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FROM THE VIEWPOINT OF THE ACCOUNTANT

BY RODNEY F. STARKEY

I have been asked to discuss the questions of practice under the securities act of 1933 and the securities exchange act of 1934.

So much has been written and said on the subject of the hazards and the burdens which have been laid upon business men by these acts that any discussion of the subject will of necessity be somewhat repetitious. However, I intend as nearly as may be to confine my discussion to two major topics: the particular aspects of the securities act of 1933 and the regulations issued thereunder which have made it excessively burdensome to prepare the accounting sections of registration statements and a brief outline of certain procedures which have been followed in making examinations for that purpose.

It is a bit premature at this time to attempt to go very far into a discussion of the question of practice under the securities exchange act. The new act appears to make it necessary for any person suing to prove reliance on the statements, which would tend to make the liability provisions as affecting accountants somewhat less onerous than under the securities act. As you know, only very tentative regulations have been issued for temporary registration of listed companies under this act. Under these regulations it would seem that after the listed companies have complied with the temporary registration requirements, any reports and financial statements made available to security holders and/or stock exchanges may be considered to have been filed pursuant to the securities exchange act, and those responsible may be considered subject to the liability provisions of section 18. It seems to me, therefore, that for all practical purposes the standard of care to be used in the preparation of any financial statements and such registration statements as later may be filed should be the same as that followed in the preparation of registration statements under the securities act.

* Addresses delivered at the annual meeting of the American Institute of Accountants, Chicago, Illinois, October 16, 1934.

A typical example of the results of the burdens imposed by the securities act and the regulations may be found in the registration statement, with the auditor's certificate, filed by the American Water Works and Electric Company, Incorporated, about seven months ago. This company was one of the first large companies to register its securities. A great deal was written at the time commenting on the fact that the auditor's certificate contained 1,350 words, that the registration statement had approximately 200 pages, that the prospectus consisted of 60 pages and that the complete set of documents filed with the registration statement, including all exhibits, ran into something like 1,800 pages. Incidentally, the cost of obtaining a copy of the registration statement alone, at the present rate per page for photostating, would be $40 and the cost of obtaining the complete registration statement with all documents would be $360. This appears to be a perfectly amazing document to offer the average investor for his protection and to allow him an opportunity to study the background of the company before he makes his investment. I am told, however, that another company which is now considering registration has estimated that the registration statement, the prospectus and all of the exhibits to be prepared and filed, if piled together, would be taller than the company's president.

Certainly these documents have not accomplished the purposes of the act. I am sure that the framers of the act were not so sanguine as to have hoped that the information could be furnished in such form as to be intelligible to the average investor. It was intended, no doubt, that the information compiled for registration statements would be available to analysts who would, in turn, be able to furnish investors with the salient features. Nevertheless, because of the extremely heavy penalties which the act placed on the issuer, its officers and the experts involved, not only for misleading statements, but for the omission of any material facts which might make the statements misleading, those who have been concerned with the preparation of such registration statements as have been filed have not felt that it was advisable to omit any of the details which have been given.

It has been the experience of my firm that notwithstanding the fact that we had been acting as regular auditors for all of our clients which have filed registration statements, and for a considerable period prior to the actual date of filing, it has taken us at least twice the amount of time to complete an examination of the

balance-sheet and related statements for the purpose of registration as it previously had taken to make regular annual examinations.

This additional time and resultant expense has been caused primarily by the seemingly endless elaboration of detail and explanatory material which has been furnished in the registration statements, in the attempt to avoid the omission of material facts and also by the additional effort expended to check and cross-check the accuracy of the details which are required both by the act itself, either specifically or by implication, and by the regulations issued by the commission.

Undoubtedly the amendments made to the act this year will be helpful—more so, of course, to the directors and officers than to the experts—but the basic fault underlying both the securities and exchange acts is still existent: namely, the theory of rescission whereby a purchaser may recover heavy penalties for honest mistakes which might bear no direct relation to the causes of the loss. As long as this distorted theory of justice to investors remains in these acts it will be difficult to approach the task of preparing accounts for registration without undue trepidation at the hazards involved. Such a state of agitation can not but have a tendency to warp one's judgment and the result is bound to be the adoption of a super-cautious attitude. Also, while this condition continues, registration statements are apt to be exceedingly unwieldy documents and in the last analysis will tend to be more confusing and misleading to investors than most of the prospectuses which were issued before the enactment of this legislation.

There is no doubt that the new prospectuses issued under the securities act are very much more honest than the few really bad prospectuses which were issued before the act. However, to my mind, there is no question that they are not as satisfactory as the former good prospectuses. Prior to the enactment of the securities act great care was given to the choice of the important information for prospectuses; selection and emphasis were considered far more important than quantity. The former good prospectuses, so to speak, were put through a sieve, but this condition may be very difficult to develop under mandatory requirements. Incidentally, it is the opinion of the best lawyers who have studied the securities act that the investor will get more effective protection under section 12 of the act referring to prospectuses than he can ever expect to get under section 11, referring to registration statements.

These difficulties are not entirely questions of administration on the part of either the present securities and exchange commission or its predecessor, the securities division of the federal trade commission. The commissioners have a very difficult problem and from the experience I have had with them I can say without hesitation that they are approaching it in an entirely sympathetic attitude and with a real desire to be helpful to business men as well as to prospective investors. The commissioners recognize that the results have not been satisfactory and are determined to reduce to the greatest possible extent the bulkiness and unwieldiness of both registration statements and prospectuses.

The commission charged with the duty of administering both acts has been given very broad powers by these acts to prescribe the form of reports, the details to be shown in the balance-sheet and earnings statement, the methods to be followed in the preparation of reports, in the appraisal and valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income and investment and operating income, and such further information as may be necessary or appropriate for the proper protection of investors.

