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## Recommended Citation

Objectives of financial statements: Selected papers, pp. 055-065

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**Volume 2 Selected Papers**

# Objectives of Financial Statements

**AICPA**

**American Institute of  
Certified Public Accountants**

May 1974

## The "Right To Know"\*

David R. Herwitz

### Summary

The question of *who* has a "right to know" *what* about a publicly held corporation has emerged in the discussions of the Study Group on a number of occasions. At the moment it may be said that the law does not appear to recognize any general, unqualified right to information about the affairs of a corporation. There is an obvious trend under stock exchange regulations and SEC pronouncements toward requiring full and prompt disclosure of all material facts and events relevant to the *financial* position of a corporation; but, at least in the case of the SEC developments, the focus seems to be as much on preventing unfair trading advantages for insiders as on validating anyone's right to know. Developments with regard to information about nonfinancial matters, such as protection of the environment and minority employment practices, are very much in a state of flux; but there does not appear to be any requirement that corporations disclose such data unless it is financially relevant.<sup>1</sup>

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\* This paper was submitted to the Study Group on the Objectives of Accounting in August 1972. Footnote one was added subsequent to that date.

<sup>1</sup> The following discussion does not deal with the question of whether stockholders by an appropriate vote can compel management to disclose non-financial information. In recent years a number of stockholder proposals for disclosure of information about corporate activities in areas of public concern have been made under SEC Proxy Rule 14(a)-8; and while none of these proposals have attracted widespread support, they have dramatized the increased interest of the investing public and society at large in the matter of corporate societal responsibility. For an excellent discussion of this subject, together with the related topics of shareholder efforts to compel broader disclosure through actions to inspect corporate books, and interrogation of management at the annual meeting, see Blumberg, "The Public's 'Right to Know': Disclosure in the Major American Corporation," *The Business Lawyer*, Vol. 28 (1973), p. 1025.

## Financial Information

The starting point for any analysis of this topic is SEC Rule 10b-5, which expressly forbids misrepresentation or other deception in connection with the purchase or sale of any security, and is viewed as impliedly requiring affirmative disclosure of all relevant information. The entire thrust of federal securities legislation, as well as the express reference to purchase or sale of a security in Rule 10b-5 [and in section 10(b) of the Securities Exchange Act of 1934 under which the Rule was promulgated] indicates that Rule 10b-5 is primarily directed at financial information which would be relevant to existing or prospective investors (including, without further delineation herein, many types of creditors). Section 13(a) of the 1934 Act seems to be to the same effect, in requiring every issuer of a registered security to file with the Commission such information and reports as the Commission may require "for the proper protection of investors and to insure fair dealing in the security" (although perhaps the Commission could find support in this broad language for compelling disclosure on a broader front if it chose to do so). Accordingly, in thinking about whether and when there may be a right to know, it seems useful to look first at financial information, and consider later other types of data relating to an enterprise. (However, it must be kept in mind that any dichotomy along this line is far from clear-cut; for example, even if it is assumed that general information about a firm's impact on the environment is outside the normal bounds of financial data, certainly a clear prospect of liability under existing antipollution legislation would be relevant financial information under the most traditional standards.)

To take the polar case under Rule 10b-5 first, there is no doubt that insiders (including the corporation itself) and their tippees must disclose any relevant nonpublic financial information they may have to existing shareholders before purchasing shares from them. But notice that this result may rest entirely upon the notion of fair play on the part of insiders toward the stockholders they are supposed to be serving, and does not depend upon any general right to know on the part of stockholders. However, in view of the reference to sale as well as purchase in Rule 10b-5 it was perhaps inevitable that the Rule would also be applied to sales of stock (despite the serious technical obstacle that finding a civil remedy for *buyers* under Rule 10b-5 seems inconsistent with the express but somewhat qualified remedies for injured buyers under sections 11 and 12(2) of the Securities Act of 1933). Finding liability to a buyer, of course, takes Rule 10b-5 beyond the confines of fair play on the part of insiders to existing stockholders, as does applying the Rule in the case of a misrepresentation by one who is not an insider (although that may be rested simply on the traditional legal prohibition against affirmative misstatements).

