed 1933 act that the financial statements had to be sworn to as being correct: "I do not see that anyone can certify under oath that a balance sheet giving many millions of dollars of assets is as a matter of fact correct. He can state his opinion based upon a thorough investigation."[21] Furthermore, one of Carter's principal arguments against audits by federal employees was that government involvement with financial statements would increase the public's reliance on the information.[22]

Carter's warnings to Congress about financial statements were aimed more directly at the limitations of auditing, while the criticisms of financial statements by most other persons were directed toward the shortcomings of accounting principles. Healy of the FTC, in congressional testimony, pointed out that financial statements failed to reflect the effects of inflation.[23] May, in a letter to Colonel M. C. Rorty in 1933, also stated a concern about financial statements that is still with us—their usefulness to investors:

> The investor who actually relies on specific statements in a prospectus is a comparatively rare bird. Subscriptions to new securities from such sources would not supply a fraction of the needs of the country. The great bulk of the subscriptions come from persons who rely on more general considerations, such as their belief in the issuer or in the underwriter.[24]

One of the reasons for these defensive statements by Carter and May could have been to offset the view of those laypersons and accounting spokesmen, such as Professor Ripley of Harvard, who spoke of financial statements as a product of a precise science. Carter and May seemed to have the floor regarding this issue at the hearings on the securities acts because the other point of view appears not to have been presented by the profession.

Congress may have disregarded the disparagement of auditors because (*a*) many investors did rely on financial statements, and the securities acts would encourage greater reliance; (*b*) accounting, more than auditing, was being attacked; and (*c*) the critics of financial statements, then as now, recognized their value for interperiod, and intercompany, comparisons.

It is interesting to note that in 1931 the auditor's report was revised in an effort to reduce user reliance. As described by the AIA: "Ac-

20. 1933 Senate Hearings, p. 57.
21. Id.
22. Ibid., 55-63.
23. Ibid., 216-219.
24. May, *Twenty-five Years*, vol. 2, p. 60.

countants therefore, by again changing the wording of their reports, endeavored to make clear that the report was an opinion and not a guarantee. The word 'certify' was eliminated and words indicating agreement with the books were removed."[25] Notwithstanding, Congress still included the word "certified" in the securities acts.[26] It is difficult to draw conclusions about congressional intent from these facts because even Colonel Carter did not adopt the new terminology at the 1933 Senate hearings: "I do not see how the Federal Trade Commission can properly discharge its duty by merely accepting a statement that has not been independently examined and certified to by an accountant."[27]

Rejection of Federal Auditors and the Federal Licensing of Public Auditors

The federal government had some experience with "federal audits" prior to 1933 through national bank examinations and uniform reports required in the railroad industry. They were not very effective and apparently were not examined at the 1933 hearings.

The rejection of audits by government employees of corporate issuers leads at first to the conclusión that Congress lowered investors' reliance on the auditing process. However, persons who knew that Colonel Carter had a strong influence on the 1933 Senate hearings typically reached the opposite conclusion, that Congress was promised that public accountants would perform at a high level. For example, A. A. Sommer, when he was an SEC commissioner, stated:

> It [Congress] considered [in 1933] requiring that the accounts of publicly held companies be audited by a corps of federally employed accountants. Only the earnest importunings of the [accounting] profession and assurances of its adequacy to do a satisfactory job impelled Congress to forego this proposal.[28]

However, a close examination of the 1933 Senate hearings indicates that an assessment of Carter's "assurances" to Congress is a more complex issue.

As discussed in chapter 1, Carter's testimony did promise substantial auditor performance because he wanted Congress to rely on a profession that it was not very familiar with and did not hold in very high esteem. He began his testimony by implicitly complimenting the work of independent accountants. Carter recommended that the pro-

25. Letter from the AIA to the NYSE, December 21, 1933, in *Audits of Corporate Accounts* (New York: AIA, 1934), p. 28.
26. Securities Act of 1933, sched. A, items (25)-(26), and Securities Exchange Act of 1934, secs. 12(b)(1)(J)-(K), 13(a)(2).
27. 1933 Senate Hearings, p. 56.
28. "The SEC and the FASB: Their Roles," an address by then SEC Commissioner A. A. Sommer, January 21, 1974, reprinted in Wiesen, *Regulating Transactions in Securities* (St. Paul, Minn.: West Publishing Co., 1975), p. 273.

posed 1933 act "be changed so as to afford even greater protection to the investor than it now contemplates."[29] In a preamble to his independent accountant proposal, Carter characterized FTC review of financial statements as placing "a burden of proof" on the FTC "rather than upon the issuer to develop full and reliable information."[30] Carter thereby suggested that Congress could have confidence in the response which issuers and public auditors would make to the requirement of independent audits.

Then, and throughout much of his testimony, Carter denigrated the quality of the work that Congress could expect of government auditors on each occasion on which he complimented the work of his independent profession. He stated that auditing of issuers was "an impractical thing for the Government agency to do . . . effectively."[31] Carter gave the following answers to the senators' questions about whether the agency supervising the act ought to perform an audit after the independent accountant's audit, if the proposed 1933 act were changed to require independent audits:

> SENATOR REYNOLDS: All right. Then it goes to the Commission, does it not?
>
> MR. CARTER: Yes.
>
> SENATOR REYNOLDS: Have they got to check their accounts and your accounts?
>
> MR. CARTER: I do not think so. I do not think they would have to go to that.
>
> SENATOR REYNOLDS: Why should your members ask that they be permitted and empowered to check these accounts?
>
> MR. CARTER: Because it is generally regarded that an independent audit of any business is a good thing.
>
> SENATOR REYNOLDS: All right. Then, after it goes to the Commission they have to check up to see who is right; they have to go through and audit again. There has to be a Government audit, as suggested by Senator Barkley. Would it not be creating more difficulty and more expense and more time for the Government if auditing organizations interest themselves in these various and sundry corporations?
>
> MR. CARTER: I do not think so. I think if a corporation wished to issue some securities and had been employing independent public accountants for 20 years those accountants should be able to make this examination more economically and quickly than the Government.
>
> SENATOR REYNOLDS: Could they do it more economically than the Government?
>
> MR. CARTER: I think so.
>
> SENATOR GORE: There would not be any doubt about that.
>
> SENATOR REYNOLDS: Why?

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29. 1933 Senate Hearings, p. 55. Carter seemed to apply that statement to all of his proposals, including the abandonment of government audits, even though that change was not the first one Carter discussed.
30. Id.
31. Ibid., p. 57.

MR. CARTER: We know the conditions of the accounts; we know the ramifications of the business; we know the pitfalls of the accounting structure that the company maintains. You have got every kind of business to deal with.[32]

Thus, Carter implied at the 1933 Senate hearings that federal auditors would not be sufficiently experienced to audit an issuer within a reasonable time and cost limit and with a reasonable level of expertise.