During the past few years all the larger stock exchanges in the country have been adopting more and more comprehensive rules designed to enhance and expand the amount of information which should be furnished to or made available to investors. In all these efforts accountants have coöperated to the full extent. A noteworthy example of the efforts of accountants in this direction is outlined in the bulletin sent in January, 1934, to all members of the American Institute of Accountants containing correspondence between the special committee on coöperation with stock exchanges of the Institute and the committee on stock list of the New York Stock Exchange. It is particularly of interest to note that the suggestions of the Institute's committee were promulgated in September, 1932, some time before the securities act had ever been drafted.

There is, however, one most important and fundamental distinction between these efforts at raising the standards to be followed in making reports to investors on the one hand by stock exchanges, business executives and professional accountants and on the other by compulsory regulation through the medium of a federal commission. A voluntary movement can always attain

higher standards because of its flexibility. Regulation by an outside commission, however, no matter how intelligently and sympathetically administered, of necessity has a rigidity which must prove irksome, and, because of such rigidity, the standards set never can reach as high a plane of perfection as can the more flexible standards adopted and followed voluntarily without regulation. The first method is undoubtedly the more progressive and more satisfactory method. Self-government with a minimum of regulation will always be the ideal of an intelligent people.

Since the passage of the securities act a very large part of the criticism which has arisen has been levelled against the regulations promulgated by the federal trade commission for the administration of the act. Undoubtedly these regulations calling, as they do, for elaborate details of certain balance-sheet items have proved to be exceedingly burdensome for the few large companies which have attempted to register and particularly those which have been in business for a longer period of time.

For example—

The details of ledger value, cost, profits to affiliates, unrealized appreciation and other historical information required for all major classifications of property, plant and equipment from organization or, if not practicable, beginning January 1, 1922.

The comparison requested for the amounts of depreciation taken for financial purposes with the amounts claimed for federal income taxes for every year for which federal income tax returns have been filed.

The several schedules requiring cost and other statistical information for each investment, without specific limit of the period of time to be covered.

Similar historical statistical information required for the capital-stock and surplus accounts.

The result of these requirements has been that, although the financial statements originally were designed to be of assistance to investors, the balance-sheets, profit-and-loss statements and related schedules with the explanatory notes in several of the registration statements which have been filed for the larger companies have comprised approximately two-thirds of the total number of pages included in the registration statement. Furthermore, it is safe to say that at least 50 per cent. of the schedules furnished

contained historical statistical information of no interest whatsoever to the layman, information that he could not possibly understand, but, because the information was included in the registration statement the issuer, its officers and directors and the experts jointly and severally are subject to the exceedingly heavy liability provisions of the act in the event that honest mistakes have been made in its compilation.

With reference to the requirements on details of fixed assets and investments, personally I believe there has been entirely too much stress laid on the values at which capital assets were stated in the accounts. This had led to the oftentimes vicious practice of stating book values of stocks being dealt in on the stock exchange as if these book values had a real significance. I am inclined to believe that a substantial part of the speculative losses of the last few years has been due to this unwarranted faith in that intangible something which asset values are supposed to represent.

It is very difficult, however, to determine exactly how much of this condition is the fault of the regulations and how much is the fault of the act itself. In schedule A of the act, items 25 and 26, balance-sheets are called for "showing all of the assets of the issuer, the nature and cost thereof whenever determinable, in such detail and in such form as the commission shall prescribe, and all liabilities of the issuer in such detail and such form as the commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created." In addition, "a profit-and-loss statement showing earnings and income, the nature and source thereof and the expenses and fixed charges in such detail and such form as the commission shall prescribe." These provisions in the act have imposed on the commission a difficult and responsible task. It would be easy for them to play to the congressional gallery by taking the safe position and by insisting on more and more extensive details in registration statements; however, I am confident that the members of the commission realized that such an attitude would have a distinctly adverse effect on the economy of the country and that they are willing to take the responsibility of preparing regulations under the present acts which will impose as little burden on registering corporations as possible.

One of the most complicated practicable problems which the commission has to face is that all corporations are not homogeneous and that the regulations issued will have to be complied

with by large and small, seasoned and unseasoned corporations and that between both extremes there lies a great variety of accounts. Generally speaking, there are three possible solutions to this difficulty. The commission can issue one set of forms so comprehensive in detail that all types of corporations can use it, albeit not satisfactorily. They can promulgate a variety of forms which would lead to endless confusion as to which form is adaptable for a specific company. Or they can publish their regulations on a basis of as much flexibility as is possible under the acts as they stand at the present time. This latter procedure, to my mind, would be the most eminently satisfactory one.

For many years accountants have been attempting to improve the standards of presentation of financial statements and the extent of disclosure to be contained in these statements. However, the theory of rescission which underlies both of the acts, with the consequent heavy liabilities incurred for misleading financial statements, has probably given a weight and a prominence to the presence of these statements which can not exist. One most important and practical aspect which will have to be faced in the preparation of registration statements is that the wrong inferences may be drawn by the uninformed investor. One of these inferences is that the most important factor underlying the success or failure of business enterprises rests in the correct preparation of accounts relating to the past history of these enterprises.

It is interesting to note that since the passage of the securities act, the preponderance of issues registered and presumably sold to the public has consisted of the most speculative enterprises, viz., financial and investment companies, mining companies, breweries, distilleries and other ventures of similar character. Such issues have furnished the larger part of the new investment material during the last year and a half. In all fairness it should be said that every effort has been made by the federal trade commission and by its successor in the administration of the two acts, the newly formed securities and exchange commission, to see that no one should be misled into believing that the government in any way intended to guarantee these speculative issues. Nevertheless, it seems to me that there is a great possibility that many of the small investors who have purchased such securities have done so with the feeling that in some way the securities have been accredited by the government of the United States.

This is a very real danger both to the government and to all the accountants who have participated in the preparation of registration statements; and this danger will continue. As accountants, therefore, we are vitally interested to see to it that a campaign of education of investors is undertaken so that the limitations adhering to financial statements for companies whose securities are admitted to registration by the commission will be more clearly understood.

