(1933)

AMERICAN INSTITUTE OF ACCOUNTANTS

ACCOUNTANTS

AND THE

SECURITIES ACT

135 Cedar St., New York

Introduction

This pamphlet on accountants and the securities act consists of two papers read at the annual meeting of the American Institute of Accountants, New Orleans, October 17, 1933. A sub-committee of the Institute's special committee on public relations, which has studied the subject, believes that the submission of these papers in this form is the best way of directing the attention of members of the Institute to the many important questions involved in the Federal Securities Act of 1933.

The committee had considered preparation of a special report to members, but the impossibility of making definite recommendations, in view of a number of legal and accounting questions which have yet to be answered finally, led the committee to the conclusion that a formal report would be impracticable.

The papers in this pamphlet represent only the opinions of the respective authors. The Institute's committee is not prepared officially to adopt or endorse the conclusions which the authors have reached. The committee does believe, however, that these carefully prepared papers bring out clearly the problems of primary interest to accountants who expect to undertake engagements within the purview of the securities act. It is earnestly recommended that members of the Institute familiarize themselves with the contents of this pamphlet, together with the form of registration statement and the regulations promulgated by the Federal Trade Commission, which the Institute has already distributed to its members.

The Institute's committee may find an opportunity to suggest specific amendments to the securities act, if the question of amendment arises during the coming session of congress, and, therefore, the committee invites members who have given thought to the matter to submit suggestions which might be helpful.

JOHN L. CAREY, *Secretary*.

New York, October 30, 1933.

Accountants and the Securities Act*

BY SPENCER GORDON

The securities act of 1933 has already been the subject of wide discussion. Its provisions have been analyzed and its historical and philosophical basis expounded on many occasions. It has elicited vigorous criticism and equally vigorous defense.

But the articles that I have seen contain little mention of the duties and liabilities of accountants. We read at length of the effect of the act upon the financial interests and upon the public, but the difficulties imposed upon accountants are of too technical and special a nature to warrant extended mention in articles dealing generally with the statute. In this address I shall direct myself particularly to the problems of accountants, the origin and extent of their responsibility, the defenses available to them in case of suit and the extent of their liability. I shall thus hope to avoid a repetition of much that has been ably said by others and to deal more thoroughly with the parts of the statute which have particular relation to the accounting profession.

WHEN RESPONSIBILITY ATTACHES

The statute provides for the registration of securities with the federal trade commission by the filing of "registration statements" in regard to such securities.

No suit can be brought under the statute against an accountant as such unless he—
". . . has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, . . ." (Section 11 (a) (4).)

See also section 7 in regard to filing the written consent of the accountant so named.

EXTENT OF RESPONSIBILITY

Section 11 (a) (4) provides for suits against an accountant only—
". . . with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by him;"

The officers and directors of the issuing corporation who sign the registration statement and the directors upon whom liability is imposed by the act may be sued with respect to any part of the registration statement. The accountant, however, may be sued only with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by him. He is not responsible for any other part of the registration statement.

* An address delivered at the annual meeting of the American Institute of Accountants, at New Orleans, Oct. 17, 1933.

BASIS OF SUIT

Section 11 (a) provides for suit—

"In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, . . ."

Section 8 provides that the effective date of a registration statement shall be the twentieth day after the filing thereof, with certain exceptions and with further provisions relating to amendments, inaccurate statements, etc. It is apparent that any attempt at literal enforcement of the provisions of section 11 (a) would create an impossible situation, in that, while provision may be made to insure the truth or untruth of statements when they are made or up to the time that a document containing such statements leaves the control of the maker, it is manifestly impossible for anyone except a prophet to make accurate statements of what facts will be twenty days later. This has resulted in the promulgation of article 15 of the commission's regulations, which provides that the statement—

"shall be dated and shall state that such accountant. . . does believe at the time of the date of such certificate that the statements therein are true . . .

"If anything comes to the attention of such accountant or other expert, or he obtains knowledge of any facts before the effective date of registration which would make any of the material items therein untrue or indicate that there was an omission to state a material fact required to be stated or necessary to make the statements therein not misleading, he shall bring such immediately to the attention of the commission."

Volumes might be written as to what is "a material fact" within the meaning of section 11 (a). The American Law Institute has recently issued its *Restatement of the Law of Contracts*. In chapter 15 on fraud and misrepresentation this statement is made:

"Where a misrepresentation would be likely to affect the conduct of a reasonable man with reference to a transaction with another person, the misrepresentation is material . . ."

Relying on this definition I may venture to say that a "material fact" within the meaning of this section 11 (a) is a fact the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding or disposal of the security in question.

The term "registration statement" is defined in section 2 (8) as including—

". . . any amendment thereto and any report, document, or memorandum accompanying such statement or incorporated therein by reference."

Thus any certificate, report and/or valuation accompanying the registration statement would be held a part thereof and might be the basis of a suit.

WHO MAY SUE—LIMITATION—WAIVER

". . . any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue—."