The limited congressional preparation for federal auditing is another reason that it is not possible to conclude that the rejection of federal auditors displayed a high level of congressional expectations of public auditors. This is evident in the following dialogue with Carter:

SENATOR REYNOLDS: Suppose that we decide in the final passage of this bill here to employ five or six hundred auditors from your organization, that would be all right, then, would it not?

MR. CARTER: I do not think the Government could employ five or six hundred independent accountants.

SENATOR REYNOLDS: Why could they not?

MR. CARTER: I do not think the type of men that are in the public practice of accountancy would leave their present practice to go in the Government employ.

SENATOR REYNOLDS: Well, if it were sufficiently remunerative they would?

MR. CARTER: Yes; if the Government made their time worth while.

SENATOR REYNOLDS: The bill here provides for taking care of the expenses incident thereto by way of registration.

MR. CARTER: Well, you will have to build some more buildings in Washington to house them if you are going to do that.

SENATOR REYNOLDS: Then we had better not pass this bill at all.[33]

It cannot be determined whether Senator Reynolds was being facetious in his reference to new government buildings for auditors in Washington because of the limited thought that had been given to the establishment of a corps of government auditors.

In sum, Carter argued that independent, public auditors would be preferable to government auditors, but his conclusion was based on a low appraisal of what government auditors could accomplish.

The fact that Congress planned to pay the government auditors through registration fees also supports low congressional expectations of the work of federal auditors. Even comparing these funds to the small independent auditing fees for small issuers, as described by Carter in chapter 3 ("Cost Constraints" section), would have revealed that only very limited audits could have been performed. This was especially the case if the other costs of supervising the 1933 act would have had to have been paid by the registration fees.

Congress may not have realized this problem of funding federal audits because it did not consider the scope of the FTC's initial

32. Ibid., pp. 58-59.
33. Ibid., p. 59.

examination of an issuer's financial statements, nor the circumstances which would have required a more intensive examination. In an exchange between Carter and Ferdinand Pecora, counsel at the 1933 Senate hearings, it appears that Pecora contemplated a higher standard for FTC "re-examination" of a registration statement prior to registration cancellation than did Carter.[34] The absence of substantial congressional consideration of this subject is further evidence that Congress did not have high expectations of auditors' duties.

Although Carter began his testimony at the 1933 Senate hearings by complimenting the work of independent auditors, he was more restrained in the balance of his testimony. As described above, Carter warned that financial statements and the accompanying auditor's report were statements of opinion. He did not shirk the accounting profession's responsibility for some of the "debacle" in the securities markets, giving the following bland response to a question on that subject: "You still have some very sound companies and industries in this country."[35] Carter did not assert that accountants had a great interest in auditing—"the detail work of auditing is usually done by a subordinate"—nor did he promise fixed guidelines on auditing.[36] Once congressmen realized how little they knew about auditing, independent auditors, and government auditors, Carter did not have to pressure them to abandon proposed federal audits.

In contrast to the issue of competence, the independence of auditors was not focused upon at the 1933 Senate hearings, even though a corps of federal auditors would have avoided issuers' directly paying auditors.

The failure of Congress to adopt federal licensing of auditors suggests, on balance, low congressional expectations of auditor performance, since, as seen in chapter 3 ("Auditor Competence" section), the states were not uniformly effective in regulating the profession through licensing. Furthermore, proposals for the federal licensing of auditors were not new in 1933. As early as 1899, John A. Cooper, a prominent CPA, proposed a national system of registering accountants.[37] A decade later, Edward N. Hurley, chairman of the FTC, made similar proposals, which were opposed by the AIA.[38]

The licensing issue is discussed in chapter 3 as it relates to the competence of auditors. Other specific congressional expectations discussed in that chapter evidence limited expectations of auditors' duties, particularly cost constraints on audits.

34. Ibid., p. 63.
35. Ibid., p. 60.
36. Ibid., p. 61.
37. Speech before Illinois Association of Public Accountants, Chicago, Dec. 12, 1899, in *The Accountant* 29 (1903): 1251-53 and 1508.
38. "Registration of Accountants," *Journal of Accountancy* 23 (1917): 185-89.

3

Specific Congressional Expectations

Responsibility for Accurate Financial Statements

Auditors vis-à-vis Management

The chairman of the 1933 Senate hearings made the following analysis of management's duty to provide accurate financial statements under the 1933 act:

> I do not see why the company should not be responsible, because the people it employs to check up inventories, and all that sort of thing . . . must know about [these things], and they must not be misleading so as to cause loss.[1]

This statement seems to indicate that Congress was relying more on management than auditors to discover errors in the reporting of inventories and "that sort of thing." However, that observation must be tempered by the fact that the chairman's statement was made in the context of defending the shared responsibility for false statements between the company and others in sections 11 and 12 of the 1933 act.[2] A discussion of liability under the 1933 act was presented in chapter 2.

Similarly, it would be incorrect to base speculation about congressional expectations of auditors vis-à-vis management on Carter's dis-

1. U.S., Congress, Senate, Committee on Banking and Currency, *Hearings on S. 875*, 73d Cong., 1st sess. (1933), p. 210 [hereinafter cited as 1933 Senate Hearings].
2. Ibid., pp. 208-211.

suading Congress from requiring an officer of an issuer to "verify under oath . . . that the statements, exhibits, and documents are correct."[3] Carter attacked this provision on the basis that neither management nor auditors could make this promise about financial information, nor would investors benefit from it.[4] On balance, Carter's testimony at the 1933 Senate hearings emphasized the responsibility of management as compared to that of auditors:

> [The auditor's opinion] can only be an opinion based upon certain accounting assumptions which must be applied to the opinion of some *individual as to values.*[5]

A self-serving statement from the accounting profession about the primary role of management in financial reporting may have come to the attention of Congress. In the letter by nine leading accounting firms to the president of the NYSE on February 24, 1933, the accounting firms stated:

> We think it well to . . . emphasize the fact that accounts must necessarily be largely expressions of judgment, and that the primary responsibility for forming these judgments must rest on the management of the corporation. And though the auditor must assume the duty of expressing his dissent *through a qualification in his report,* or otherwise, if the conclusions reached by the management are in his opinion manifestly unsound, he does not undertake in practice, and should not, we think, be expected to substitute his judgment for that of the management when the difference is not of major importance, when the management's judgment is not unreasonable and when he has no reason to question its good faith.[6]

The search for specific congressional intent on the relative roles of management and auditor prior to, or at the time of, enactment of the securities acts is shown to be difficult when one reconsiders the following statement by one of the principal draftsmen of the 1933 act:

> Many uncertainties remain—some necessarily so. May an accountant rely upon an appraiser's certificate, where it does or where it does not contain qualifications? May he rely upon an officer's certificate of inventory? In a financial statement, what falls within the realm of fact, what within the realm of opinion?[7]

However, the post-enactment history of the securities acts may be instructive about congressional intent. Staub, in a 1941 speech, described the SEC's lack of involvement with auditing matters:

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3. Ibid., pp. 57 and 62.
4. Ibid., p. 62. In this testimony, Carter stated that the oath could be given by issuers if it was in terms of "the best of his knowledge and belief."
5. Ibid., p. 56.
6. American Institute of Accountants, *Audits of Corporate Accounts* (New York: AIA, 1934), p. 25.
7. Douglas and Bates, "The Federal Securities Act of 1933," *Yale Law Journal* 43 (1933): 198.