One of the most radical changes brought about by the enactment of these two securities acts has been the complete abolition of the privity of contact between our profession and our immediate clients. Incidentally, this condition apparently has been aggravated by the amendments to the liability provisions of the securities act of 1933. By these amendments, officers, directors and others do not have to sustain the burden of proof affirmatively that they had reasonable grounds to believe and did believe that the statements were true and that there was no omission to state a material fact, but they need only show from the negative standpoint that they had no reasonable grounds to believe and did *not* believe that the statements were *untrue*, etc. According to several prominent attorneys this reversion to the negative attitude will serve to lessen to a great degree the responsibility of officers and directors, but it in no way relieves the expert, that is, the professional accountant, appraiser or engineer, except to the extent that one expert may rely on a report of another. This can only mean that regardless of the source of our instructions or regardless of the person responsible for our fees, our ultimate client is now the investor, and it is to him that we are directly responsible for our part in the presentation of accounts.

Aside from the preparation of the accounts themselves, the content of the accountant's report and the explanatory notes appended to the accounts are of great importance. The radical increase in responsibility which came with the passage of the securities act means that until a great many years have passed and there have been legal decisions rendered which shall have clarified a large number of questions surrounding the presentation of accounts, every accountant signing a registration statement will have to be ready to sustain the burden of proof as against any investor and to the satisfaction of the courts that he had complied with all the requirements laid upon him by the acts. This is going to make it necessary for the accountant to have available, at

all times within the statutory period allowed by the acts, sufficient evidence to show that his examination was conducted properly, that the scope was as extensive as required by the acts and that in his report he discussed all the things which might have affected the judgment of the investor.

Because of the lack of precedent, it may be a rather difficult matter to sustain the burden of proof that an accountant's examination was as extensive as contemplated by the acts.

The first general effort undertaken by the profession to establish standards for accountants' examinations and the presentation of financial statements was made in 1917. At the suggestion of the federal trade commission, a committee of accountants and the federal reserve board issued the first bulletin *Verification of Financial Statements*. This bulletin was subsequently revised in 1929 and has remained unchanged since that time. In the preface and in the general instructions to this bulletin, its very definite limitations are clearly indicated, and it is stated that the procedure described is designed primarily for industrial and mercantile concerns. However, since this bulletin is the only outline of standard practice and procedure, in spite of its limitations, it would seem that the accountant charged with the necessity of sustaining the burden of proof that his investigation was a reasonable one at least should be in a position to show that his examination, generally speaking, was as extensive in scope as that contemplated by the bulletin.

Doubtless, there will always be a certain amount of controversy as to some of the procedures outlined in this bulletin. At the present time, however, it is the only document of its type in existence, and failure to comply with the suggestions contained in this bulletin might entail very serious consequences in the event that an accountant signing his report in connection with a registration was made party to a suit.

Even in the case of public-utility companies it is possible to go through this bulletin item by item, and with a very few exceptions the procedures suggested can be followed. The procedures and practices outlined in this bulletin are given as suggestions only and if the accountant finds it necessary to deviate in any material particular from these suggestions he should be able to explain the reasons for such deviations in his report or should have careful notes in his permanent files containing such explanations.

I believe that accountants may well profit by the example of many attorneys who keep a careful diary of each case, outlining from day to day all important discussions and questions raised and their ultimate disposition. Such a diary produced in court at some later date, if necessary, would certainly furnish the clearest and most convincing evidence of the care used in conducting the examination.

Recently the suggestion was made in a meeting with certain of the commissioners, which received immediate approval by all concerned, to the effect that there should be compiled a book of instructions, either gotten out by the commission itself directly or prepared with the assistance of accountants and sponsored by the commission; this set of instructions to take the place of the present bulletin *Verification of Financial Statements* for the specific purposes of the securities acts. Since the commission has such wide powers for administering these acts, the effect of such a book of instructions would be exceedingly helpful to our profession and would serve to a great extent to clarify for the future the procedures and practices which should be followed to constitute a reasonable investigation.

It is always a very difficult thing when faced with an entirely unmeasurable hazard to keep one's equilibrium. Five years hence the hazards of these acts which now loom up so fiercely to us, as professional men, may have proved to be entirely insignificant. As a relatively new profession in this rapidly changing world, however, we are now finding ourselves at an exceedingly crucial point.

I should like to offer the following practical suggestions for the preparation of registration statements. These suggestions to a very large extent constitute a résumé of advices from attorneys and others in connection with the preparation of registration statements which have been filed with the benefit of discussions with the examiners for the commission who review the statements.

Accountants' reports or certifications, as they are termed by the present regulations, may be expected to include three general types of comments on the accounts of registering companies: First, they should outline such matters as relate to the extent of the examination which, although not considered by the accountant as matters which should have been covered to make his examination a reasonable one, might be assumed by laymen or by the courts to have been covered. It is very often astonishing to

find that people usually well informed have an entirely different conception of the extent of an accountant's examination from that contemplated by the accountant himself. Possibly, to a certain extent, this confusion has been enhanced by accountants; perhaps there has been too much of an air of mystery and obscurantism about the whole thing. In the circumstances, it would seem to be a policy of wisdom to see to it that the ordinary restrictions to the regular examinations are adequately commented on in the reports.

For instance, in spite of all of the controversy on the subject there is still a very definite confusion in the minds of a great many people as to the extent of the responsibility which an accountant can accept for the inventories at a given date. When we sign a certificate without qualification of inventory values, what we mean, of course, is, accepting the quantities and condition of the items inventoried, as vouched for by responsible officers, we have satisfied ourselves that the valuations of these items as applicable to a going concern, have been carefully and accurately made, in the aggregate, at approximate cost or on some other clearly described basis. My suggestion is that such a statement should be incorporated, where applicable, in the accountant's report.