By section 2 (2) the word "person" is defined as including an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization or a government or political subdivision thereof. Suit may be brought under section 11 (a) not only by such a person acquiring the security at the time of the original offering to the public but by any such person who may acquire the security at any time thereafter—

"unless it is proved that at the time of such acquisition he knew of such untruth or omission."

In order to maintain such a suit the person acquiring the security does not have to show that he was misled by the incorrect statement or omission, nor does he have to show that he relied on or even that he ever read the registration statement or any part of it. Unless he actually knows of the untruth or omission, he may purchase the security blindly, and if he later discovers a material misstatement or omission in the registration statement he can take advantage of this as the basis for his suit. The statute places the burden on the defendant to prove that the plaintiff knew of the untruth or omission at the time he purchased the security. The plaintiff does not have to negative this as part of his affirmative case. If, however, the defendant does prove such knowledge on the part of the plaintiff, it is a complete defense to the suit allowed by the act.

The only limitation on such a suit is contained in section 13 providing that—

"No action shall be maintained to enforce any liability created under section 11 . . . unless brought within two years after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . In no event . . . more than ten years after the security was bona fide offered to the public."

Section 14 provides that—

"Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the commission shall be void."

This probably invalidates only a condition, stipulation or provision which has been agreed to by the person acquiring the security in connection with such acquisition. It would hardly be held to mean that a competent person who had once acquired a security could not later, with full knowledge of the facts, give a release of liability or agree to any other condition, stipulation or provision.

DEFENSES

By section 11 (b) certain defenses are allowed, in addition to proof that the plaintiff at the time of the acquisition of the security knew of the untruth or omission:

". . . that before the effective date of the part of the registration statement . . . (A) he had . . . ceased . . . to act in every . . . relationship in which he was described in the registration

statement as acting or agreeing to act, and (B) he had advised the commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement." (Section 11(b) (1).)

While this provision seems to relate primarily to resignations by directors, etc., its language is broad enough to cover the case of the accountant. If an accountant gains any knowledge which makes him wish to repudiate the matter attributed to him before the effective date of the registration statement, he can do so and can escape liability by advising the commission and the issuer in writing that he has ceased to act in the relationship of accountant and that he will not be responsible for the part of the registration certificate attributed to him:

". . . that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge;" (Section 11 (b) (2).)

In the case of the accountant it probably would be unusual for the part of the registration statement attributed to him to become effective without his knowledge, in view of the fact that his written consent is required to be filed under section 7. But such a situation might arise, for example, where the accountant's consent had been forged or had been filed in violation of an agreement to hold it pending further examination of some phase of the registration statement. In such case he may escape liability in the manner indicated:

". . . as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert;" (Section 11 (b) (3) (B).)

This provision deals with the situation which will usually be presented in a suit against an accountant and the defense which will usually be made. Whether or not such a defense will succeed will depend, not upon whether the accountant himself believed that he made a reasonable examination, but upon whether the court or the jury under directions from the court determines that the examination was in fact reasonable in the light of all the evidence in the case. The accountant can testify as an expert as to what he believes is a reasonable investigation and what the practice of accountants is in that regard, and he can produce other accountants to give substantiating testimony, but all that will be admissible only as evidence of what in fact is a reasonable investigation. The same is true of the question of whether the accountant "had reasonable ground to believe and did believe." Those are questions of fact. What the accountants may testify is admissible in evidence, but it is not conclusive.

Thus although the accountant involved may testify that he made what was in his opinion a reasonable investigation and that in his opinion he had reasonable ground to believe, and in fact did believe, that the statements were correct, nevertheless the court or jury, whichever has the duty of determining the facts in a particular case, may find from all the evidence that the accountant has not sustained the burden of proof upon any one or all of these points and that he

has not established that he made reasonable investigation, that he had reasonable ground to believe and/or that he did in fact believe.

The defense that the part of the registration statement which is involved in the suit did not fairly represent the accountant's statement as an expert or was not a fair copy of or an extract from his report or valuation as an expert is self-explanatory. Whether this defense has been established will also be a question of fact. Expert testimony will be desirable in many cases, but will not be conclusive:

". . . as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement of the expert or was a fair copy of or extract from the report or valuation of the expert;" (Section 11 (b) (3) (C).)

The application of this subsection to the accountant appears to be as follows: Under section 11 (a) (4) he can be sued only with respect to matter which purports to have been prepared or certified by him. But in a balance-sheet or profit-and-loss statement certified by an accountant there may be items as to which he indicates that he in turn has relied upon another expert. As to such items, section 11 (b) (3) (C) is a defense if the accountant had reasonable ground to believe and in fact did believe that they were true, etc., and that they fairly represented the statement of the expert, etc.

". . . as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true, and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, and that such part of the registration statement fairly represented the statement made by the official person or was a fair copy of or extract from the public official document." (Section 11 (b) (3) (D).)