A more testing question as to the scope of Rule 10b-5 comes when one who is not an insider (whether he acts as buyer or seller) is guilty of mere nondisclosure, as distinguished from an affirmative misstatement (or a half-truth). Under common law principles, there was doubt whether any obligation to speak arose in an ordinary arm's-length transaction, absent some special relationship such as that of a fiduciary to his beneficiary. Hence

the construction of Rule 10b-5 (which, it should be recalled, does not expressly require disclosure except where necessary to prevent something that has been said from being misleading) to require disclosure by insiders to selling stockholders might have been premised on the view that the relationship between insiders and stockholders was "special,"—quasi-fiduciary—leaving intact the common law insistence on some special relationship as a condition for requiring disclosure; and this indeed was the early view of Rule 10b-5. But the more recent developments indicate that the courts are moving in the direction of finding that Rule 10b-5 requires disclosure of any material, nonpublic information (except perhaps the product of a person's own effort or imagination) by any buyer to his seller, or vice versa. Even so, query how constructive it is to think of this as a right to know on the part of the complaining party; it may be as aptly thought of as a localized version of the abolition of "caveat emptor" in favor of "caveat venditor."

Much more consistent with a general right to know on the part of investors is the growing trend toward requiring publicly held corporations "to make prompt and accurate disclosure of information, both favorable and unfavorable, to security holders and the investing public." Sec. Act Release No. 5092 (October 15, 1970) was expressly reaffirmed by the Commission in Sec. Act Release No. 5263 (June 22, 1972). Release No. 5092 emphasizes that this obligation is not satisfied merely by fulfilling the periodic reporting requirements to the SEC (including the required reporting of important events within ten days after the end of the month in which they occur); the company "still has an obligation to make full and prompt announcements of material facts regarding the company's financial condition." The disclosure policies of the various stock exchanges are in the same vein. For example, the New York Stock Exchange's "Policy on Timely Disclosure" starts with the following statement: "A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities."<sup>2</sup>

What is the authority for this requirement by the Commission and the Exchanges of prompt public disclosure? Of course the Exchanges have the power to promulgate reasonable rules governing the conduct of the companies whose stock is listed thereon; and the Commission's Release seeks to draw some support from that, expressly referring to the "rules and directives of the major exchanges" embodying a "policy of prompt corporate disclosure of material business events." But the real enforcement arm here, potential civil liability, is more likely to flow from violation of SEC rules and regulations than those of the stock exchanges (although the possibility of suspension from trading or delisting by an Exchange must be kept in mind), so the Commission's posture becomes the most important one. In any event, note that this broad, general disclosure requirement goes beyond the scope of Rule 10b-5 as discussed thus far, for it is not confined to situations where

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<sup>2</sup> *New York Stock Exchange Company Manual*, A-18; accord, *American Stock Exchange Company Guide*, pp. 101-114.

an insider or anyone else is personally taking advantage of the information not yet released to the public; in addition, it is not aimed principally at protecting existing stockholders of a company, as distinguished from the investing public at large. Instead, this insistence on immediate full disclosure seems to rest on a kind of "integrity of the marketplace" footing, or, a right to know on the part of all of the investing community. Indeed, the SEC Release concludes with the observation that prompt disclosure of material corporate developments is necessary "so that investor confidence can be maintained in an orderly and effective securities market."

On the other hand, there are some intimations in Release No. 5092 which indicate that it may stem largely from Rule 10b-5. Thus the Release notes that unless the policy of providing adequate information is followed, a company may not be able to purchase its securities, and the insiders may not be able to trade its securities without running a serious risk of violating Rule 10b-5. The Release does not contain any suggestion that a failure to make the prompt disclosures called for would subject the company or its management to liability to market buyers or sellers even if the company and its insiders were not trading. Is that because Rule 10b-5 would not support liability in such a case? Not according to Professor Bromberg, who suggests in his article, "Disclosure Programs for Publicly Held Companies—A Practice Guide,"<sup>3</sup> that there could be liability under the Rule in those circumstances. As he notes, the *Texas Gulf Sulphur* case held expressly that the company could be liable to market buyers and sellers for publishing *misleading information* even though the company was not itself dealing in its shares.<sup>4</sup> However, it must be noted that this does not reach the question of whether a company has an affirmative obligation to disclose current developments, such as the ore strike in *Texas Gulf*. Similarly, in most of the other cases cited by Professor Bromberg there had been some affirmative statements, which became misleading upon the failure to go on to disclose other pertinent information, thus bringing the situation squarely within clause (2) of Rule 10b-5, prohibiting any omission to state a material fact which is "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