It is significant that in the course of the seven years during which the Securities and Exchange Commission has been reviewing the registration statements filed with it under the Securities Act (security issues) and the Securities Exchange Act (security listings and corporate annual reports) the questions which the Commission has raised regarding financial statements have in only a few instances been the result of financial irregularities as such but have dealt largely with the propriety or otherwise of the application of accounting principles to various circumstances and transactions of the registrants.[8]

The SEC initially emphasized that the accuracy of financial statements was the primary responsibility of management. Barr and Koch suggested that as a reason why the SEC in its early years failed to bring many cases against auditors or to establish extensive auditing requirements:

Of special significance was the *Interstate Hosiery Mills* case in which the Commission set forth its views as to the relative responsibility of a registrant and its management and a certifying accountant in assuring the accuracy of financial statements. The Commission stated in its decision that the fundamental and primary responsibility for the accuracy of information filed with the Commission rests upon management, and the employment of independent public accountants, however reputable, is not a substitution for management's accounting of its stewardship but instead, serves as a check on that accounting.[9]

Many years later the SEC expressed the same position in addressing the independence of accountants: "The financial statements are the responsibility of the client and all decisions with respect to them must ultimately be assumed by the client."[10]

The SEC's first involvement with financial statement problems not only emphasized management's responsibility, but also, according to a commentator, required only auditor disclosure of financial statement deficiencies:

From these and other cases it is apparent that the Commission is willing to pass financial statements which may be deficient in setting forth accepted accounting practice provided the certifying accountant clearly points out the deficiency and states what the effect would be had more acceptable practice been followed. Its reasoning for this treatment results from the fact that it is administering a disclosure rather than a regulatory act and that a statement from the accountants concerning the accounting practice of the registrant gives a better picture of the managerial policy of the company than if the independent accountant were to revise the registrant's balance

8. W. A. Staub, *Auditing Developments During the Present Century* (Cambridge, Mass.: Harvard University Press, 1942), p. 91.
9. Barr and Koch, "Accounting and the S.E.C.," *George Washington Law Review* 28 (1959): 187.
10. U.S. Securities and Exchange Commission, *Independence of Accountants*, ASR no. 126 (July 5, 1972), p. 3.

sheet and income statement to reflect more generally accepted principles and practices.[11]

This statement appears to apply to auditing problems, as well as to the choice of accounting principles. As stated above, a fine line separates the two aspects of accounting, and this was more so in the 1930s than it is today.

Auditors vis-à-vis Directors

Arthur Andersen, writing in 1935, described a limited role for auditors vis-à-vis directors:

> The [lay person] must realize that the determination of the value at which assets of a corporation are stated in its accounts is a function of the board of directors. It is the function of the accountant to describe the basis of stating such values.[12]

This statement is also relevant to the previous discussion of the comparative duties of management vis-à-vis auditors. In this subsection, the principal issue is the role of nonmanagement (outside) directors in reviewing financial statements.

The provisions of section 11 of the 1933 act have been discussed above, along with the significant and relevant changes adopted in 1934. The emphasis there was on the high congressional expectations of auditor duties that may have resulted from the possibly limited "review" role planned for directors.

The case for imposing significant responsibilities on directors was made at committee hearings in 1933. A House committee was informed that the British law allowed directors to rely upon, among other things, "the statements of certified public accountants with respect to the financial affairs of the company, of experts with respect to certain values of property carried in the balance sheet, of the public accountants and the president and officers with respect to accounts and bills receivable and their estimate of whether they are good."[13] The same point was made at the 1933 Senate hearings by Ollie M. Butler, an attorney for the Department of Commerce and one of the draftsmen of the 1933 act, who testified: "[Director reliance] is possible under the

11. A. Smith, "Accounting Practice Under the Securities and Exchange Commission," *The Accounting Review* 10 (1935): 331. In 1938, the SEC made it clear that the use of accounting principles "for which there is no substantial authoritative support," will be presumed to be misleading despite disclosure (U.S. Securities and Exchange Commission, *Administrative Policy on Financial Statements*, ASR no. 4, [April 25, 1938]).
12. Andersen, "Present-day Problems Affecting the Presentation and Interpretation of Financial Statements," *Journal of Accountancy* 60 (1935): 334.
13. U.S., Congress, House, Committee on Interstate and Foreign Commerce, *Hearings on H.R. 4314*, 73d Cong., 1st sess. (1933), p. 169 [hereinafter cited as 1933 House Hearings].

British system of government, where the central government has absolute control over [auditors and other] experts, and can demand certain requirements of them."[14] He described as "not so adequate" the "qualification" legislation regarding accountants in some states, and concluded that "to excuse the directors for a misstatement based on the report of some auditors or certified accountants would practically nullify the strength of the responsibility [of directors] provision [of section 11 of the 1933 act]."[15] Similarly, a Senate Banking and Currency Committee report accompanying the proposed 1933 act stated: "If a director can excuse himself by saying that he has in good faith relied upon an accountant's statement . . . , then the investor will continue in the same position from which the nation is struggling to extricate him."[16]

Further evidence that Congress set high expectations for directors vis-à-vis auditors was the fact that, as Butler reported to Congress, the attack on the proposed 1933 act was "being made chiefly against the responsibility of directors and the revocation [of registration] clauses of the bill."[17] As described in chapter 2 in the section on "Reliance on Financial Statements," Congress assisted directors in 1934 by enacting two amendments to the 1933 act. However, Folk observed that "neither amendment intended or effected a change of substance."[18]

There are factors, however, which indicate lower expectations of directors. As observed in chapter 2, in 1933 Congress set greater responsibilities for U.S. auditors than were required of their British counterparts. Furthermore, at the 1933 Senate hearings the time limitations of outside directors were discussed. One senator observed that directors lacked the ability to "verify every figure which was in their annual statement or prospectus."[19] Another senator suggested, as a solution to this problem, that an auditor ought to be criminally liable for any false statement in his report, even if it arose from only gross negligence. He stated: "You would be reaching the source in that case."[20] Mr. Breed, counsel to a tristate investment bankers association, posed the following rhetorical question to the senators discussing this topic:

> Which of you gentlemen who sits on a corporation's board of directors, which has a list of accounts receivable, can physically possibly go over every one of a thousand and in some cases it may be tens of thousands of

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14. *1933 Senate Hearings*, p. 247.
15. Id.
16. U.S., Congress, Senate, *S. Rep. no. 47*, 73d Cong., 1st sess. (1933), p. 5.
17. 1933 Senate Hearings, p. 248.
18. Folk, "Civil Liabilities Under the Federal Securities Acts: The BarChris Case," *Virginia Law Review* 55 (1969): 18-19. A second part of the article appears in the same volume at pp. 199-271.
19. 1933 Senate Hearings, p. 209.
20. Id.