Although this subsection would ordinarily be applicable to others than accountants, it is possible that the accountant's certificate may in part purport to be a statement made by an official person or a copy of or extract from a public official document. In such case the accountant will not be held for errors of fact in the statement or document if he had reasonable ground to believe and did believe that the statements were true, etc., and that the official statement or document was fairly represented in the registration statement.

As to each of these defenses the accountant is required to "sustain the burden of proof" (Section 11 (b)). In a trial the burden of proof is ordinarily upon the plaintiff. In all suits brought under section 11 the plaintiff must therefore sustain the burden of proof that there has been, in the part of the registration statement attributed to the accountant, an untrue statement of a material fact or the omission to state a material fact required to be stated in the registration statement or necessary to make the statements therein not misleading, and the plaintiff must also sustain the burden of proof that he has acquired such security, and that the accountant has with his consent been named as having prepared or certified the statement which is the subject of the

suit. If the plaintiff establishes these facts, the burden of proof is imposed on the defendant to establish the defenses allowed under section 11 (b). The term "burden of proof" has been discussed in innumberable cases. Perhaps as good a definition as can be found is contained in the old New Hampshire case of *Lisbon v. Lyman*, 49 N.H. 553, 563, where Chief Justice Doe said:

"The burden of proof (in this case on the subject of emancipation) was on the plaintiff; and this burden was not sustained, unless the plaintiff proved it by a preponderance of all the evidence introduced on the subject. But it was not necessary for the plaintiff to produce anything more than the slightest preponderance . . . Before any evidence was introduced, the scales in which the jury were to weigh the evidence were exactly balanced; if they remained so after all the evidence was introduced, emancipation was not proved; if they tipped ever so little, in favor of the plaintiff, emancipation was proved."

STANDARD OF REASONABLENESS

Section 11 (c) provides:

"In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship."

Broadly speaking, a person occupying a fiduciary relationship is in the position of a trustee, and the duties of trustees have often been the subject of judicial expression. In tentative draft No. 2 of the American Law Institute's restatement of the law of trusts, section 169, the following appears:

"The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill as he has.

"Comments:

"a. The standard of care and skill required of a trustee is the external standard of a man of ordinary prudence in dealing with his own property. A trustee is liable for a loss resulting from his failure to use the care and skill of a man of ordinary prudence, although he may have exercised all the care and skill of which he was capable.

* * * * * *

"b. Whether the trustee is prudent in the doing of an act depends upon the circumstances as they reasonably appear to him at the time when he does the act and not at some subsequent time when his conduct is called in question."

In the conference report on the securities act of 1933, H.R. report No. 152, 73rd congress, 1st session, appears the following:

"The standard by which reasonable care was exemplified was expressed in terms of the fiduciary relationships. A fiduciary under the law is bound to exercise diligence of a type commensurate with the confidence, both as to integrity and competence, that is placed in him. This does not, of course, necessitate that he shall individually perform every duty imposed upon him. Delegation to others of the performance of acts which it is unreasonable to require that the fiduciary shall personally perform is permissible. Especially is this true where the character of the acts involves professional skill or facilities not possessed by the fiduciary himself. In such cases reliance by the fiduciary, if his reliance is reasonable in the light of all the circumstances, is a full discharge of his responsibilities."

Section 11 (c) is, however, a very difficult section to construe in its relation to the accountant, because we have had no previous experience of an accountant as such acting in a fiduciary relationship.

"The performance of the duties of a trustee requires the exercise of a high degree of fidelity, vigilance and ability. Especially is this true when the trustee is a company organized for the purpose of caring for trust estates, which holds itself out as possessing a special skill in the performance of the duties of a trustee, and which makes a charge for its services which adequately compensates it for a high degree of fidelity and ability in the administration of a trust estate." —*Estate of Allis,* 191 Wis. 23.

As the accountant holds himself out as possessing a special skill in the performance of his duties, and as he performs these duties for compensation, if he is to be held to the standard of persons occupying a fiduciary relationship he must exercise a high degree of fidelity, vigilance and ability. Until the section in question has been construed by the courts, I can only say that it seems to increase the measure of precaution that the accountant must exercise to fulfill his duty of reasonable care. He should approach his work as though he were auditing a transaction involving the funds of a widow or minor child for whom he is the guardian or trustee.

EXTENT OF LIABILITY

Section 11 further provides:

"(e) The suit authorized under subsection (a) may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, (2) or for damages if the person suing no longer owns the security."

The first branch of this subsection contemplates a suit brought by a person still holding the security. Upon tender of the security to the person sued, he may recover the consideration paid, with interest from date of payment, less the amount of any dividends or other income received from the security. There is no requirement that the plaintiff be one who acquired the stock at the original offering. Any subsequent purchaer still holding the security may sue under the section.