Of course, the line between simple nondisclosure, and a failure to disclose something which is needed to prevent what has already been said from being misleading, can be quite obscure. For example, *Heit v. Weitzen*,<sup>5</sup> one of the cases cited by Professor Bromberg, held that the publication of financial statements which did not disclose that substantial amounts of the corporation's income resulted from overcharging on government contracts constituted a violation of Rule 10b-5, for which market purchasers might recover against the corporation. While in a sense this might be viewed as

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<sup>3</sup> *Duke Law Journal* (1970), pp. 1139, 1144.

<sup>4</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F2d 833, 860 (2d Cir. 1968).

<sup>5</sup> 402 F2d 909 (2d Cir. 1968).

"mere" nondisclosure of an independent fact—the overcharges on the government contracts—it is equally appropriate to regard the published financial statements as affirmatively misleading for lack of an offset to the reported income figure, and/or a contingent liability on the balance sheet. (Parenthetically, it might be noted that in making Rule 10b-5 applicable in this type of case, no one supposes that it will actually induce public revelations about overcharges; rather the hope is that the additional risk of liability under Rule 10b-5 will lead to a cessation of overcharging.)

In any event, the court in the *Texas Gulf Sulphur* case expressly disavowed any unqualified obligation to publicize all material corporate developments immediately. Rather, the court specifically reserved the right of the corporation to refrain from publicizing information about the possible mineral strike long enough to allow the corporation to pursue its own interests by acquiring additional mineral rights in the area. As the court put it, "the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and the SEC."<sup>6</sup> However, this was coupled with the warning that insiders, including the corporation, must refrain from dealing personally in the company's stock, or revealing the information to outsiders, during any such period of nondisclosure. (The aforementioned disclosure regulations of the Exchanges also recognize that a corporation may delay disclosure in order to serve some legitimate corporate interest, but they call for immediate disclosure in any event if widespread rumors develop or there is evidence of trading by insiders or tippees; SEC Release No. 5092 is silent on this.)

Thus it appears that the fundamental theme of Rule 10b-5 (and of the Exchange disclosure regulations as well) is the prohibition against unfair advantage to insiders or their tippees, not the right of the stockholders, or the investing community at large, to have prompt access to all relevant information. (It may also be noted that protection of existing shareholders is not an absolute. For example, take a case like *Texas Gulf*, where it is good news that is not disclosed promptly although this may serve the best interests of the corporation and hence indirectly the main body of the stockholders, it will certainly put at a disadvantage any existing stockholders who sell during the period of nondisclosure, while benefiting any outsiders who buy the stock during the period of the market rise when the information is finally made public. Thus the interests of selling stockholders, once the principal beneficiaries of Rule 10b-5, are subordinated to those of the corporation, so long as no insiders are taking advantage of the undisclosed information.) Incidentally, Professor Bromberg acknowledges also that the basic thrust of Rule 10b-5 is toward fairness more than information as such. In his book, *Securities Law: Fraud*, he comments that the primary goal of the Rule is to promote fairness in securities transactions by limiting the trading of insiders with secret information and then goes on to criticize those commentators who

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<sup>6</sup> 401 F2d at 850, note 12.

“have lost this perspective and treated 10b-5 as though it were an absolute requirement for disclosure.”<sup>7</sup>