> items of accounts due from all over the United States and the world, and guarantee that every one of those are worth 100 percent on the dollar?[21]

Additional evidence of both high and low congressional expectations of director responsibilities is presented below in the sections on auditor and auditing firm competence. The most conclusive and probably most important point to note from the allocation of responsibilities between directors and auditors is that Congress was concerned about the balance between the two. The importance of this observation is discussed in this study's Conclusion.

Employee Defalcations

As stated in chapter 2, the NYSE's 1933 announcement requiring independent audits stipulated that the scope of the audit be no less than that indicated in the 1929 FRB Bulletin titled "Verification of Financial Statements." The bulletin stated: "The scope of the work indicated in these instructions includes . . . an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check."[22] It was the NYSE's understanding that the bulletin "clearly indicated that the scope of the examination therein provided for was not such as would lead naturally to detection of . . . defalcations on the part of employees. . . ."[23] Similarly, the 1933 reply of the nine leading public accounting firms to a request for information by the NYSE confirmed that audits, especially of large companies such as those on the NYSE, would not "naturally" detect employee defalcations. The letter stated: "Such companies rely on an adequate system of internal check to prevent or disclose defalcations, and independent accountants making a financial examination do not attempt to duplicate the work of the internal auditors."[24] The following statement in the report of the NYSE's Committee on Stock List to the exchange's governing committee agreed with this assessment of audit scope, but then stated a higher expectation:

> Your committee is satisfied that the detailed scrutiny and verification of the cash transactions of large companies can most efficiently and economically be performed by permanent employees of the corporation, particularly today, when bookkeeping is to so large an extent done by mechanical means, and that it would involve unwarranted expense to transfer such work to independent auditors or to require them to duplicate the work of the internal organization. Your committee, however, feels that

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21. Ibid., p. 169 (Mr. William C. Breed was considered a lobbyist for persons who were directors of corporations).
22. U.S. Federal Reserve Board, *Verification of Financial Statements*, FRB bulletin (Washington, D.C.: U.S. Government Printing Office, 1929), p. 1.
23. AIA, *Audits of Corporate Accounts*, p. 19.
24. Ibid., p. 23.

the auditors should assume a definite responsibility for satisfying themselves that the system of the internal check provides adequate safeguards and should protect the company against any defalcation of major importance.[25]

For the purpose of assessing congressional expectations, it is more important to analyze the auditors' view of the extent of their duties than the NYSE's expectations of auditors. Although May, in his role as chairman of the AIA's Special Committee on Cooperation with Stock Exchanges, wrote to the Committee on Stock List in December 1933 that the need for detailed audits existed "where the internal check and control are necessarily limited or severely restricted . . . ," he qualified the auditor's responsibility: "We would, however, point out that it is always a matter of judgment on the part of corporate management to weigh the risks against which safeguards are desirable in comparison with the cost of providing safeguards."[26] May concluded his letter with the following statement:

> The whole matter lies in the field of discretion, and if in any case a defalcation should occur and escape detection, the accountants cannot be expected to accept any financial responsibility, but only to accept such blame as may attach to a possible error of judgment on their part with respect to their review of the methods and extent of the internal check and control.[27]

Management's ability to place cost constraints on the detection of employee defalcations is part of the broader subject of cost constraints on audits discussed below.

Testing and Staff Supervision

A new auditor's report developed in 1933 included the concept of sample testing for the first time: ". . . we examined or tested accounting records of the company and other supporting evidence. . . ."[28] May described the importance of testing in 1933:

> While the work of accountants today involves the use of a large staff, it is obviously impracticable for the accountant even with a large staff to examine all the transactions of even a moderate-sized corporation. His procedure is, therefore, a varied one—in some cases, he will make a fairly complete independent check; in other cases, he will make tests; in still other cases, he must rely on the records of the corporation, satisfying himself that they are so kept and checked as to justify such reliance as a reasonable business procedure.

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25. Ibid., p. 19.
26. Ibid., pp. 26-27.
27. Id.
28. G. Cochrane, "The Auditor's Report: Its Evolution in the U.S.A.," *The Accountant* 123 (1950): 460.

> In considering, therefore, what degree of responsibility may wisely and rightfully be imposed on the accountant, one must start from the premise that: (a) his work is in part in the nature of confirmation of facts, and in part an expression of judgment; (b) his procedure is necessarily to a large extent one of testing—he cannot scrutinize every transaction; (c) his work is necessarily carried on largely through subordinates.[29]

It is important to note May's last point, that at the time the securities acts were adopted an audit required the extensive use of subordinates. The statement was made in a speech that was published in the *Journal of Accountancy* and was, therefore, available to Congress when it enacted the 1934 act.[30]

As discussed in chapter 2, Carter stated at the 1933 Senate hearings that "the detail work of auditing is usually done by a subordinate."[31] Congress may have realized that the auditing process was subject to ordinary failures in communication and training.

Auditor Competence

Congressmen and others suggested in 1933-4 that there was a wide variation in the competence of auditors. In the course of considering the federal licensing of auditors,[32] Butler testified that in some states the statutes licensing accountants were "adequate," while in other states they were "not so adequate."[33] As described above, this was the reason that Butler advocated that section 11 of the 1933 act require that directors have some responsibility for the accuracy of the financial statements.

Senator Couzens stated that the federal licensing of auditors was feasible since the Bureau of Internal Revenue had been able to certify persons who practiced before it.[34] Butler claimed that licensing would provoke criticism from those who were not allowed to practice their profession, but Couzens dismissed this as unimportant. Butler suggested that the Senate committee might want to consider the licensing question in executive session, to determine whether auditors should be "controlled" through licensing "to an extent that their statements might

29. G. O. May, *Twenty-five Years of Accounting Responsibility: 1911-36*, vol. 2 (New York: American Institute Publishing Co., 1936), p. 72.
30. The speech was delivered to the Illinois Society of Certified Public Accountants in Chicago, Ill., on December 6, 1933, and published in *Journal of Accountancy* 57 (1934): 9-23.
31. 1933 Senate Hearings, p. 61.
32. 1933 Senate Hearings, pp. 208-210, 247, and U.S., Congress, Senate, Committee on Banking and Currency, *Hearings on S. Res. 84 and S. Res. 56 and S. Res. 97*, 73d Cong., 2d sess. (1934), p. 7616 [hereinafter cited as 1934 Senate Hearings].
33. 1933 Senate Hearings, p. 247.
34. Ibid., pp. 247-248.