The liability thus imposed upon the accountant may be largely unrelated to and greatly in excess of any damage caused by the accountant's error. For example, in a $1,000,000 stock

issue, the accountant may have made an untrue statement of a material fact by omitting to mention liabilities of $100,000, which in the average case would presumably have affected the value of the securities, when issued, to the extent of ten per cent. By reason of ensuing business conditions the stock which sold for $1,000,000, and in the average case should have sold for $900,000, had the accountant been correct in his statement, may fall on the stock exchange to a total value of $100,000, the stock which was issued at 100 then selling at 10. In this situation the holders of the stock may tender it to the accountant and require him to pay the consideration that they have given for it with the adjustments heretofore mentioned, so that if all the original purchasers still have their stock the accountant will have to pay approximately $1,000,000 and will receive stock worth only $100,000, a net penalty to the accountant of $900,000, although his error only affected the stock to the extent of $100,000.

The second branch of the subsection allowing "damages if the person suing no longer owns the security" apparently does not impose as clear a liability as the recovery of consideration expressly provided in section 11 (e) (1). In order to be consistent with that section, we should expect a provision somewhat as follows:

"or (2) to recover damages, equal to the consideration paid for such security with interest thereon, less the amount received for the security and any income received thereon, if the person suing no longer owns the security."

This would have placed the person who no longer owns the security in the same position as to ability to recover damages as the person who still holds the security. But the act does not so provide, and, if this ambiguity is not obviated by subsequent legislation, it may be held, in a suit by a person who no longer owns the security, that only real damages can be recovered—that is, damages which are the natural result of the untrue statement or of the omission and can be traced to the error of the accountant. In the absence of clear language imposing such a liability, the courts should be slow to give "damages" which are caused by subsequent economic and market conditions and are not caused by the act of the person sued.

It is interesting to note, however, that Felix Frankfurter, a distinguished lawyer who is reputed to be one of the authors of the act, in an article in *Fortune* for August, 1933, seems to consider that the damages will include the full loss to the investor whether caused by the accountant's error or by subsequent events. His article states in part:

"When circumstances permit suit, the investor, on tender of the security, may recover the consideration he paid, or damages if he has parted with the security. Since the remedy is in the nature of a rescission, it avoids the inquiry, practically impossible, as to the extent of the damages due to the misrepresentation and the extent due to other causes. To force the injured party to disentangle these items of damage would impose upon him an unfair burden in litigation. Where a material misrepresentation has been made, it is not for those who have been guilty of bad faith or incompetence or recklessness to put the buyer to proof that his bargain was not bad for still other causes."

Section 11 contains a further provision:

"(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."

The effect of this provision in a suit under section 11 (e) (1) is reasonably clear. Such a suit is to recover the consideration paid for the security with interest thereon, less the amount of any income received therefrom, upon the tender of such security. Under section 11 (g) if the consideration paid, with the adjustments provided, is greater than the price at which the security was offered to the public, the amount recoverable under section 11 (e) (1) is reduced to such price.

But when we attempt to determine the effect of section 11 (g) on suits for damages under section 11 (e) (2) if the person suing no longer owns the security, a difficult question is presented. If the courts hold that the damages recoverable are only such damages as are the natural result of the untrue statement or of the omission, there would appear to be no reason for the application of section 11 (g) in a section 11 (e) (2) case, as such damages could hardly exceed the price at which the security was offered to the public. But if the courts hold that the remedy of damages given by section 11 (e) (2) should be construed in such a way that the person who has parted with the security has a remedy equivalent to the remedy of recovery of consideration expressly given by section 11 (e) (1) to the person who still holds the security, then section 11 (g) may affect such a suit for damages in either of two ways, depending on whether the courts attempt to give a construction which will make the section consistent or whether they follow the literal words of section 11 (g).

1. In order to make the remedies provided by section 11 (e) (1) and 11 (e) (2) entirely consistent, section 11 (g) should be construed to mean that in a suit for damages the measure of recovery shall be based not upon the consideration actually paid for the security but upon the price at which the security was offered to the public if that was less than the consideration paid. Such a construction would make section 11 (e) (1) and (2) and section 11 (g) consistent with the express provisions of section 11 (e) (1) and with the clear application of section 11 (g) to section 11 (e) (1).

2. If, however, section 11 (g) is construed literally, the only provision we find is that the amount recoverable shall not exceed "the price at which the security was offered to the public," and under a literal construction there is apparently no limit to the possible liability. For example, a security might be offered to the public at 100, subsequently purchased by the plaintiff at 200 and sold again at 100. The 100 lost by that particular plaintiff would not exceed the price at which the security was offered to the public. In the case of a fluctuating security with an active market there may be an infinite number of such purchasers who have sustained such losses, in each case up to but not beyond the price at which the security was originally offered to the public. As the same share of stock may be sold again and again as the quotations go up and down, the total of these losses may be more than the total amount at which the issue was originally sold to the public and may in fact be infinite in amount. Although this construction must be recognized as a possibility, I think that it is improbable that the courts will so hold, because it involves the reading of language into section 11 (e) (2) to make it harmonize with section 11 (e) (1), but the refusal to continue the harmonizing process by reading anything into section 11 (g).