Without attempting to make any forecast for the moment, I would not be surprised to see Rule 10b-5 continue developing more in the direction of this semi-penal emphasis on barring unfair advantage than toward a broader recognition of a right to know (although, of course, these two themes are often quite parallel). To illustrate, suppose an employee of the Federal Reserve Board, overhearing a decision to change interest rates which will be announced shortly, goes into the market for his own account before the public disclosure. I suspect that the employee would be found liable under Rule 10b-5 to those with whom he dealt (if they could be traced), in order to discourage this kind of conduct, although no one has a right to know this information until the proper announcement. Compare this with a case in which a company like Texas Gulf has made a major discovery on which it is delaying disclosure for bona fide corporate reasons. If the company were to disclose this information in the interim on a confidential basis to a lending institution with which it was negotiating for a promptly needed loan, I doubt that there would be liability to anyone else under Rule 10b-5, despite a general right to information on the part of the investing community, because the limited disclosure was in pursuit of a proper corporate objective (although the company might be liable if the lending institution breached the confidence and used the secret information in the market). Of course the situation would be different if the company were dealing with several lending institutions and made the disclosure to some but not all; that would be improper, just as it would be if the company made the disclosure to a few favored stockholders or prospective stockholders. That is because investors must be treated fairly vis-à-vis one another, and not, it would seem, because of a right to know on anyone's part.

### **Nonfinancial Information**

Assuming that a distinction can be drawn between financial and non-financial information, the case for a right to know about nonfinancial matters would seem to be even weaker than with regard to financial data, at least under the regulations of the SEC and the Exchanges, with their heavy emphasis upon the integrity of the market and protection of investors. And former Chairman Casey of the SEC is on record in several speeches as opposing any effort to move the Commission beyond its normal sphere of financial data and into a kind of indirect policing of social policies like environmental protection and civil rights. Nevertheless, there have been some developments on the borderline between social responsibility and financial information that may be instructive. In Sec. Act Release No. 5170 (July 19, 1971), the Commission called attention to the fact that some of its requirements governing disclosure of legal proceedings and description of registrant's business might well “relate to material matters involving the

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<sup>7</sup> 1971, p. 275.



environment and civil rights"; in particular, the Release notes that disclosure is required when compliance with legislation relating to environmental quality may necessitate significant capital outlays, or materially affect the earning power of the business, or cause material changes in the business. In addition, a company must disclose any material legal proceedings arising under statutes relating to the protection of the environment, such as the Federal Water Pollution Control Act and the Clear Air Act. Similarly, disclosure is required of any legal proceedings arising under civil rights legislation which might result in the cancellation of a government contract, or termination of further government business, or sanctions imposed for violation of the non-discrimination rules of any federal regulatory agency.

More recently, Sec. Act Release No. 5235 (February 16, 1972) promulgated proposed amendments to the Commission's registration and report forms designed to specify more precisely the disclosure required in Release No. 5170 relating to environmental matters. The proposed amendments are generally consistent with Release No. 5170, but they go somewhat further in (1) apparently requiring disclosure of any pending governmental proceedings, whether or not material amounts are involved, and (2) calling for disclosure of any proceedings "known to be contemplated" by governmental authorities against the company.

These proposed amendments have been sharply criticized by Mr. Hornbostel of the Financial Executives Institute, as well as by a spokesman for an American Bankers Association Securities Subcommittee. One of Mr. Hornbostel's objections is that requiring disclosure of the effect that environmental compliance "may have" on capital expenditures, earnings and competitive position would amount to requiring forecasting, at a time when the legal and accounting issues involved in publishing forecasts are still very much under study. He also contended that a company should not be required to "forecast" the actions of government authorities by attempting to report on proceedings against the company that were merely "contemplated" by such authorities.

However these current SEC proposals work out, they are obviously well within the traditional financial framework. As is well known, much of the current debate goes well beyond this, pressing strongly for a greatly heightened corporate recognition of social responsibility, and urging more disclosure in general and development of accounting techniques in particular to help dramatize these concerns and measure performance relating to them. Thus Professor Schwartz of Georgetown Law School, who was very active in "Campaign G M," notes in his article, "Corporate Responsibility in the Age of Aquarius,"<sup>8</sup> that securities laws are supposed to be concerned with not only protection of investors but also "the public interest," and he finds a public interest "in learning of the social performance of public companies." He urges "a study of disclosure rules under the proxy and periodic reporting requirements to devise areas of inquiry about the public sector of a com-

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<sup>8</sup> *The Business Lawyer*, Vol. 26 (1970), p. 513.

pany's activities," and adds that "accounting rules could be examined for means for describing social costs which at present are not absorbed by the company."