be taken as a safeguard to the investing public."[35] Butler and Couzens agreed that their main concern was that the majority of directors should not merely be "advertising matter," but they concluded their exchange by apparently accepting the existing variation in the performance of auditors, Butler stating that "the serious director would experience very little difficulty with this law, because he would be careful in the selection of his auditors. . . ."[36]

The issue of licensing of auditors was also discussed at the 1934 Senate hearings when Healy testified:

> SENATOR KEAN: . . . What I thought was that you ought to have authority in this bill to license accountants and engineers. What do you think of that? I have just put it to the witness, Mr. Chairman, as to whether the Commission ought to have authority to license accountants and engineers.
>
> MR. HEALY: My first reply was—some of the committee were busy with something else—that I would be very pleased, as far as I am concerned, if the day would come when public accountants would be licensed and would have to report to stockholders instead of to directors and would have a dignified position of responsibility under Federal laws. Whether or not public sentiment and the sentiment of Congress is at the point where they are willing that engineers and accountants should be licensed by the Federal Trade Commission I do not know. I have some doubt about it.
>
> THE CHAIRMAN: We have enough to deal with now without going into outside questions. The complaint about this bill is that it goes too far.
>
> SENATOR KEAN: Yes; it does in some respects; I agree to that. I am opposed to the bill in some respects, but I am in favor of having accountants that are responsible and engineers that are responsible. For instance, if I make an issue of securities I hire the highest class and the best people that I can get, and I do not restrain them in any way. They are to make a report of the situation. I take their report and publish it, and I am bound more or less by that report. I issue securities by it, and I pick the very best I can get. If they make mistakes, I suffer.
>
> THE CHAIRMAN: Would it be any better if they were licensed? Licensed men make mistakes.
>
> MR. PECORA: It would not add to their knowledge or efficiency. The fact that a lawyer has a certificate of admission to the bar does not improve his knowledge of the law.
>
> MR. HEALY: I should like to interject an observation, if the committee will permit, which is not particularly apropos of anything, that eventually the solution for many of these problems is going to come from a compulsory incorporating or licensing of all corporations engaged in interstate commerce.
>
> THE CHAIRMAN: You mean, to give them Federal charters?[37]

This testimony from the 1934 Senate hearings leads to the same conclusions about congressional consideration of auditors' competence as the 1933 Senate hearings.

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35. Ibid., p. 248.
36. Id.
37. 1934 Senate Hearings, p. 7616. Part of this testimony is referenced in chap. 1, n. 21, in the discussion of "Congressional Consideration of the Role of Auditors Under the Securities Acts."

In the first place, auditors' competence and federal licensing of auditors were not given profound consideration. At the 1934 Senate hearings quoted directly above, Healy found that "some of the committee were busy with something else" when he discussed the licensing of auditors the first time. He was not being rhetorical when answering, "I do not know," to the question whether auditors ought to be licensed, but the chairman ended the discussion.

At the 1933 Senate hearings Butler suggested that directors in Britain could rely on financial statements because in Britain "the central Government has absolute control over such experts [e.g., auditors], and can demand certain requirements of them."[38] This was an overstatement of British regulation of auditing. Accountants were not licensed in Britain, only their professional institutes were. In fact, it has been said that British auditing has always been more "free enterprise" than U.S. auditing because of the absence of government involvement with licensing.[39] Butler's misconception was not repeated at the 1934 Senate hearings when the subject of federal licensing of auditors was discussed.[40] The misinformation at the prior year's hearings can only support the thesis in chapter 1, that Congress lacked a vigorous interest in auditing matters.

Secondly, the testimony indicated that there was great variation in the competence of auditors. It was stated that the quality of state licensing of accountants varied. Directors were advised to "be careful in the selection of . . . auditors."[41]

Thirdly, there was significant disparagement of auditing, as seen in chapter 2. Butler testified that licensing would be required to make the auditor's statement a "safeguard," and Healy hoped that "the day would come" when public accountants "would have a dignified position of responsibility under Federal laws."[42]

For these reasons, and by rejecting the federal licensing of auditors after some evidence that it was feasible, Congress appeared to lack interest in affirmatively raising the performance level of auditors.

Auditing Firm Competence

The congressional hearings produced testimony implying that the small accounting firms were less competent than the larger ones. Congress could have anticipated that the financial statements of

38. 1933 Senate Hearings, p. 247.
39. Professor Brief made this statement in an interview described in chap. 1, n. 33.
40. 1934 Senate Hearings, p. 7616.
41. 1933 Senate Hearings, p. 248.
42. Id. and 1934 Senate Hearings, p. 7616, respectively. However, as discussed above, this testimony must be tempered by its context—an attempt to have Congress place greater responsibilities on directors.

smaller companies would be reviewed by smaller accounting firms. The large accounting firms would avoid audits of companies which were not well established because such companies had a greater likelihood of producing 1933 act liability. Douglas and Bates, writing shortly after the 1933 act was adopted, stated: "It may be expected that the reputable [accounting] firms may be more chary than ever of becoming experts for any but the more substantial issuers."[43] If Congress did not expect that the 1933 act would prevent small companies from raising capital,[44] then Congress could have anticipated that small accounting firms would be reviewing the financials for 1933 act registration statements.

When members of the Senate Banking and Currency Committee questioned Carter about the cost of audits, they inquired about the cost for the "thousands of small companies putting out an issue for their original financing."[45] However, Congress might have anticipated that only large companies would be entering the equity markets, since Congress was told that underwriters would only participate in issues by such companies because of their own exposure to 1933 act liability.[46] Furthermore, size of the issuer was then, as now, a requirement for listing on an exchange, and the "OTC" market was not effective to handle the trading of small issues. Therefore, the small accounting firms would not be frequently involved with 1933 act registration statements.

In any event, testimony on the tiered structure of the accounting profession must have lowered congressional expectations of auditors' duties to some extent. Healy told the 1933 House hearings that there are "many fine accounting firms," and "many accounting firms that are not so fine."[47] At the 1933 Senate hearings Huston Thompson engaged in the following dialogue:

> MR. THOMPSON: . . . Senator Couzens, I think if I were in that position [director of a large corporation] I would see to it that I got the very best accountants possible, persons I could depend on.
> SENATOR COUZENS: That is true.
> MR. THOMPSON: Ernst & Ernst, or somebody like them.[48]

As cited above, Butler, testifying at the same hearings, stated that "the serious director would experience very little difficulty with this law, because he would be careful in the selection of his auditors. . . ."[49] It is unclear whether Butler was referring to individual auditors or to audit-

43. Douglas and Bates, "The Federal Securities Act of 1933," p. 198.
44. 1933 House Hearings, p. 243.
45. 1933 Senate Hearings, pp. 60-61.
46. 1933 House Hearings, p. 243.
47. Ibid., p. 244.
48. 1933 Senate Hearings, p. 210.
49. Ibid., p. 248.

ing firms. Large accounting firms tend to have more experience with corporate and securities matters and to have certain structural advantages over smaller firms, of which Congress, in 1933-4, may have been aware.