There is also what seems to be an entirely unwarranted idea that accountants should accept definite responsibility for the valuation shown for plant assets and other fixed assets. Time and again financial writers have commented on this phase of accounting. Why should we not see to it that a clear description is given of the cost or other historical basis of valuation of such assets both in the accounts and in the certificate, and that this basis generally is not considered as subject to the fluctuations of current market quotations or price levels?—Assuming of course that this is the condition which we find.

The extent of verification of other items, such as accounts receivable, reserves for doubtful receivables, claims recoverable, contingent liabilities, etc., if not as extensive as that contemplated by the federal reserve bulletin would also be essential to a more clear understanding of the meaning of an accountant's certification. With respect to all items of this nature, it should be clearly indicated in the accounts that the amounts shown are stated on the basis of a going concern.

In the case of contingent liabilities, particularly, a definite statement as to procedure should be included. An example of

this will be found in the description attached to the schedule "contingent liabilities" appearing in the certificate of the American Water Works and Electric Company, Incorporated. I quote this in part, "We have received a certificate from a vice-president, the treasurer and comptroller of the issuer to the effect that to the best of their knowledge and belief the issuer and its subsidiary companies had no material contingent liabilities at September 30, 1933, not mentioned in balance-sheet instructions No. 27 of the registration statement. The amounts shown as principal of bonds guaranteed by the issuer have been checked to documents furnished us by the issuer. All the other information in this schedule has been accepted by us, but without responsibility on our part."

In the second group of special comments which one would expect to encounter are matters in the accounts on which the accountant is not in a position to formulate a definite opinion. Such matters are the most difficult ones to distinguish. One of the outstanding examples of the items falling into this group is the provision for renewals and retirements taken out of income by public-utility companies in lieu of provision for depreciation. The entire subject of rate-making is involved in this question and in a large group of public-utility operating companies it is exceedingly doubtful that any two reputable engineers would agree on the exact amount to be provided at a given date to bring the properties down to their going-concern value. It is not a question of attempting to estimate the life of these properties or the salvage value and the resultant simple mathematical calculation of the amount which would be deducted per annum. The supreme court recently has indicated in the case of *The Illinois Bell Telephone Co.* that public-utility properties for all intents and purposes may be considered to be permanent and that for rate-making purposes they should not be written off to their salvage values during a period of years by what is more generally called a straight-line depreciation method. When the accountant is called upon to certify the accounts of public-utility companies, either as a unit or as a group, such as would be found in the larger public-utility holding companies, he is apt to find that he is faced with a question of technical skill and judgment which is not within his province. His only alternative in such cases is to state his position clearly and to refuse to accept responsibility for the amounts provided for renewals and retirements. In such

circumstances naturally the company's officers would want to disclose the basis that they had used in making the provisions for renewals and retirements and should express definitely their opinion that they believe these provisions are fair and reasonable. Obviously the accountant can not attempt to relieve himself of responsibility if he has grounds for belief that the provisions made by the company are not reasonable.

Another instance, and one unfortunately which has been fostered by a suggestion in the federal reserve bulletin, is the question of examining deeds to property. In certain isolated cases such an examination might be practicable, but even if made, the fact that a deed existed which looked like a good deed would not necessarily mean that it constituted a title to the property. Accountants in their reports should state definitely that they are not responsible to the extent of seeing that the company has good title to its properties. It seems as though very little responsibility attaches to attorneys under either the securities act or the exchange act; certainly this is one that should properly belong to them.

Another example is the valuation of certain assets based on reports of other experts, such as appraisers and engineers.

A further example would be valuations given by the board of directors to properties acquired through issue of stock, etc. Practically all of the state laws place a definite responsibility on directors to value assets. Unless the accountant sees some very definite indication that these values are not reasonable, he should clearly state the source and basis of valuation and disclaim any further responsibility.

It would not be practicable in a discussion of this kind to attempt to enumerate further such questions or principles. However, it is not possible to stress too much the importance of the judgment that the accountant must exercise in reporting matters which fall into this category.

There is also a third distinct group of comments. Into this group would fall the larger number of qualifications that have regularly appeared in accountants' certificates for some years. They are usually definite questions of principle and occur in a statement of the accounts where all pertinent factors known to the accountant lead him to form an opinion different from that held by the management.

It seems to me that it must be remembered that the management of a company is the one primarily responsible for the statement of its accounts. The newly developed accountants' certificate suggested by a committee of the American Institute of Accountants, and accepted by the New York Stock Exchange and by the Controllers Institute begins by reciting that the accountant has made an examination of the balance-sheet and the other financial statements. Even in small companies where the accountant will necessarily render a more direct assistance in the preparation of the accounts from the standpoint of the law and certainly from the standpoint of accounting convention the accounts are representations made by the management.

Presumably it will always happen that differences of opinion between the management and the accountants will develop. As a practical matter, of course, the very heavy liabilities imposed on all parties by the securities and exchange acts will tend to a very large extent to prevent issuance of statement of account where there are decided differences of opinion as to the correct statement of certain items. It can not be expected, however, that the accountant's opinion will always be concurred in by the management or vice versa, and such things as the correct statement of accounts receivable before and after reserves, inventories, investments, fixed assets, abandonments of property, general reserves and the inclusion of controversial items in the income account or surplus accounts always will give rise to differences of opinion. In such instances the accountant is definitely committed by the acts to state that he has formed an opinion as to valuations, etc., different from the management.

During the past few weeks a committee of accountants composed in part of some of the members of the American Institute of Accountants, at the request of the securities and exchange commission, has been discussing suggestions for changes in the regulations under the securities act, as amended, and suggestions for regulations to be promulgated under the new securities exchange act. After these discussions had been fairly well completed and a more or less general agreement reached, a smaller sub-committee was appointed to discuss the suggestions with members of the securities and exchange commission. I think I can say without hesitation that every one on this committee has been most favorably impressed with the desires expressed by the members of the securities commission to make every attempt to simplify to

the full extent allowed by the laws, all regulations to be issued under these acts. These commissioners have a very difficult administrative task to perform, and they have approached it most sympathetically.

