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THE GOVERNMENT'S RESPONSIBILITY FOR THE
REGULATION OF ACCOUNTING REPORTS

ADDRESS

of

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Governmental responsibility or, as some term it, governmental control is often talked about as if it were a take-it-or-leave-it choice -- as if the choice were between no responsibility or control, and complete and absolute control. This is a serious misconception as to the choices available and also as to the role of government in the past. The choice is not whether or no, but how much and by what methods.

As to accounting reports, I shall assume that what is meant are the certified financial statements intended for the general public, or at least for the public security holders of the company. Governmental policies and regulations may influence to some extent, and may often control, the form and content of financial statements furnished privately to a large creditor or stockholder, or to other special persons. Indeed much governmental control of accounting reports had its origin in private litigation between a debtor and an individual or a small group of creditors. But government's responsibility for such statements is of an order quite different from that attaching to statements intended for public consumption.

We may also exclude from consideration financial statements furnished to the government solely for its special purposes. In such cases, the interests of third parties are at a minimum and the basis of presentation rests solely in the discretion of the particular authorities, except for statutory or constitutional limitations and subject to review in some respects by the courts.

With the rapid increase in use of the corporate form of organization, the subdivision of ownership and its separation from immediate control of operating policies, accounting reports have become something akin to a standard of measurement of the securities they reflect, a sort of securities yardstick. While investors cannot expect to obtain from financial statements all or even the most important information necessary to the exercise of their investment judgment, nevertheless financial statements come close to being the only common measuring rod of different companies. If investors who have no first-hand knowledge of the size, nature, income and expenses of a business (such knowledge perhaps was customary in an earlier era of smaller and more localized enterprises) purchase securities on the basis of price or reputation alone, their action is akin to purchasing goods without knowing their quantity, their grade, or their condition. This public use of accounting reports as yardsticks is the basis for government's responsibility for their regulation.

The need for standards of measurement is by no means novel. In an earlier day the flow of trade in the market place was hampered by the existence of diverse monetary media of uncertain value, by uncertain and conflicting systems of weighing and measuring, by dishonest scales and measures, by clipped and base coins. The efforts of progressive merchants and the demands of the public interest in commerce first led to establishment of local customs and means of enforcing them. Later the problem of providing these prime essentials was assigned to government, and the outgrowth has been standard coinage and currency, and standard weights, measures, and grades. Enforcement, at first by penalties, has been supplemented by governmental inspection of scales, of the goods themselves, and more recently of advertising and the description of the contents.

In the field of credit one striking example of the exercise of governmental authority to establish standards has been in the field of negotiable instruments. Again introduced by merchants to supply a business need, the idea has been adopted and standardized in essentials first by court decisions; later by uniform statutes. The most recent legislation of this type, the Trust Indenture Act of 1939, seeks to assure certain characteristics to public bond issues. Attempts not dissimilar in objective have been made to standardize securities other than evidences of indebtedness. Even corporation statutes as they permit or deny characteristics to securities and their issuers and attach liabilities and immunities, rights and duties, may be viewed in somewhat the same light.

In discussing the means by which government may discharge its responsibilities as to public accounting reports it is first desirable to determine of what such reports consist. It seems to me that conceptually complete certified statements have three ingredients:

First, a system or philosophy of accounting;

Second, a system or philosophy of reporting the results of transactions recorded by the operation of the accounting system;

Third, the review and opinion of an independent expert accountant.

It has often been said that accounting, in the sense of my first point above, is man made, essentially utilitarian, and without separate existence. In so far as this may be true, accounting may be thought to be based almost solely on expediency and would thus reflect the ideals and objectives of the particular economy, or even the particular business.

On the other hand, accounting may be viewed as an attempt to reflect basic economic concepts such as income, profits, costs, and capital values. Different schools of economic thought may place different emphasis on these concepts, or subscribe to different philosophies as to their optimum relationship and as to the best means of securing the desired relationship; yet such concepts appear to have an existence independent of the particular social, political or business organization. In this view, accounting may be thought to have a derivative independence and not to be merely an expedient, even though in being adapted to use by individual units of society the underlying economic concepts have had to be modified to some extent and have been made subject to assumptions whenever the measurement of particular factors on a truly theoretical basis is impractical or impossible.