Price Waterhouse & Co. stated the following in a 1933 letter to its branch offices regarding notification to the national office of objections to a client's "form or substance of accounts": "Obviously, unless the leading firms take a stand for proper principles when the necessity arises, it is not fairly to be expected that the smaller firms, which occupy a much less favorable position, will do so."[50] The "less favorable position" of smaller firms results from the greater likelihood that they will be dependent on one or a few clients for economic survival, which is also the case for small local offices of large firms.

National office review provides another structural advantage for larger firms, since the audit staff can contact in-house specialists on various matters. The auditor's increased competence is also useful in resisting client demands. Although there does not appear to be specific evidence of congressional awareness of national office review, testimony quoted in this study has shown that congressmen seemed to have general familiarity with the large accounting firms.

In sum, committee members who considered the 1933 act seemed to believe that large accounting firms were more prepared to handle new responsibilities under that act, but they did not take particular action based on that belief.

Independence Under Client "Pressure"

The greater ability of large firms to withstand client "pressure" has been discussed in the previous subsection. Congress may have expected that auditors generally would be able to resist client pressure because of the trend in that direction in 1933 and the effect of enacting laws that placed heavy responsibilities on auditors.

The Trend in 1933

Cochrane reports that auditors had little authority vis-à-vis their clients in the early 1920s:

> Efforts were continually made by outstanding accountants to discourage . . . misleading accounting and reporting methods but, unfortunately, the professional accountant was not then clothed with authority either by stat-

50. A letter to all United States and Canadian Offices of Price Waterhouse & Co., January 16, 1933, in May, *Twenty-five Years*, vol. 1, pp. 145-146.

> ute or by public acceptance. Corporate management frequently depended on its legal advisers for accounting advice and the efforts of accountants to obtain acceptance of the accounting principles involved were nullified by advice that the presentation desired by the company was legal.[51]

According to Cochrane, by the late 1920s "accountants more and more frequently objected to the practices used and many insisted upon qualifications in their reports,"[52] although there is no specific evidence that this trend was brought to the attention of Congress.

Liability Under the Securities Acts

Congress could have expected that enactment of the securities acts, especially the 1933 act, would strengthen the auditor's ability to influence the preparation and presentation of financial statements. The auditor's report was widely required by a federal statute and an administrative agency, and it could create civil and criminal liability for the auditor. Cochrane stated: "The [1933] Act, of course, placed a new and heavy responsibility on the professional accountant and, of necessity, increased his authority."[53] Staub, speaking in 1941, expressed this point in the following way:

> Accountants have taken seriously the provisions of the two securities acts and have sought to impress the importance thereof on their clients as well, particularly in respect of those accounting matters which are particularly within the scope of the auditor's duties. The requirements of the acts and the activities of the Securities and Exchange Commission have given valuable support to accountants in their continuous efforts for improvements in accounting practice and for the adequacy of disclosures essential to presenting a complete picture of financial position and results of operations.[54]

A new law can be welcome because it provides a reason for not participating in questionable conduct. For example, financial vice-presidents of corporations have been better able to resist the pressure from security analysts and others to disclose "inside information" since the SEC began its pursuit of insider "tipping" in the mid-1960s.[55] Auditors have probably welcomed the recent enactment of a law against most kinds of foreign bribes.[56] Auditors had a similar reaction to their increased responsibilities in 1933-4.

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51. Cochrane, "The Auditor's Report," pp. 449-450.
52. Ibid., p. 450.
53. Ibid., p. 454.
54. Staub, *Auditing Developments*, p. 25.
55. Wiesen, "Disclosure of Inside Information—Materiality and 'Texas Gulf Sulphur'," *Maryland Law Review* 28 (1968): 221.
56. *Foreign Corrupt Practices Act of 1977.*

Time and Cost Constraints

Congress considered the time and cost of audits for 1933 act registration statements and for the annual reporting requirement under the 1934 act. Some congressmen were concerned that there would be insufficient time and money for a yearly audit.

Time Constraints

When Congress considered the proposal for federal auditors under the 1933 act it did not contemplate that there would be time constraints on such audits. Registration statements under the act would be filed throughout the year, and therefore, the auditor's work would be likely to be distributed over the year.

At the 1934 Senate hearings, May implied that if the proposed 1934 act did not require that the fiscal years of regulated companies be staggered, Congress should expect some deficiencies in auditor services:

> If the amount of auditing required were expanded as this bill would necessitate, it would tax the resources of the accounting profession. The great difficulty of the present position is that nearly all companies end their year at December 31, and if the amount of work to be done at December 31 were so enormously increased as this bill would increase it, then I do not think it would be within the capacity of the accounting profession, by any reasonable expansion, to take care of that work within a reasonable period after the end of the year.
>
> I would like to see introduced into the bill a provision which would help to distribute the work of auditing over the year. I think it would enormously increase the value of the audit to the investor.[57]

The SEC perceived the same problem six years later in the McKesson & Robbins case:

> We deplore, as do accounting firms, the necessity for recruiting large numbers of temporary employees during a very short busy season. This condition and the lack of training in the firm's methods which it ordinarily entails are inimical to attaining the best results from the auditors' services. A major improvement in this condition could be made by the general adoption by corporations of the natural business year for accounting purposes.[58]

Since Congress was informed in 1934 of the difficulty accounting firms would have in sending highly trained staff on audits in the first three months of each year, Congress appears to have been conscious of the time parameters which the 1934 act would create.

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57. 1934 Senate Hearings, pp. 7177-78.
58. U.S. Securities and Exchange Commission, *In the Matter of McKesson & Robbins*, ASR no. 19 (December 5, 1940), p. 4.

Cost Constraints

As discussed in chapter 2, Congress did not give great thought to the proposal for federal audits, partly because such audits would not be a very extensive undertaking. Congress expected that federal audits would be (1) performed by persons who might have limited auditing experience and would certainly have limited experience with the audited company, (2) performed by a small number of auditors, (3) funded solely from registration fees, and (4) conducted without extensive guidelines. Therefore, the congressmen at the 1933 Senate hearings were inclined toward low audit costs when they dropped the federal audit proposal and considered independent audits.