In a subsequent article,<sup>9</sup> Professor Schwartz criticizes SEC Release No. 5170 for taking "a needlessly narrow concept of the role of the SEC"; he contends that instead "the SEC should search for ways to define clearly what must be disclosed and to develop understandable requirements that a court can enforce, rather than look for reasons not to do so." He describes the potential advantages of such a broader disclosure requirement in these terms:

Shareholders need pertinent information about the impact of corporate decisions, and not just for the purpose of being able to decide whether earnings or stock prices will be affected. Rather, since the shareholders' position in management's election is what legitimizes management's power, shareholders should be able to make decisions on the basis of adequate information before they make themselves part of the process. Institutions that are concerned with public welfare should be especially mindful of this relationship.

There is also a great indirect value involved in the disclosure of this kind of information. Disclosure can work like a market mechanism. The disclosure of unflattering information imposes a cost—the cost of embarrassment—which might quickly turn into the cost of consumer retaliation. To avoid paying that cost, companies would have to change the facts required to be disclosed should they be embarrassing. Thus, disclosure would lead to the employment of more blacks, the abatement of pollution, or the production of safe automobiles so as to avoid recall.

But there is another side to the disclosure coin in the social responsibility area, as Professor Ruder of Northwestern University, who is largely in philosophical agreement with Schwartz, noted.<sup>10</sup> After arguing that public corporations should use their corporate power and assets to satisfy public obligations, he adds the following observations (without any express recognition of how disquieting they may be):

Since it is probable that in the short run the earnings and dividends of a corporation which recognizes public obligations will not be as great as are those of corporations which do not recognize such obligations, management's decision to forego short run profits will probably be material to the average shareholder. Thus, a management policy determination to pursue public obligations may become a material fact which must be publicly disclosed. Failure to do so

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<sup>9</sup> *Georgetown Law Journal*, Vol. 60 (1971), p. 57.

<sup>10</sup> *University of Pennsylvania Law Review*, Vol. 114, (1965), p. 209.

may give rise to liabilities for the company and for corporate management.

Whatever the merits of Professor Schwartz's views, the important point in the immediate context is that he does not purport to rely upon any basic legal right to know doctrine; rather he looks principally to a broadened scope for Rule 10b-5 and other traditional disclosure weapons (sparked perhaps by allegedly enlightened self-interest on the part of stockholders). Indeed, speaking more generally there does not appear to be any authority for a legally-recognized right to know on the part of society about the affairs of publicly owned corporations simply because they are large and powerful and may have a very significant impact on substantial segments of the public. However, one commentator, Schoenbaum, does claim to detect some development of a doctrine along this line:

In recent years a new policy basis for corporate disclosure has emerged. Its scope is not yet clear and it has not yet received formal recognition in the law, but its significance cannot be underestimated. This is the idea . . . that disclosure has a role in regulating corporations as major power centers of our society. Acceptance of this wider role of disclosure to any degree is to say that there is a direct relationship between corporate disclosure under the securities laws and corporate responsibility.

The novelty of this view should be emphasized. It would mean that disclosure is not merely investor-oriented but society-oriented. The efficient allocation of capital resources is secondary to the ethical and moral aspects of disclosure—and ethics and morality encompass more than merely restraining overreaching by insiders. The heart of the problem is getting at the impact of corporate behavior on society, not only as to its financial affairs, but also in the areas of civil liberties, the environment, health, safety and consumer rights.<sup>11</sup>

It is to be noted that even Professor Schoenbaum looks ultimately to the SEC to develop this as a viable, working doctrine. He decries the barrier imposed by the current SEC emphasis on disclosure as relating merely to investors and the investing community. He observes that it is already “commonplace for corporations to recognize that disclosure should relate to the social influences of the business and its responsibility to society” in their annual reports, and urges the Commission to fashion rules requiring and governing the inclusion of such information in the annual reports. These additional comments may also be of interest:

. . . the addition of society-oriented disclosure rules to present Securities and Exchange Commission regulation need not involve a

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<sup>11</sup> “The Relationship Between Corporate Disclosure and Corporate Responsibility,” *Fordham Law Review*, Vol. 40 (1972), pp. 565, 578.

departure from the principle of profit maximization or require the acceptance of a totally new concept of corporate duty. It would merely be a recognition of the fact that the large corporation is not a private and autonomous institution, but is a community asset which is public in its conduct, its mores and its impacts. The basis of increased disclosure is simply that although a corporation exists to maximize profits, society has a right to be informed of the undeniable public impact of its actions.