The committee of accountants rendered a preliminary report to the securities and exchange commission in which the following recommendations were made in summary form:

1. The financial information required should be limited to that which will be of substantial value to investors.
2. Uniformity of major accounting principles in a particular industry is desirable as an ultimate objective, though uniformity in their application may be undesirable. For the present, corporations should be required merely to indicate the principles which are followed.
3. No standardized forms of financial statements should be prescribed. Statements in the form and detail best adapted to the particular conditions should be accepted.
4. There should be coördination of the requirements relative to financial statements for:
   (a) Listing on a national securities exchange;
   (b) Registration statements and prospectuses under the securities act of 1933;
   (c) Annual reports.
   This would entail substantial modification of the present regulations under the securities act.
5. The commission should endeavor to advise investors as to limitations of financial statements as guides to the value of investments.
6. If the commission should decide to require quarterly reports, these reports should consist only of income statements; they should be issued promptly; they should be in condensed and comparative form; and they may be based on estimates if necessary.
7. The commission should encourage corporations to adopt their natural business years as fiscal years.

To my mind the most important recommendation is the fifth, stressing the question of education of investors as to the limitations of financial statements as guides to the value of investments.

Profit-and-loss statements and balance-sheets must necessarily be based to a very large extent on a combination of judgment and estimates, and their real value to an intelligent investor lies in the guidance they may afford him as to the probable future results of operations.

Certain periodic expenditures such as rents, interest and wages can be determined with a fair degree of accuracy, but these are

not the only elements which enter into the determination of the profits of a business enterprise. In the case of a going concern, for instance, how much can be realized from the ultimate collection of the accounts receivable? How much will the inventories of raw materials, goods in process and finished goods realize when sold? What can the investments be considered to be worth at a given time? How much depreciation or depletion or amortization has been accrued on physical plant, franchises and other fixed properties? All such questions call for technical skill and the application of judgment. Furthermore, it must be realized that the estimates made, in the light of circumstances then known, may be revised from time to time as new factors are discovered.

Without doubt, a review of all profit-and-loss statements, issued by large companies in past years, with the intent of discovering the misstatements which had been made on the basis of honest estimates, which later proved to be incorrect, would show startling results. Notwithstanding this, however, it would not be logical to take the position that the significance of statements of operations depends entirely upon their ultimate accuracy.

These and other basic factors underlying the preparation of all financial statements as of a given date, although thoroughly understood by accountants and by many business men as well, are not clearly appreciated by investors generally. This lack of clear understanding of the significance, the value and the limitations of financial statements on the part of the investing public has, of course, been the outstanding reason for the great storm of protest which arose on the passage of the securities act of 1933 at the inclusion of such heavy liability provisions.

The committee of accountants, at the request of the securities and exchange commission, submitted in draft certain specific suggestions for revised instructions to be issued for the registration of securities under the securities act and for the registration of securities on a national security exchange as provided by the securities exchange act. In making these suggestions the correspondence between the Institute's committee and the New York Stock Exchange, already referred to, was drawn on to a very large extent.

The outstanding features of these suggestions were, first, that so far as possible the commission in its regulations should avoid insisting on inflexible forms of financial statements; second, that the most important thing to accompany financial statements of

registering corporations should be a statement of the accounting practices followed by the registrant.

Further, that in such a statement of accounting practices the question of consistency was of the utmost importance, and that a registering corporation should be required to indicate the effect of any material change in its practices from year to year.

It was also urged that wherever possible all historical information in the form of schedules for fixed assets, investments, capital stock, etc., should be eliminated, if not specifically required by the act itself.

No one can foretell what may be considered necessary for an accountant to sustain the burden of proof in court under the liability provisions of either the securities act of 1933 or the securities exchange act of 1934.

Perhaps too much emphasis has been laid on the unlimited liabilities of the acts, although unquestionably the hazards of continuing in professional practice have been greatly increased. However, if it has been possible for the accountant signing a registration statement to satisfy himself that he has been dealing with a client who is both ethical and responsible; if his examination has been complete and extensive so that it can be favorably compared with such other standards as have been raised voluntarily by the profession, for example, the federal reserve bulletin *Verification of Financial Statements;* if he has satisfied himself that his report and the statements covered by it outline, first, the accounting practices followed in the preparation of the accounts; second, such limitations of the scope of his examination as were considered necessary; and, third, the effect of any differences of opinion between himself and the management of the company as to the valuation or correct presentation of the accounts—then it seems to me that he is in a position to accept his responsibilities with the courage that comes from the confidence engendered by a piece of work well done.

FROM THE VIEWPOINT OF THE ATTORNEY

BY A. I. HENDERSON

Discussion of the securities act has tended to concentrate on the severity of the liability provisions and the technical difficulties of compliance with regulations of the commission with respect to financial statements. This is natural, since the problems they presented were immediate and pressing. Much less consideration has been given to the effect which the securities act, and to an even greater extent the securities exchange act, may have on general principles and methods of accounting, particularly on the conception of the general purpose and nature of financial statements. If my views are correct this legislation will ultimately bring about important changes in accounting practices and methods. I believe that the practical problems which arise under the acts should be considered from this broader point of view if accounting is to develop along sound lines, and I shall try to discuss some of those problems on that basis. You will realize, however, that this involves considerable conjecture and that my views must be taken as suggestions, not as final legal conclusions.

Practice under the two acts will, I believe, become substantially uniform—both because I think the commission will adopt regulations with that object in view and because it will be impossible in practice to maintain two different standards of accounting. I shall not, therefore, attempt to distinguish between the two acts.

I am not sure that it is generally recognized, but I think the exchange act is much the more important in its effect on accounting. It imposes liability for false or misleading statements in the financial statements of every corporation with a listed security. The commission will probably require that quarterly statements be filed in most cases. Furthermore, the principles established in the exchange act and the standards developed for financial statements subject to that act may well have a substantial effect on the development of the common law with relation to financial statements which do not fall under the act.