Carter provided a sanguine description of the ability of companies to pay for an audit by an independent accountant in the following two dialogues at the 1933 Senate hearings:

> MR. CARTER: Eighty-five percent of all the companies listed on the New York Stock Exchange have independent audits.
>
> SENATOR GORE: So it would not be any added expense?
>
> MR. CARTER: Not to them.
>
> THE CHAIRMAN: This bill covers all of them, those listed and those not listed.
>
> MR. CARTER: Those are the ones that should be independently audited.
>
> SENATOR REYNOLDS: Which ones?
>
> MR. CARTER: Those that are not listed.
>
> SENATOR REYNOLDS: All right; the ones that are not listed are the little fellows, are they not?
>
> MR. CARTER: Yes, sir.
>
> SENATOR REYNOLDS: Could they pay you $75 a day to go into their books?
>
> MR. CARTER: They do not have to.
>
> SENATOR REYNOLDS: Who pays you?
>
> MR. CARTER: It does not cost them $75 a day.
>
> SENATOR REYNOLDS: How much do you charge a day, then?
>
> MR. CARTER: It would cost them an average of, I should say, $25 a day.
>
> SENATOR KEAN: What big companies charge $25?
>
> MR. CARTER: That is about an average.
>
> SENATOR KEAN: Marwick, Mitchell & Co. cost more than that.
>
> MR. CARTER: I am giving you an average.
>
> SENATOR KEAN: Waterhouse & Co. cost more than that. What companies do you know of that charge only $25 a day?
>
> MR. CARTER: I said that was an average for all. The rates range from $100 a day for a partner down to $15 and $20 a day for a junior. The average scale of rates that are charged are $35, $30, $25, $20 and $15, depending upon the class of men.
>
> SENATOR KEAN: How many men would it take?
>
> MR. CARTER: Put one partner in.
>
> SENATOR KEAN: Only put one partner in?
>
> MR. CARTER: Yes, sir.
>
> SENATOR KEAN: That is $100 a day.
>
> MR. CARTER: That is right, at that rate for the proportion of his time devoted, and he is usually worth it.
>
> SENATOR REYNOLDS: How many days does it take on the average to audit a small company?

MR. CARTER: It would depend upon the business.

SENATOR REYNOLDS: Of course, I understand, but generally, Colonel, just give me some idea.

MR. CARTER: Well, take a company selling automobiles doing a relatively small business, you could probably audit it in two days and a half.

SENATOR REYNOLDS: That would be $250?

MR. CARTER: Yes; assuming the highest rate for partner, the detail work of auditing is usually done by a subordinate.[59]

. . . .

SENATOR ADAMS: How much of a burden is this going to put on the comparatively small company? You were speaking a while back of the companies whose stocks are listed being independently audited. Now coming under the control of this bill are going to be thousands of small companies putting out an issue for their original financing. How much of a burden and cost is that going to put on them?

MR. CARTER: Very little measured in value to the investor and to them.

SENATOR GORE: What would be the range?

MR. CARTER: My experience would be that the average company pays around $500 or $600 or $700 for its auditing, that is, taking the large and small together.

SENATOR GORE: How often do they resort to that?

MR. CARTER: Every year. And the largest organizations of our country do it and have been doing it for the last 15 years.

SENATOR GORE: Have had these independent audits made?

MR. CARTER: Have had these independent audits made, yes.[60]

The hourly fees of auditors have increased about tenfold since Carter's 1933 estimate. Congress might have expected that auditors' hourly rates would rise dramatically due to increased auditors' responsibilities, which would necessarily lead to increased education requirements, "support" staff specialists, and legal costs and damages. However, Congress could not have projected, from Carter's testimony, the hours required for audits of financial statements currently filed with the SEC pursuant to either of the securities acts.[61] Some senators seemed skeptical at first of Carter's low estimates of audit costs, but the Senate committee did not insist that he explain his assumptions more precisely. The Senate committee was apparently satisfied that audit costs would be reasonable.

At the 1934 Senate hearings, May indicated that public companies might have to pay very high annual audit fees:

MR. MAY: . . . We happen to be discussing the question with the Stand-

59. 1933 Senate Hearings, pp. 60-61.
60. Ibid., p. 59.
61. Schneider and Manko, "Going Public: Practice, Procedure and Consequences," *Villanova Law Review* 15 (1970): 283 [reproduced in part in Wiesen, *Regulating Transactions in Securities*, p. 48], made the following estimate of accounting fees for a company "going public": "If there have been no prior audits and new accountants are engaged at the time of the offering, fees in the $25,000 to $50,000 range, and even higher, would not be unusual." The authors imply that the fee could not be much less.

ard Oil Co. of New Jersey just now in regard to what an annual audit might cost.

SENATOR KEAN: What kind of a figure did you give them, if I may ask?

MR. MAY: I told them it was so enormous that we could not make any commitment. But I should say an annual audit of the Standard Oil of New Jersey would probably cost, with all its several hundred companies included, certainly a quarter of a million, possibly more.

SENATOR KEAN: A quarter of a million dollars each time?

MR. MAY: Yes. That would be doing it the quickest possible way. It would be doing it at the end of the year and not working on it all the way through. . . .[62]

The conflict between the estimates by Carter and May of the cost of annual audits can be explained by the respective purposes of their testimony. Carter wanted to dissuade Congress from requiring federal audits, and therefore he emphasized the low cost of independent audits. May apparently did not want Congress to require annual audits, and therefore he emphasized their high cost. The Senate committee's failure to question May in 1934 about Carter's testimony the previous year indicates a lack of congressional interest in auditing. However, by not objecting to May's assertion that audits might be performed "the quickest possible way," the Senate committee displayed a concern that audit costs be maintained at reasonable levels.

Estimating Income

Congress was informed at the 1934 House hearings that many companies were closing their books on December 31, although it was not the end of their "natural year."[63] At the 1934 Senate hearings, May gave examples of more "natural years": September or October closings for automobile and tire companies, October closings for packing houses, and June closings for railroads.[64]

Since Congress did not require "natural" closing dates, Congress may have been willing to tolerate two effects on auditing. In the first place, calendar year ends create staffing problems as discussed above. Secondly, "unnatural" closing dates magnify the problems of matching revenues and expenses.

62. 1934 Senate Hearings, pp. 7182-83.
63. U.S., Congress, House, Committee on Interstate and Foreign Commerce, *Hearings on H.R. 7852 and H.R. 8720,* 73d Cong., 2d sess. (1934), p. 652. The statement was made in a memorandum prepared by J. Harry Covington, counsel for the AIA.
64. 1934 Senate Hearings, p. 7186. The statement was made in a memorandum prepared by May.

The Auditor's Report

Cochrane describes the four changes in the auditor's report through 1933. The first report stated that the "books" of the company had been audited.[65] After minor changes in a second report, the report that took effect around 1931 stated that the "accounts" of the company had been examined.[66] The new report in 1933 stated that the "accounting records" had been examined "or tested."[67] Congress should have expected that the auditor's report would be changed, and its assurances reduced, after the passage of the securities acts.

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65. Cochrane, *The Auditor's Report*, p. 449.
66. Ibid., p. 451.
67. Ibid., p. 453.