In this field of accounting principles, the courts as one branch of the government have long been exercising a directive influence. This influence, however, is largely fragmentary and infrequent. As in other fields, the disputes which are settled by litigation are but a fraction of those arising. Moreover, the issues presented seldom are framed as accounting problems. In the greater number of cases the approach of the court is through such concepts as liability, duty, fraud and intent, rather than the accountant's language of sound, conservative, generally accepted, and consistently maintained principles.

The recent case of *Ebbert v. Plymouth Oil Company** may illustrate the problems of this type of governmental control. In that case officials of the company had caused the expenditure of corporate monies in a suit against them. For some seven years, these expenditures were shown as a deferred charge on the balance sheet without explanation, and were then charged to earned surplus. The precise issue was whether plaintiff's suit was barred by inexcusable delay or whether the treatment amounted to such a concealment as to enable the plaintiff to maintain suit within a reasonable time after discovery through the charge to earned surplus. On this question the court said, in part: "We think, however, the ordinary person is not to be visited with knowledge of this technical terminology, and so far as the plaintiff is concerned what the statements conveyed to her was that this large sum . . . was an asset of the corporation and amounted to a concealment of its true nature . . ." Treatment of these expenditures as a deferred charge is doubtless to be condemned on accounting grounds. Consequently, the court's result could also be reached by saying that these expenditures were not proper deferred charges since they neither represented the cost of past services whose benefits might equitably be spread over several periods, nor the cost of services to be rendered in the future. The language of the opinion, however, may imply that in financial statements one may use with safety only terms which would be self-explanatory to a person who knew nothing of business or finance, no matter how customarily and widely such terms were employed. Moreover, it would seem that one who took care to inform himself of customary usage would be in a worse position than one who intentionally or negligently did not. Although the accountant's certificate does not appear from the opinion to have been before the court, the *Journal of Accountancy*** has indicated editorially that the nature of the item was there explained.

A second method of discharging the government's responsibility is by the adoption of statutes which codify accounting principles. Corporation statutes occasionally prescribe or prohibit particular uses of surplus, classify surplus according to its origin, require consideration of certain items such as depreciation, or state rules of valuation as criteria for the permissibility of particular financial acts. However, few if any, prescribe rules for what most concerns the accountant--what is income, when is income, what is an expense, when is an expense. None include an integrated scheme of accounting. Indeed, enactment of detailed statutes is probably neither practicable nor, in the present state of accounting technique, at all desirable. It has been proposed, however, that a uniform law of accountancy, preferably Federal, is a desirable step.*** According to its sponsor, such a statute would not be all inclusive but would codify only those principles upon which agreement could be reached after a relatively short discussion.

A third method of exercising governmental control is by delegation to an administrative agency of power to prescribe or prohibit accounting practices in the fields subject to its regulation. Such power may extend to the prescription of uniform systems of accounts and the

* 13 Atl. (2) 42 (Pa. 1940)

** Editorial, 70 *Journal of Accountancy* 2 (1940)

*** Frederick S. Fisher, *Legal Regulation of Accounting*, 55 *Journal of Accountancy* 9, 27 (1933); *The Integration of Legal and Accounting Concepts, Papers on Accounting Principles and Procedures*, The American Institute of Accountants (1939).

prohibition of any accounting records inconsistent with those required. This method of assuming responsibility is most commonly employed in dealing with relatively homogeneous businesses which are affected with the public interest. Utilities, utility holding companies, and common carriers are the most usual examples. In most cases these powers are granted not for the primary purpose of controlling the accounting policies of the companies but as a means of accomplishing the basic intent of controlling certain aspects of the business. To the extent that the accounting prescribed serves as the basis for presenting information to the public, such accounting powers result in government responsibility for the portrayal of financial condition and results of operation which is placed before the public.