Greater corporate disclosure requirements would have two important effects. First, corporate decisions which have a societal impact would be more open to public view. There would be increased debate among the public and among the corporation's shareholders concerning many decisions. Shareholder and public opinion would act as a check on management and stimulate executives to higher ethical standards regarding public interest matters. . . .

A second result of increased disclosure would be to expose those areas of corporate behavior which cannot be reformed internally, but which must be dealt with through government action and legislation. The theory here is that disclosure is the least restrictive form of regulation in that it provides an incentive for self-reform. But there will be matters which can be corrected only through direct action by government. Disclosure would provide a basis for knowing when new laws are needed and, just as important, when they are not needed.<sup>12</sup>

It remains to be seen whether these views will ultimately prevail.

Just for the sake of completeness, let me add that Leonard Savoie's article with the inviting title of "The Public's Right to Know,"<sup>13</sup> does not reach these newer developments, but rather is addressed principally to traditional financial information and the importance to the accounting profession of satisfying the public's desires and needs in this area. And in an interesting reverse twist on the right to know, the Court of Appeals for the Second Circuit has just decided, in *Frankel v. SEC*, that the Freedom of Information Act does not require the Commission to allow a private plaintiff to inspect and copy the Commission's investigatory files on Occidental Petroleum, which had been the subject of a suit by the SEC for violations of Rule 10b-5, terminating in a consent decree.

### **Whose Statements Are They?**

This question has arisen in a variety of contexts in the Study Group's discussions. In one sense, it is not really a live issue at all at the moment; for it is almost universally stated or assumed that a company's financial state-

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<sup>12</sup> "The Relationship Between Corporate Disclosure and Corporate Responsibility," *Fordham Law Review*, Vol. 40 (1972), pp. 565, 578.

<sup>13</sup> *Financial Executive*, Vol. 36 (1968), p. 20.

ments are both representations of the management and the ultimate responsibility of management. True, there may be some inconsistency between this view and the acknowledged power of the accounting profession to dictate the rules under which management must prepare "its" statements, but this role of the profession has long been viewed as fully justified because of the need to control the inherent self-interest of management in the results shown by the financial statements.

Nevertheless, the question of whose statements they are may have special relevance in connection with the right to know issue, especially in relation to nonfinancial information. For even if corporate managements have become somewhat inured to the control exercised by the profession over *how* to report financial results in the traditional accounting statements, there might be a good deal more resistance to any effort by the profession to determine *what* information is to be reported. After all, if there is any significance in the notion that the financial statements are management's, it might at least be taken to mean that the question of what the financial statements are to report upon is a matter for management to decide. So there might be some force in an objection to pressure from the accounting profession for the addition of a whole new dimension to management reporting, such as societal data; and this would be especially true if the profession was not prepared to take a significant share of responsibility in connection with the new reporting. (Incidentally, similar observations might be made about pressure on management to publish its forecasts.)

Before concluding, it is worth mentioning that research to date has turned up only one searching examination of the "whose statement" question on the merits, not surprisingly by Mr. Herbert Miller.<sup>14</sup> Mr. Miller observes that although the statements are usually said to be management's, the constraints of generally accepted accounting principles and the rules of the SEC leave management with only limited control over "its" statements. Thus the statements end up as "the product of mixed responsibility, of compromises, of successful and unsuccessful persuasion by the CPA, and of chain-reaction imitation of what has been done in some other set of financial statements." He concludes with the following observation: "It seems reasonable to expect that all interested parties, including management, would gain if the CPA more aggressively sought and assumed greater responsibility in connection with the financial statements with which he is identified."

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<sup>14</sup> "Audited Statements—Are They Really Management's?" *Journal of Accountancy* (October 1964), p. 43. An article by Frese and Mautz in the March-April 1972 *Harvard Business Review* accepts the traditional view and urges that management should accordingly become more deeply involved in accounting policy issues.