The most important change in the law made by these acts is the extent to which the field of responsibility of the accountant has been broadened. In the past every accountant relied to a greater or less extent on the theory that he was only responsible to the

corporation that employed him to audit its books and that there was no practical responsibilty to the public, although this theory was qualified by judicial decision, notably by Judge Cardozo's opinion in the *Ultramares* case. The securities act and the exchange act, so far as statements filed under those acts are concerned, have entirely superseded this theory. In effect, the accountant, if he fails to exercise due care, is responsible to every investor, and the accountant must sustain the burden of proof that he exercised due care.

At first glance, the increase in the number of persons to whom the accountant may be liable seems to be the most important feature of this change in the law, since it greatly increases the danger of bedevilment by suits. Actually, I think the more important feature, in its effect on accounting methods, is the nature of the persons to whom accountants have been made responsible.

The officers of a corporation whose books the accountant audits have full knowledge of the affairs of the corporation; they are familiar with accounting practices and conventions. It is most unlikely that financial statements which have been prepared with even moderate care should mislead them. On the other hand, the investing public is not skilled in accounting, nor are most judges and juries. Accounting is a closed book to them. The investor generally regards a balance-sheet as a statement of fact rather than a statement of opinion. He does not recognize the limitations of figures as a means of showing financial condition. The misleading nature of financial statements will therefore, I believe, be determined not on what such statements convey to persons of substantially equal skill and knowledge, but on what they convey to persons who are not familiar with accounting practices and conventions. While an accountant may obtain a great deal of protection through footnotes to the financial statements and qualifications in his certificate, a balance-sheet and income statement which are plastered with footnotes and accompanied by several pages of qualifications are not very satisfactory in either practice or theory.

The acts clearly indicate that the purpose of publishing financial statements is to give information to the investor, not merely to check the bookkeeping of the corporation. I think the best protection for the accountant is to recognize this purpose and to approach the preparation of financial statements with it constantly in mind. When an accountant considers the form in

which an item should be presented, he should try to place himself in the position of a layman and use the form of presentation which would be most effective in giving that layman a fair picture of the facts. He should not cling to accounting conventions which have no necessary justification; they will be a constant source of trouble. A balance-sheet is not and can not be a statement of fact; it must always be largely a matter of opinion. But I believe it is desirable to make it an opinion based as little as possible on artificial conceptions.

Nearly every balance-sheet carries certain items as assets which in no sense constitute real assets. It may be necessary to carry these items as assets, but in many instances I think the method followed is traditional. I am not convinced that a change in practice might not result in fairer balance-sheets and more accurate income statements. Recently I heard an accountant criticize the practice of certain corporations of charging bond discount against income for the year in which the bonds were sold, instead of setting it up as an asset and amortizing it over the life of the bonds. His reasons, of course, were that the practice made the income statement for future years inaccurate. I am not sure that he was right. He ignored the fact that from another point of view his method also made the income statement for future years inaccurate. He ignored the fact that he was setting up an entirely conventional asset on the balance-sheet; that the same information could be given to the investor by a statement of the practice of the corporation, and that such a statement would be more intelligible to most investors. He also ignored problems which arise with such an asset, if the bonds are retired before maturity.

I am not urging that immediate abandonment of established accounting conventions, even if they are unnecessary. Any such action would result in confusion and damage. At best, changes of this kind can only be made gradually over a considerable period of time. I believe, however, that development in accounting practice along this line will result not only in protection for the accountant, but also in increasing the value of financial statements to investors and others who are entitled to rely on them for information.

Another important point in the exchange act, in which it differs from the securities act, is the fact that a person who sells a security in reliance on a false or misleading statement as well as a

person who buys a security in reliance on such a statement has a right of action. As a result of this provision liability can arise from understatement as well as from overstatement. By understatement I mean an understatement of favorable factors or an overstatement of unfavorable factors. It is true that liability for understatement exists at common law, but for various reasons it is not of much practical importance. Its importance under the exchange act should not be overemphasized. It is impossible to suppose that conservatism will be penalized to the same extent as exaggeration. Nevertheless, I think it requires some change in point of view on the part of accountants and others who prepare financial statements, and there are many situations where it may be of real importance.

There is another theory of accountants that I am afraid will not stand up under the acts. Many, if not all, accountants maintain that they do not prepare the financial statements but merely certify that the statements prepared by the corporation fairly represent the financial condition of the corporation as shown by its books. This theory may be sound; although, if you analyze your actual practice, I think you will realize that it is hard to reconcile the theory with the facts. I certainly do not think that accountants can rely on it for any great measure of protection, although it may give some protection in certain cases. I do not think anyone believes that a court will relieve an accountant of liability where there is a false figure on the books, which also appears in the balance-sheet or income account, unless the accountant can show that he was not negligent in failing to discover the error. The difference between that obvious case and a misleading presentation of particular items seems to me to be only a matter of degree, not of substance, and I do not expect the courts to make any such distinction. Whether or not the accountant actually "prepares" the financial statements is, I am afraid, largely immaterial. He is expressly made liable under the securities act and although he is not named in the exchange act, I think it must be assumed that an accountant is a person who makes, or causes to be made, statements in financial statements filed under the act, and therefore, liable under Section 18, unless the courts decide otherwise.

The book value of fixed assets is in most cases an artificial figure. It does not represent realizable value or replacement value. It is usually nothing but a bookkeeping figure which

may be based on cost, independent appraisals, the judgment of the directors and a number of different factors. There is little doubt, however, that the average investor regards this figure as representing a number of dollars which can be realized in one way or another. It is true that skilled investors know that this view is not correct, and they recognize that it does not purport to be a realizable value, and that it is the general practice to treat it as an artificial figure. Nevertheless, I do not believe that it is safe to rely on this general practice. One reason for my belief is that, while the practice is to treat the figure as a book figure, there is and can be no uniformity in the method used in arriving at the book figure. The accountant should, therefore, indicate clearly the fact that the figure is a book figure and also indicate what it does not show. I am not suggesting that the amount shown on the balance-sheet should be changed or that the accountant attempt to estimate a realizable value or that he insist on obtaining an appraisal. That would be obviously impracticable and would disrupt corporate accounting. But I believe that the nature of the figure should be clarified, that, as far as practicable, the bases on which it is determined should be shown, and possible misconceptions of its nature should be negatived. This can best be done by a footnote to the balance-sheet.