When the administrative powers run only to reports filed with the agency, and do not include powers to control a company's own books or statements to other persons, governmental responsibility is perhaps limited to the area of use of reports filed with it, but its influence often extends into other fields. By setting examples, conflicting practice in related fields is placed on the defensive. Even when an agency does not exercise or does not have power to prescribe the accounting to be followed, its influence on trends of thinking may be significant and in a sense responsibility goes hand in hand with influence. Under such circumstances, government should encourage the establishment and consistent application of sound accounting principles.

To summarize this section, I feel that prescription of accounting standards within homogeneous industries is feasible and is necessary if regulation of the industry is desired. A warning must be attached that, when this is done, government assumes also as to that field a major share of the responsibility for continued improvement and clarification of the accounting principles to be followed. In the variegated and ever-changing pattern of industrial and commercial activity it is preferable, for the present at least, to leave formulation of accounting standards to business and its professional accounting advisers, assigning to government the dual function of requiring by statute, if necessary, the observance of accepted standards and of insisting upon and participating in continuous efforts to clarify and accelerate the development of accounting thought.

The second ingredient of accounting reports, which I have mentioned above, is the principle of disclosure to be followed. Here, particularly, the use to which the report is to be put is of importance. Much of the discussion as to single and multi-purpose statements revolves not around "accounting principles" but rather around what omissions of known information are permissible and how far, and in what groupings, the detailed information in the records may be condensed. A collateral problem is what information excluded by custom or necessity from the accounting records, as such, must be noted in the statements lest the bare figures lead to unwarranted inferences. One might mention here such matters as restrictions on surplus, liquidating preferences, contingent liabilities, bases of valuation, and the degree of consolidation. The contrast between the interests of various types of readers is at once apparent. Short term creditors, for example, may attach little or no significance to liquidating preferences, while the same information may be of vital importance to the prospective purchaser of common stock.

In this field as in others governmental responsibility has been reflected in court decisions, and here the terms of the law, such as fraud, _____ or misrepresentation, are far more apposite. The question may perhaps be raised as to whether in the long run liability will not be premised

upon failure to observe sound and generally accepted accounting principles and sound accounting principles of disclosure, rather than upon the rather tortuous reasoning sometimes found. Except in a few instances, statutory prescription as to the nature and detail of reports appears to have been rudimentary. Requirements for a statement showing the assets and liabilities are not infrequent, but standards capable of direct application are only infrequently found.

The greatest assumption of responsibility by government in this field, however, has been through the medium of administrative agencies. State utility and insurance commissions and the Interstate Commerce Commission, for example, have prescribed uniform systems of accounts and have been granted varying degrees of visitorial powers. Reports though public have generally been designed with the needs of regulation in mind rather than the problem of presenting information to investors and, as a result, have not been particularly well adapted to the latter purpose. Such requirements have exerted considerable influence on the form and content of the financial reports which the subject companies utilized in their capital and credit seeking endeavors.

Blue sky commissions of the states, and the Securities and Exchange Commission under the two Securities Acts, illustrate the assumption by government of responsibility for reports through the medium of what may be termed disclosure statutes. While authority is given the Commission to prescribe rules of accounting to be followed in prospectuses and reports under its jurisdiction, principal reliance is laid upon full and fair disclosure. Prescription of accounting rules under these statutes is as yet at a minimum for the most part the only requirement is the observance of generally accepted practices.* However, much of the work of the staff consists of consultation with registrants to determine the manner in which generally accepted principles apply to the facts of the particular case. And many of the Commission's published opinions are directed to the same point.

To summarize this section, it is my view that establishment of minimal standards of disclosure by prescription, either directly or by delegation to administrative agencies, is feasible and has resulted in improvement in accounting reports. In view of the importance of accounting reports in the securities market as today constituted, I also believe that this is a necessary governmental responsibility. The objection that statutory minima may become maxima does not appear to have restricted progressive companies to the minimal standards, and does appear to have forced improvement by substandard companies.