OTHER REMEDIES RESERVED

By section 16 it is provided:

"The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity."

In *Ultramares Corporation v. Touche et al*., 255 N. Y. 170, it was held that an accountant was liable for negligence only to one with whom he was in privity of contract, but that his liability for fraud ran to any person injured by such fraud, and there might be negligence so gross as to be evidence of fraud. Not involved in this case, but well established at common law, are the principles that the injury must be caused by a reliance on the act of the accountant, and that the damages recoverable must be the natural consequence of the accountant's negligence or fraud.

Under the securities act of 1933, in regard to the parts of the registration statement attributed to the accountant, with his consent, the accountant's liability is greatly broadened:

1. As to the persons who may recover in cases other than those of fraud: They need have no contractual relationship with the accountant.

2. As to the injury: This may be caused in part by events other than the negligence or fraud of the accountant.

3. As to the amount of the damage recoverable: This has been increased by section 11 (e) (1) and perhaps by section 11 (e) (2).

And "all other rights and remedies that may exist at law or in equity" remain.

CONCLUSION

In the provisions of the securities act of 1933 and in the authorities that I have given in support of the views expressed in this address, there has been much use of the word "reasonable," "reasonable investigation," "reasonable ground to believe," "circumstances as they reasonably appear," "the conduct of a reasonable man." Perhaps one may think that I should have discussed these expressions and should have explained their meaning, but it seemed to me that it would be more appropriate to do this in one place and at the conclusion of my address.

The best definition that I have ever seen of the reasonable man is contained in a volume entitled *Misleading Cases in the Common Law* by A. P. Herbert. I quote from the judgment of Lord Justice Morrow in *Fardell v. Potis*, at page 12:

"The common law of England has been laboriously built about a mythical figure—the figure of 'the reasonable man.' . . . He is an ideal, a standard, the embodiment of all those qualities which we demand of the good citizen. . . .

". . . It is impossible to travel anywhere or to travel for long in that confusing forest of learned judgments which constitutes the common law of England without encountering the reasonable man. . . . There has never been a problem, however difficult, which his majesty's judges have not in the end been able to resolve by asking themselves the simple question, 'Was this or was it not the conduct of a reasonable man?' and leaving that question to be answered by the jury.

". . . The reasonable man is always thinking of others; prudence is his guide, . . . He is one who invariably looks where he is going and is careful to examine the immediate foreground before he executes a leap or a bound; who neither star-gazes nor is lost in meditation when approaching trapdoors or the margin of a dock; . . . who never mounts a moving omnibus and does not alight from any car while the train is in motion; who investigates exhaustively the bona fides of every mendicant before distributing alms and will inform himself of the history and

habits of a dog before administering a caress; who believes no gossip, nor repeats it, without firm basis for believing it to be true; who never drives his ball till those in front of him have definitely vacated the putting-green which is his own objective; who never from one year's end to another makes an excessive demand upon his wife, his neighbors, his servants, his ox or his ass; who in the way of business looks only for that narrow margin of profit which twelve men such as himself would reckon to be 'fair,' and contemplates his fellow-merchants, their agents, and their goods with that degree of suspicion and distrust which the law deems admirable; who never swears, gambles or loses his temper; who uses nothing except in moderation and even while he flogs his child is meditating only on the golden mean.

"Devoid, in short, of any human weakness, with not one single saving vice, sans prejudice, procrastination, ill-nature, avarice and absence of mind, as careful for his own safety as he is for that of others, this excellent but odious character stands like a monument in our courts of justice, vainly appealing to his fellow-citizens to order their lives after his own example."

I leave you with this definition and with the juries which will be duly empaneled to try any suits arising under the securities act of 1933.

Problems of Accountants under the Securities Act of 1933*

BY JAMES HALL

INTRODUCTORY

Mr. Gordon, in his paper on "Accountants and the securities act" has analyzed with skill and clarity the provisions of the securities act relating to the responsibility of accountants under the act, the defenses available to them in case of suit and the extent of their liability. But the most important part of the paper, from the viewpoint of practising accountants, is the discussion under the head of "Standard of reasonableness," of the fiduciary relationship imposed upon accountants by the provisions of section 11 (c) of the act.

In concluding, Mr. Gordon expresses the opinion that under the securities act, in regard to the parts of the registration statement attributable to the accountant, with his consent, the liability of the accountant is greatly broadened:

"(1) As to the persons who may recover in cases other than those of fraud: they need have no contractual relationship with the accountant.
(2) As to the injury: this may be caused in part by events other than the negligence or fraud of the accountant.
(3) As to the amount of the damages recoverable: this has been increased by section 11 (e) (1) and perhaps by section 11 (e) (2)."

* Address delivered at the annual meeting of the American Institute of Accountants, New Orleans, Louisiana, October 17, 1933.

And moreover—quoting again from Mr. Gordon's paper—"All other rights and remedies that may exist at law or in equity remain."