There may also be problems arising from liability for understatement in this account—always keeping in mind, however, that the danger of liability from understatement should not be exaggerated. When the book figure is clearly less than the actual value of the property, I do not think that fact can be ignored. Suppose, for example, that a corporation has acquired land for $100,000, which is carried on the balance-sheet at cost, and a vein of gold has been found on the land so that its value is greatly increased, and the accountant has knowledge of this. I do not believe that it is safe to carry the land at cost on the balance-sheet and to leave this fact unnoted, even though there has been no write-up on the books of the corporation and none is contemplated. I do not mean by this that the accountant should attempt to estimate the increased value of the land, but there should be a note on the balance-sheet indicating that the cost figure does not represent the present value and that the present value may be in excess of the balance-sheet figure. If there has been an appraisal or other determination of the value, the footnote should probably disclose that figure. A similar problem is

presented when property which has been fully depreciated, but still has a substantial value, is not carried on the balance-sheet.

Investment securities present analogous problems. If the securities are carried at cost and the value has greatly increased, the problem is the same as in the example I have given of land. If the securities are carried at market value that may be misleading if the block is so large that it can only be disposed of at substantially less than current quotations or if the block represents control and is, therefore, worth substantially more than current quotations. The value at which stock of a subsidiary is carried may also require consideration. If the value is substantially less or more than its liquidating value, as shown by the books of the subsidiary, that should be indicated. In some cases, however, that may not be enough. A statement that the value on the balance-sheet of the parent company is the book value shown on the books of the subsidiary is not very informative and may be insufficient, even though the balance-sheet is accompanied by a balance-sheet of the subsidiary. It may be necessary to incorporate the substance of any notes on the balance-sheet of the subsidiary in a note on the balance-sheet of the parent company.

Items such as patents and goodwill, which are ordinarily, and I think properly, carried at a purely nominal value, present similar questions. If the value at which patents are carried on the balance-sheet is a nominal one only and if, in fact, the patents so carried bring large royalties to the corporation, or are responsible for substantial income to the corporation, a note to this effect should be made. However, I do not think the accountant should attempt to put a dollar value on the patents.

Goodwill may, perhaps, be treated somewhat differently. I think there is a question whether any such item as goodwill has ever belonged on a balance-sheet, but, since it is recognized that it may be so carried, is it safe to omit goodwill entirely, or carry it at $1.00, if it is clearly an important factor in the business of the corporation? I am not sure of the answer, but I incline to the view that no explanation is necessary. Certainly, if goodwill is carried at a substantial value, it will ordinarily require an explanatory note.

Reserves, including the reserve for depreciation, are other items which will frequently require annotation. The basis on which such reserves are set up should, I think, be given. If the reserves vary from those usually considered necessary or if the

accountant believes that the reserves are substantially inadequate or excessive, those facts should be indicated.

The treatment of surplus is a difficult question. Most of the difficulty arises, I think, from the classification of surplus, which is, I believe, an unfortunate practice. The corporation laws which permitted stock without face value are partly responsible for the practice, but the accountants themselves must also share the responsibility.

In my opinion surplus or deficit is only a balancing item on the balance-sheet. It is the arithmetical difference between assets and liabilities, including capital stock. It is important for the investor to know how that difference was created, but I do not think that this can be done accurately on the balance-sheet. I should, therefore, like to see only one item of surplus on the balance-sheet and to have the balance-sheet accompanied by an analysis of surplus, which should show the surplus at the beginning of the period under review and all credits and charges to surplus during the period.

Unfortunately, classification of surplus is such a well established practice that there is little chance that it will be abandoned. I do think, however, that any classification may convey to the mind of the investor certain implied representations which are frequently incorrect and that, therefore, it will often be necessary to annotate surplus so as to deny those implied representations. For example, I am afraid that an item "earned surplus" implies to many investors that the amount is available for dividends and that it is the only amount available for dividends. The availability of surplus for dividends is primarily a legal question and an extremely difficult one. It is often the case that the accountant's figure for earned surplus on the balance-sheet does not conform to the amount available for dividends, in the opinion of counsel for the corporation.

It is also fairly common to see a statement on a balance-sheet that part of the surplus is not available for dividends. The authority for any such statement should, I think, always be stated, such as an opinion of counsel or specific provisions in the charter of the corporation. It is not, however, a statement which I think an accountant can or should make as his own and I think that he may incur liability for so doing if his conclusion happens to be incorrect.

In considering the income statement, I believe that the ac-

countant should realize that it is being recognized more and more as the important statement for the investor—more important than the balance-sheet. As this importance is recognized, the necessity for accuracy becomes correspondingly important. As a practical matter I believe that errors in the income statement are much more apt to be the basis for liability than errors in the balance-sheet. Since a common method of estimating the fair market value is to multiply the earnings per share by 10 or some other arbitrary figure, an error in the income statement is in practice considerably magnified.

Particular care should be taken with non-recurring items. I doubt if general statements will usually be enough. Frequently it will be advisable to specify the nature of the non-recurring items, and when the amounts of such items are available, I believe they should be given.

The effect of depreciation and other reserves on the income statement is so well recognized that it needs little discussion. I feel, however, that too much emphasis has been put on the rates at which depreciation is taken and not nearly enough emphasis has been placed on consistency in those rates, and—what is perhaps even more important—on the valuation of the assets on which the depreciation is based. In many cases where a footnote has been made on the balance-sheet relating to the value at which assets are carried or to depreciation or other reserves, it will frequently be necessary to make a corresponding note on the income statement.