The third aspect of the modern accounting report is the accountant's opinion. Largely because of widespread public use of the certificate or opinion the practice of accountancy has become a profession affected with the public interest. Such professions are characterized by the existence of obligations on the part of their members, not only to their employers but also to others who rely upon their work. As in other professions similarly characterized, professional standards and professional ethics become of importance to government as well as to the members. Governmental regulation has taken the form of statutes, court decisions and enforcing agencies such as grievance committees. Thus, use of the designation "C.P.A." has been

* See Accounting Series Release No. 4, April 25, 1938.

restricted in most states to those who meet certain statutory standards as to moral fitness, education, and professional ability. Although the public practice of accounting has not been confined to such persons, the trend seems to be running rather strongly toward confining the practice of those who have not met the standards prescribed to accounting activities which do not involve obligations to the public at large.

Because of the relative newness of the public nature of the profession, court decisions as to professional standards are still in the formative stage and not well integrated. Without seeking here to state the substance of the few existing decisions, there is an observable trend, I think, toward attaching liability to accountants who have permitted use of their names as experts without, however, having made an adequate examination upon which to rest their opinion. I think it is even possible to discern a tendency in this direction, despite express limitations included in the certificate.

Standards of conduct have been incorporated in the regulatory statutes and violations of them are made the basis for exclusion of applicants and for revocation of the certificate. Most professional accounting societies have adopted detailed statements of professional ethics, violation of which is ground for suspension or expulsion. Administrative agencies which require or permit the filing of accountants' opinions as to financial statements have denied the privilege of practice before them to accountants who are not qualified to practice* or who have violated the basic requisites of professional practice.**

One aspect of the problem of professional ethics is worthy of mention since it has been stressed in the rules and regulations of the Commission. This is the question of independence. Shortly after the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 rules were promulgated requiring that under these Acts accountants must be independent of the companies whose statements they certify. Subsequent rules have expanded and defined the concept as to preclude substantial financial interests, relationships such as officer, director or employee, and participation in the internal accounting procedures of the company. Such requirements seem to me indispensable if the objectivity and impartiality of the outside auditor are to be maintained. In part, this principle was adopted by the American Institutes of Accountants in a resolution dated October 15, 1934.

There has also been discussion of the desirability of prescribing standards to be observed by the accountant in ascertaining facts upon which to base his opinion. For the most part, attempts in this direction have resulted in the statutory requirement of a reasonable examination by an expert, or an examination in accordance with the professional standards of the time. Professional societies have sought to define standards of auditing procedure, and in at least one case, that of Savings and Loan Associations, have reached agreement on a rather detailed and positive procedure. Such bulletins are valuable to administrative agencies, and presumably to courts, in measuring particular performances. It may be expected, moreover, that the increased interest and importance of such standards to the public will lead to their further development and

* See Rule 2-01 of Regulation S-X.

** See Rule 11 (e) of the Commission's Rules of Practice.

more precise statement by the profession itself. Until experience should prove the contrary, such a program would, I think, be preferable to the others that have been suggested, namely, the detailed prescription of the scope of and procedures to be followed in the audit program; the general use of direct governmental examinations as in banks or insurance companies; or the placing of sole responsibility on the company with no requirement for review by independent auditors.

It may be appropriate to conclude by mentioning briefly the pertinent accounting provisions of the most recent expression of government responsibility for regulation of accounting reports--the Investment Company Act of 1940. This Act is significant to this discussion in at least four respects:

- (1) It places particular emphasis on reasonable uniformity in accounting principles, and extends to the Commission visitorial and other powers designed to assure their formulation and observance;
- (2) It extends governmental regulation to the general form and content of reports to stockholders; and
- (3) It expressly requires of the certifying accountant adherence to professional standards and minimal performances.
- (4) The selection of auditors is made subject to ratification or rejection by the stockholders.

In general, the approach of this statute to the complex problems of accounting and accounting reports is, I think, representative of that embodied in recent legislation in other fields of industrial and commercial life in which government has come to recognize increased responsibilities. To the extent practicable, definite and precise requirements have been established. Elsewhere, statutory standards and objectives have been laid down in general terms and there has been assigned to an administrative agency the task of working out in detail within definite, statutory framework the means by which such standards and objectives will be attained.