The opinion expressed by Mr. Gordon as to the liability of accountants under the securities act is far from comforting; in fact, Mr. Gordon's remarks rather suggest that acceptance of engagements for examinations that involve the registration of securities under the provisions of the securities act may be fraught with serious consequences to accountants because of the possibilities in the way of legal blackmail and unjust claims by disgruntled investors.

Accountants must, therefore, for their own protection, consider seriously the problems that they are likely to encounter should they decide to accept engagements for examinations that involve the registration of securities under the provisions of the securities act regardless of the risks presented. Of the many problems that accountants would be likely to encounter in the course of such engagements, the following are suggested as being, perhaps, the most important.

CASH

First, as to the item "cash." It has been customary for accountants, when examining national organizations with numerous branches, to rely upon acknowledgments from branch managers or other custodians as to the existence of cash funds at points not visited during the examination. Should it develop subsequently that a number of these unverified cash funds were overstated or non-existent at the date as of which he had certified the balance-sheet, it might be that the accountant, by reason of the fiduciary standard imposed upon him by the act, could be held liable on the grounds that in accepting certificates from others, as to such cash, he had not fulfilled his obligation to the investor.

ACCOUNTS RECEIVABLE

Now as to accounts receivable. It is only in exceptional cases that accountants are authorized to confirm accounts-receivable balances by communicating with the debtors. And even when accountants are authorized to confirm the balances, they are seldom able to obtain acknowledgments for more than 75 or 80 per cent of the balances. Yet it may be that nothing short of a 100 per cent confirmation of the balances would be required of a fiduciary. Until the courts rule upon the point, however, accountants would seem justified in extending very materially their scrutiny of the accounts receivable. They might be justified also in insisting upon confirmation of exceptionally large or otherwise unusual balances. It goes without saying, of course, that accountants should explain at some length in their reports or certificates the scope and results of their inquiries in regard to the accounts receivable.

RESERVES FOR DOUBTFUL NOTES AND ACCOUNTS

The regulations (instruction 9—balance-sheet) call for a statement as to "whether in the judgment of the issuer, all notes and accounts receivable known to be uncollectible have been charged off and whether adequate reserves have been provided for doubtful notes and accounts." But there is nothing in the regulations to indicate how the accountant should proceed in the event of a difference of opinion as to the adequacy of the reserves. Possibly it would be proper for the accountant to certify the accounts subject to an estimated deficiency of blank amount in the reserves for doubtful notes and accounts. On the other hand, it may be that the accountant, as a

fiduciary, should not certify the accounts until the issuing corporation adjusts its reserves in conformity with the accountant's estimate of the requirements.

INVENTORIES

Heretofore accountants have relied, to some extent at least, upon the certificates of responsible officers in the client's organization as to the correctness of the quantities and descriptions of the individual items in the inventories of materials and merchandise. As fiduciaries, however, it may be that accountants will be required to assume complete responsibility for the correctness of the quantities and descriptions in inventories. In that event, accountants will be under the necessity of extending the scope of their examination of the inventories as at the closing date of the three-year period—possibly to the point where they would actually oversee the taking of the inventories, either alone or in conjunction with recognized experts in the particular lines of material or merchandise to be inventoried: some clients, undoubtedly, would protest most strenuously against the expense that such an extension of the accountant's activities would entail, but that is a feature of the matter that we need not discuss at this time. Only a limited examination would be possible, of course, in respect of the inventories applicable to the opening date of the three-year period and those prepared as at the end, respectively, of the first and second years of the three-year period: it should be stressed, however, that the opening and intermediate inventories are not to be ignored.

With further reference to inventories, many accountants are willing—or, perhaps I should say, eager—to admit their limitations as valuers. But with the securities act imposing a fiduciary standard, accountants, sooner or later, may find that the role of valuer has been forced upon them. Accordingly, it would seem desirable for accountants to extend the scope of their investigations into inventory values to an extent that will enable them to accept a reasonable degree of responsibility as to values.

PLANT AND EQUIPMENT

Now let us consider charges to the plant and equipment accounts in respect of capital expenditure. It is clear that the charges for the period of three years for which profit-and-loss accounts are required should be examined more or less thoroughly, according to the effectiveness of the system of internal control and the proportion of the work undertaken by the construction staff of the issuing corporation. But to what extent should the accountant examine the expenditures from the inception of the enterprise to the beginning of the three-year period referred to above? A superficial examination of the expenditures for the prior period would not be conclusive and might expose the accountant to charges of negligence. On the other hand, the cost of a thorough examination for the prior period might be prohibitive in the case of a long-established company.

Another important point connected with property and plant accounts is the extent to which the accountant could be held liable in case he failed to detect abandonments of property and plant that had not been charged off in the accounting records. Possibly the accountant would be entitled to rely upon a certificate from a responsible officer of the issuing corporation as to the nature and amount of any unrecorded abandonments, either consummated or contemplated.