Conclusion

An examination of congressional intent regarding auditors' duties under the securities acts produces little "primary" evidence of congressional expectations. However, testimony at committee hearings and published commentaries about the state of auditing in 1933-4 permits reasonable support for some conclusions. Such "extrinsic" evidence can be used to deduce what Congress meant to achieve in the acts, because, as one legal research scholar recently wrote, " . . . American courts exclude almost no form of extrinsic aid in the interpretation of statutes."[1]

Some people have believed that Congress made a thorough study of auditing in 1933-4. For example, the SEC stated in a 1958 release that the 1933 Senate hearings "considered *at length* the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public" (emphasis supplied).[2] This study concludes that the securities acts were quite thoroughly conceived and debated generally, but that the duties of auditors were not of great interest to congressmen.

The securities acts were not adopted casually. The acts were drafted by leading lawyers, who were able to refer to previous securities regulation bills that had been introduced into Congress, to state "Blue Sky" laws, and to the British Companies Act. Congressional hearings considered the views of the draftsmen and of some of the leading spokesmen of the accounting profession.

On the other hand, an analysis of the legislative history indicates a lack of knowledge about auditing on the part of congressmen and less than a vigorous interest in the topic when it was raised at hearings. The 1933 proposal to have federal auditors was never advanced beyond a preliminary consideration, and the creation of the SEC in

1. Sloane, "Legal Research: Federal Legislative History," *New York Law Journal*, December 14, 1976, p. 4, col. 1.
2. U.S. Securities and Exchange Commission, *Independence of Certifying Accountants*, ASR no. 81 (December 11, 1958), p. 2.

1934 appears to have been an extravagant substitution for profound thinking about the duties of auditors.

The absence of careful consideration of auditors' duties tends to rebut the argument that Congress was placing heavy responsibilities on auditors. Also supporting "low" expectations of auditors' duties was testimony emphasizing the limitations of accounting and auditing, the inadequate qualification standards for accountants in some states, and the absence of a unified national association of accountants. The statements of a spokesman of the accounting profession, which led to the rejection of federal auditors, could promise little in independent auditor services because of the insufficient thought which had been given to the plans for federal auditors.

On the other hand, a "high" degree of expectations could be supported by the provisions of section 11 of the 1933 act, the creation of the SEC in the 1934 act, the progress in auditing in the fifty years prior to 1933-4, and the possibly high expectations of investors.

The SEC seems to apply the securities acts to auditors on the basis of high congressional expectations. This may be justified by the broad language in the acts delegating authority over auditing to the SEC, the remedial purposes of the securities acts, the creation of the SEC itself, and the absence of specific congressional intent regarding auditors' duties. However, an application of the acts to auditors should be bound by (*a*) specific congressional expectations of auditors and auditing and (*b*) the requirement that statutes cannot be too vague.

Congressional intent regarding specific auditor services highlights two themes. In the first place, Congress was particularly concerned with the balance of responsibility between accountants and directors, and between accountants, corporate managers, and underwriters, generally. Secondly, Congress was aware of some of the limitations of auditing, especially reliance on subordinates, the time and cost constraints of audits, and variations in auditor and auditing firm competence. Congress appeared to have an understanding of these inherent problems of auditing if the silence of congressmen when told of these problems at the hearings on the securities acts can be construed as legislative intent.

Courts and the SEC seem to have adopted a flexible and expandable approach to auditors' responsibilities under the securities acts. A House committee report accompanying the 1933 act bill may have contemplated this approach: "The duty of care to discover varies in its demand upon participants in the security distribution with the importance of their place in the scheme of distribution and with the *degree of protection that the public has a right to expect*" (emphasis supplied).[3] Similarly, Landis, in a speech to accountants shortly after the

3. U.S., Congress, House, *H. Rep. 85*, 73d Cong., 1st sess., 1933, p. 9.

1933 act was passed, referred to "the flexibilities inherent in the Act and its capacities for adaptation to the complexities of the situations it covers." He went on to tell the audience that to understand the 1933 act, accountants should "[remember] always . . . that the public interest and the protection of investors must be the guiding consideration."[4]

In 1939 the SEC's chief accountant described this flexible approach to interpretation of the securities acts as they affect accountants:

> By statutory mandate, it is thus the duty of the Commission in each problem it faces to keep in mind not only "What does the public investor receive," but also "What is the public investor entitled to expect." Fortunately, the Congress has invested the Commission with regulatory and rule making powers designed to ensure that the answers to these two questions shall not be unreasonably different.[5]

Not only the SEC, but the courts too, have interpreted the securities acts to meet the changing expectations of the public, as seen in the following statement by A. A. Sommer when he was an SEC commissioner:

> It is clear that in very large measure the courts have shaped the responsibilities of the auditors and provided them with benchmarks against which to measure their conduct because the auditors were slow in doing so themselves in response to such "surging" forces in society as a great demand for disclosure, a greater involvement of the public in the securities markets, more insistence upon disclosure reasonably understandable in the marketplace, and more demanding definition of the role of the auditor in this society.[6]

Court opinions, such as in the *BarChris* case, have appended elaborate rules of conduct for auditors onto rather bare provisions of the securities acts.[7] According to Chatov, the accounting profession has sought "flexibility" from the 1920s to the present in order to avoid direct government control.

It is difficult to denote the limits to administrative agency and court interpretation of statutes. Courts and agencies should ascertain legislative intent when applying a statute. Agencies are limited in the creation

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4. J. M. Landis, "Liability Sections of Securities Act Authoritatively Discussed," an address before the Eleventh Annual Fall Conference of the NYS Society of CPAs held in New York City, October 30, 1933, appearing in *The American Accountant* 18 (1933): 334.
5. W. W. Werntz, "What Is Expected of the Independent Auditor: From the Viewpoint of the Investor," an address delivered at the annual meeting of the American Institute of Accountants September 21, 1939 (Washington, D.C.: Securities and Exchange Commission), p. 1.
6. "The Legal Liability of the Accountant," an address by Commissioner A. A. Sommer, September 24, 1973, reprinted in Wiesen, *Regulating Transactions in Securities* (St. Paul, Minn.: West Publishing Co., 1975), p. 279.
7. See Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

of rules by the requirement that the applicable statute be sufficiently specific in its delegation of authority to the agency.

Only in rare cases has legislation been successfully attacked for lacking specificity. Therefore, agencies and courts have been able to create responsibilities that comport with the public's expectations. Furthermore, the *failure* of Congress to object to an interpretation of its legislation, such as the application of the securities acts to auditors, provides some evidence of legislative intent.

Landis reported in his 1933 speech quoted above,

> No member of either House at any time voted against the passage of the bill, nor took occasion to criticize any provision that the bill contained. . . . I cite [this and other] facts merely as illustrative of a Congress with its emotions unaroused but deeply conscious of the evils which unrestrained exploitation of our capital resources had brought into existence.[8]

When Congress voted on the securities acts, the actual duties of auditors must have seemed to be an area in which flexibility, reflecting actual experience, would be appropriate. Congress thereby left posterity with the dilemma of placing proper limits on the application of the securities acts to auditors.

8. J. M. Landis, "Liability Sections of Securities Act Authoritatively Discussed," p. 330.