I referred before to the protection which the accountant can obtain by the form of his certificate. There is no doubt that he can protect himself in many respects by his certificate, but I do not think that it is in any sense complete protection. It is important that the certificate correctly state the scope of the examination and that it be accurately phrased. It can, I think, qualify the financial statements by excluding certain questions which have not been covered because they are outside the field of accounting. It will often be advisable to include a statement of the principles and methods which have been followed, such as the method of taking inventory or of checking accounts receivable. I do not believe, however, it is desirable to use the certificate as a substitute for footnotes on the balance-sheet. If any item in the balance-sheet requires qualifying or explanatory comment, I believe it is much better practice to carry those comments,

wherever practicable, as footnotes to the balance-sheet, although they may also be included in the certificate. In other words, I do not think that a certificate should be used to correct an incorrect balance-sheet. Furthermore, I do not think that when a matter is really within the field of accounting a statement in the certificate that the accountant does not take any responsibility for it will necessarily be an effective defense against liability. For example, I think it is probably effective to state in the certificate that one is not responsible for the validity of legal title to the properties of the corporation. I think it is doubtful if a statement that the accountant did not check the accounts receivable will relieve him of liability, in the absence of valid reasons for not making such a check. I recommend that so far as possible notes in qualification and explanation of balance-sheet items should appear on the balance-sheet as notes to the particular items affected and not as qualifications in the certificate or at least that items which are qualified in the certificate should carry a specific reference to the certificate. A properly annotated balance-sheet, with a short and simple certificate which accurately describes the scope of examination, is, I think, more desirable and probably more effective than a treatise on the things which have not been done. I recognize that this may lead to cumbersome notes and strange looking balance-sheets. Perhaps the answer is that if the notes make the balance-sheet look ridiculous, it is time to consider whether or not the items in the balance-sheet do not need revision. Probably a good many balance-sheets would be substantially improved by revision. I hope to see the number of notes required constantly decrease as accounting develops and improves.

The accountant can also obtain some protection from certificates furnished by officers of the corporation to the effect that all facts within their knowledge have been disclosed. Such certificates are valuable, but they must not be relied on to take the place of the work which the accountant should do himself. The purpose of such certificates is to enable the accountant to check the facts which he has discovered through his examination, not to take the place of the examination.

Another very important matter for the accountant's own protection is the manner in which he keeps his working papers and records. It is important not only for the accountant but also for the officers and directors of corporations whose accounts he audits that he should keep complete records of the work which he does

and that these records should be prepared at the time the work is done and should be signed by the man who does it. Such records will be the chief evidence which he will have in any suits which may be brought against him in reference to financial statements. Working papers and records may do more harm than good, however, if they are not entirely accurate. It is very easy for rough working papers to contain statements which are not entirely accurate and will be corrected in the final report. Nevertheless, the existence of such a paper, which contradicts the final report, may be a difficult thing to explain in a court several years later in the face of a hostile examination. Even more important is the danger of including inferences, opinions or recommendations in working papers, which, for one reason or another, are not followed in the report. For example, a junior accountant, in going over the books, may make a note that a certain entry is in his opinion incorrect. His seniors, however, may not agree with this conclusion and may overrule him. In such cases I think it is essential that the records should show that the conclusion of the junior accountant was overruled, not overlooked, and the reasons for which it was overruled. The best way to avoid those difficulties, however, is to insist rigidly that working papers be entirely accurate, be confined so far as possible to facts and shall not include premature conclusions or criticisms.

I have so far discussed only those things which the accountant should do in order to protect himself. In the effort to protect himself, the accountant must remember that he owes a duty to the corporation which employs him. There are certain risks involved in doing business as an accountant and those risks must be recognized and accepted. It is perfectly possible that by leaning too far backward an accountant may place corporations and their officers and directors in an extremely difficult position which is not justified by the facts. It is a fairly common practice for accountants to write reports or memoranda recommending changes in the methods of accounting followed by a corporation. I do not mean to discourage accountants making such recommendations in unqualified terms where they believe that they are essential to a sound and honest presentation of the financial condition of the corporation. I do wish to point out, however, that the form of such recommendations, if they are matters of opinion, is important. Such memoranda should clearly indicate that they are matters of form or judgment and not of substance, so that if the

officers and directors do not elect to adopt the recommendations it will not appear that they have followed improper methods against the advice of the accountant when, in fact, this was not the case. From the accountant's own point of view such memoranda also may be extremely dangerous. I can think of no surer way by which an accountant may make himself liable than to have produced in court a memorandum submitted by him to a corporation criticizing the methods of accounting of the corporation in a matter of substance, followed a few months later by published financial statements which he certified and in which his recommendations are not adopted.

I may have given the impression that I am very critical of the two acts. While I believe experience will prove that the acts require amendment in many respects, and that there is far too much emphasis on detailed information, I believe that the purpose of the acts is sound and that many of their provisions will prove to be of real benefit. While the securities act sometimes appears impossible to work under, I think that the securities commission is sincerely trying to facilitate operations under that act and that in a large measure the commission will be successful in that effort. I expect that regulations under the exchange act will be adopted which will prove workable.

I believe that this legislation will give accountants a real opportunity to develop the practice of accounting on sound and constructive lines. Let me repeat that accounting practice should develop on a basis which recognizes that the purpose of financial statements is to disclose the financial condition of a corporation and that such statements are not academic exercises in intricate accounting methods. Failure to recognize this will result not only in missing the opportunity for constructive improvement of accounting practice but will also greatly increase the dangers of liability for accountants. To put it another way, I believe accountants should deal with the problems which may arise on a common-sense basis, that the solution of doubtful questions should be guided by an endeavor to render financial statements as intelligible as possible to unskilled investors, and that accounting practices and conventions which are confusing to the investor should be discouraged.