As to the responsibility for establishing legal ownership of the properties carried on the books of the issuing corporation as owned, this would seem to be a matter for which the

attorneys retained by the bankers should assume undivided responsibility. Probably the accountant, in his report or certificate, could elect whether to disclaim all responsibility in regard to titles or, alternatively, indicate that he has relied entirely upon the search made by the attorneys.

Problems incidental to the adjustment of the property and plant accounts to conform with appraisal values may not demand attention for some time to come. But while on the subject of appraisals it would be well to consider for a moment how the accountant can best protect himself against claims arising out of errors in appraisal values reflected in the balance-sheet certified by the accountant. Regardless of the standing of the organization responsible for the preparation of the appraisal, the accountant should make such comparison of the appraisal with the property and plant accounts as may be necessary to ensure, among other things, that no leased property has been included in the appraisal as owned property, that as regards recent acquisitions listed in the appraisal, corresponding entries have been made in the financial records of the issuing corporation, and, last but not least, that no items of supplies, repair parts or similar items, included by the issuing corporation in its inventories, have been duplicated in the appraisal. When the appraisal shows a substantial overage as compared with the book value, the accountant should, in addition, make such further comparisons of the appraised and book values as will enable him to account substantially for the overage. Similarly, any parts of the property that have been out of service for an extended period should be identified and shown separately on the balance-sheet.

Depreciation and Depletion

In considering depreciation and depletion, it is of interest that the issuing corporation is required, under instruction 2 relating to the balance-sheet, to make a reasonably complete disclosure both as to policy and amounts appropriated. When the amounts appropriated appeared to be adequate, the accountant would not, of course, have any hesitation in certifying the balance-sheet and profit-and-loss account. In case the amounts appropriated were based on rates furnished by an independent appraiser or engineer it might seem advisable for the accountant to mention in his report or certificate the authority for the rates used.

But, on the other hand, when the accountant can not see his way clear to concur in the policy of the issuing corporation as regards depreciation and depletion, would it be proper for the accountant to certify the statements subject to the adequacy of the amounts appropriated by the issuing corporation in respect of depreciation and depletion, or would he be under the necessity of refusing to certify? It might be mentioned here that, in many cases, it would be practically impossible for the accountant to determine, with any degree of certainty, the amount of the deficiency in the provision for depreciation and depletion.

Intangible Assets

One can only conjecture as to the extent to which the accountant could be held responsible for the reasonableness of the values at which intangible assets are stated in the balance-sheet of the issuing corporation and the adequacy of the amounts charged off in the profit-and-loss account of the issuing corporation in respect of amortization. Here, again, the only safe course will be for the accountant to make a complete disclosure in his report or certificate.

ACCOUNTS PAYABLE

As to accounts payable, inasmuch as the certified balance-sheet is required to be available within ninety days after the date thereof, it would be unreasonable to expect the accountant to assume unlimited responsibility for the omission from such balance-sheet of undisclosed liabilities—particularly if the issuing corporation happened to be national or international in scope. But for the present, at least, all that the accountant can do is to take the usual precautions and, in addition, qualify his report or certificate.

CONTINGENT LIABILITIES

With regard to contingent liabilities (the more important of which are listed in the regulations under instruction 27—balance-sheet), it is obvious that where items of this nature do not appear in the financial or corporate records of the issuing corporation relating to the period examined, the accountant is under the necessity of relying upon the disclosure made by the issuing corporation when it certifies for purposes of the accountant as to the nature and extent of the unentered liabilities. Incidentally, the registration statement contains provision for a statement of pending litigation (item 17) and a statement of material contracts (item 46); both of these statements would be helpful to the accountant in ascertaining the contingent liabilities of the issuing corporation. Nevertheless, the accountant should indicate in his report or certificate the scope of his inquiries in regard to contingent liabilities and the extent of his reliance upon the assurances of the officers of the issuing corporation.

NON-RECURRING INCOME AND EXPENSES

One requirement of the securities act that should prove acceptable to accountants generally is that non-recurring items of income and expenses must be included in the profit-and-loss account forming part of the registration statement (see instruction 8 in regard to profit-and-loss account). Often, in the past, it has been a good deal of a problem, when preparing earning statements for inclusion in prospectuses, to decide whether the inclusion or exclusion of such items would afford the more correct forecast of future earning capacity.

CONFIRMATION OF ARRANGEMENTS

When arranging for the examination, the accountant should insist upon a definite, written understanding as to the scope and limitations of the work to be undertaken. Moreover, the accountant should insist upon this understanding—which, usually, would take the form of a proposal made by the accountant to the issuing corporation—being formally accepted on behalf of the issuing corporation by a duly authorized representative. Any subsequent modifications or extensions of the original understanding should, of course, be reduced to writing and confirmed in like manner.

It is hardly necessary, perhaps, to suggest that before accepting the engagement, the accountant should satisfy himself that the officers of the issuing corporation can be relied upon to fulfill their commitments and that they and the bankers interested are of good repute.

ACCOUNTANT'S RECORDS

In view of the fact that the burden of proof is transferred, under the securities act, to the accountant, and on the assumption that each engagement accepted in connection with an issue of securities will carry with it the possibility—if not the probability—of litigation, it is appropriate that some consideration should be given to the accountant's working papers and other records relating to the engagement. Of the many precautions that should be taken when working papers and other records may have to be produced in court, the following are, perhaps, the most important:

Each working paper should be signed by the accountant who prepared it and should show the date on which it was prepared and from what records. Where a working paper is the subject of discussion with officers or other representatives of the issuing corporation, the names of the persons present at the discussion and the date, purpose and result of such discussion should, also, be noted on the working paper by the member of the accountant's organization conducting the discussion.

The detailed time reports of the staff members of the accountant's organization should set forth in reasonable detail the nature and extent of the work done in relation to each book or account or other matter upon which work has been done. Conferences with members of the client's organization in regard to matters arising during the examination should also be referred to in the detailed time reports.

Concerning the file of documents generally referred to as the "permanent file," it would seem desirable to have any unsigned copies of such documents authenticated by the secretary of the issuing corporation. To facilitate identification of the documents in court, the date of receipt and the names of the persons who, respectively, tendered and received the documents should be noted thereon.

ACCOUNTANT'S REPORT OR CERTIFICATE

Until the situation is clarified by modification of the securities act and related regulations, or by court decisions on cases arising under the provisions of section 11 of the act, the accountant should include in his report or certificate a comprehensive statement descriptive of the scope of the examination. He should include in his report or certificate, also, whatever qualifications are necessary in respect of items in the balance-sheet and profit-and-loss account that have not been fully verified. And, finally, he should include in his report or certificate such explanations as are necessary to the end that the report will be completely informative. In one instance that came to my attention recently, the accountant's certificate had been expanded into a report of approximately thirteen hundred words.

ACCOUNTANTS' STATEMENTS

As to the form of the accountant's statements—and this applies equally to the balance-sheet and to the profit-and-loss account—it appears to be incumbent upon accountants to extend the captions and amplify the descriptions of the individual items in these statements to such extent as may be necessary to ensure that the statements shall be completely informative and readily understood by investors not familiar with accounting terminology.

"Pro forma" balance-sheets and profit-and-loss accounts are not mentioned either in the securities act or in the regulations relating thereto. This omission may, possibly, have some significance, but it is questionable whether it justifies the conclusion that registration statements and prospectuses issued hereafter are not to contain "pro forma" statements. At the same time, accountants are entitled to take the position that they do not care to certify "pro forma" statements for inclusion in registration statements and prospectuses until the federal trade commission has expressed its views in regard to such statements.

INDEMNIFICATION OF ACCOUNTANT BY ISSUING CORPORATION

And this brings us to the question as to whether the accountant should require from the issuing corporation an undertaking whereby the issuing corporation will agree to indemnify the accountant against any liability, costs or expenses resulting from suits that may be brought against the accountant by reason of the additional liability imposed upon accountants by section 11 of the securities act. One of the plans suggested takes the form of a letter from the issuing corporation to the accountant. It reads as follows:

"The undersigned, has requested you to make an investigation of its accounts for (period) and to make a certified report thereon which may be used in connection with the filing of a registration statement pursuant to section 6 of the securities act of 1933, for the purpose of registering thereunder the following:

(description of issue)

"In consideration of your making such investigation and report and of your consenting in writing to the use of such report in connection with such registration statement, the undersigned agrees that, in addition to paying the fee contemporaneously agreed upon with you it will indemnify you and save you harmless from and against all liability, costs and expenses which may be incurred by you or for your account (including the fees of your counsel) in or in connection with any suit or other proceeding which shall be brought or claim which shall be made against you under the aforesaid act based upon an allegation that such report contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, provided that such statement or omission was made by you in good faith."

Whether accountants should request, in reference to each examination accepted that involves the registration of securities under the securities act, that the issuing corporation shall undertake to indemnify them (that is, the accountants) for any claims that may be made against them and expenses that may be incurred by them, in consequence of the extension of the accountant's liability under the securities act, will depend upon many things, including the financial responsibility of the issuing corporation and the attitude that the federal trade commission may take toward such undertakings. But at the moment, the weight of opinion seems to be in favor of requesting indemnification.

FEES FOR EXAMINATIONS UNDER SECURITIES ACT

And, in conclusion, just a word on the subject of fees for examinations by accountants under the securities act. Unquestionably, accountants will be under the necessity of obtaining, in future, much larger fees than clients have been willing to pay in the past. One reason why a substantial increase in fees is imperative is that the fiduciary standard imposed by the act will force accountants to extend very materially the scope of their work, possibly to the extent of making detailed audits where tests of the transactions have sufficed in the past. Another—and probably more important—reason why a substantial increase in fees is imperative is that the act extends the liability of accountants to all the world, so to speak.