

M E M O R A N D U M

for

AMERICAN INSTITUTE OF ACCOUNTANTS

Rule 2-02 of Regulation S-X reads as follows:

“(a) The accountants’ certificate (1) shall be dated; (2) shall be signed manually; (3) shall identify without detailed enumeration the financial statements certified; (4) shall contain a reasonably comprehensive statement as to the scope of the audit made; (5) shall state whether there have been any changes in accounting principles or practices required to be set forth by rule 3-07 and shall state clearly the accountants’ opinion as to any such changes; and (6) shall state clearly the opinion of the accountants in respect of the financial statements of, and the accounting principles and procedures followed by, the registrant and its subsidiaries.

(b) In certifying the financial statements, the accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant’s own staff. The accountants shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed. Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of presenting comprehensive and dependable financial statements.

(c) Any matters to which the accountants take exception shall be clearly identified and the exception thereto specifically and clearly stated.

(d) If certification is made by an individual accountant, the above provisions as to accountants shall be read in the singular.”

It should be noted that subdivision (4) is factual and does not call for an expression of opinion; that the first part of subdivision (5) is factual and does not call for an expression of opinion and the last part calls for an expression of opinion; that subdivision (6) calls for an expression of opinion.

The Commission has proposed that Rule 2-02 be modified to read as follows:

“Rule 2-02. Accountants’ Certificates

(a) Technical requirements

The accountants' certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) Representations as to the audit

The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if any generally accepted auditing procedures with respect to significant items in the financial statements have been omitted, a specific designation of such procedures and of the reasons for their omission, (ii) shall certify whether the audit was made in accordance with generally accepted auditing standards, if any, applicable to the particular case; and (iii) shall state that the audit made omitted no procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) Opinions to be expressed

The accountant's certificate shall state clearly:

- (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;
- (ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and
- (iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in

the accounts after the entry of adjustments for the period under review.

(d) Exceptions

Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

The last part of subdivision (b)(i), reading:

“including, if any generally accepted auditing procedures with respect to the significant items in the financial statements have been omitted, a specific designation of such procedures and of the reasons for their omission”

and (ii) call for a factual statement and do not permit the auditor to express his opinion as to whether generally accepted auditing procedures have been omitted. The Commission advises that the purpose of this is twofold: (i) to make the test an objective test rather than a subjective test; and (ii) to make the administration of the Act easier for the Commission so that they can determine whether the accountant is justified in his statement as to what are “generally accepted auditing procedures” and whether his reasons for omitting them are valid.

From a legal standpoint there is no basic difference as to whether accountants say that the audit was made in accordance with generally accepted auditing standards or whether they certify that it was made in accordance with generally accepted auditing standards. The basic difference between the old rule is a change from an expression of opinion to a statement of fact. The basic difference is that it increases the civil and the criminal liability and increases the power of the Commission to issue stop orders under the provisions of Section 8 (d) of the Securities Act of 1933.

In discussing the matter with the Commission, it was brought out that Commissioner Healy at least felt that the accountants ought to accompany their certificate by a statement of exactly what they had done and what they had not done and that the Staff had

argued against this. The Staff were somewhat sympathetic to a statement that it should be sufficient for the accountants to state that the audit made was not less in scopes or procedures followed than that which reasonably prudent accountants would deem necessary under the circumstances of a particular case. Further, they were in a measure sympathetic to this being stated in the accountant's opinion, were it not for the difficulties with which they were faced as an administrative matter in applying subjective tests. It must be recognized, however, that if the change is made (1) it gives the Commission power to make an accountant change his certificate, even though he is honestly of the opinion that he was justified in omitting certain generally accepted procedures on the ground they were not applicable in a particular case, and (2) it takes away from accountants their professional standing, in that the ability to exercise judgment is of the essence of being a member of a profession. Further, it means that on civil suits, accountants will not be judged by whether they exercised that standard of reasonable expertness which reasonably prudent independent public accountants would have exercised under similar circumstances. But it means that if other accountants testify that there (1) were generally accepted auditing procedures, and (2) that such procedures were applicable to the particular case, then a court must of necessity charge the jury that if they find (1) that the plaintiff has proved by a preponderance of the evidence that there were such generally auditing procedures, and (2) such procedures were applicable to the particular case, they must find for the plaintiff and against the accountant-defendant without regard to the reasonableness of the accountant's opinion or good faith in not following such procedures. If the accountant is held liable, then officers, directors and underwriters must prove under Section 11 (b) (3) of the Securities Act of 1933 that they had no reasonable ground to believe and did not believe at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission

to state a material fact required to be stated therein or necessary to make the statements therein not misleading. This naturally places a greater burden upon officers, directors or underwriters to see that the accountants do follow generally accepted auditing procedures because if accountants state that they have (rather than stating they are of the opinion, they have), and a court finds they have not, then to the extent the statements in the accountants' certificate are untrue, the burden of proof on officers, directors or underwriters is increased. For these reasons, pressure will undoubtedly be brought on accountants to follow generally accepted auditing procedures whether in the accountant's judgment such procedures are applicable to the particular case or not.

Mr. Galpeer indicated that he did not think that it would be necessary to state that any generally accepted auditing procedures had been omitted except where the accountant now finds it necessary to qualify his certificate under the existing rule, and that he thought it clear that even under subdivision (b) (i) of the proposed rule that "significant items in the financial statement" meant those items applicable to the financial statements of the registrant under review. But Mr. Werntz seemed a little dubious about this, because of the difficulty of applying it.

If possible, it is recommended that the accountant should not be required to state the generally accepted auditing procedures with respect to significant items in financial statements which have been omitted, a specific designation of such procedures, and the reasons for their omission; that there be added in subdivision (ii) after the word "accountant" "under the circumstances of the particular case"; and that subdivision (iii) shall be reworded so as to read:

"shall state that the audit made was not less in scopes or procedures followed than that which, in the accountant's opinion, reasonably prudent independent public accountants would deem

necessary under the circumstances of the particular case after giving appropriate consideration to generally accepted auditing standards which independent public accountants would ordinarily employ for the purpose of expressing the opinions required by paragraph (c) of this rule.”

It is believed that every effort should be made to get changes made in proposed Rule 2-02 accordingly and that the wording of subdivision (iii) will give to the Commission a sufficiently objective standard so that they can cope with the accountants who do not do things merely because they are busy or because it would be expensive. If they object that they do not know what an accountant has done or what he has omitted, there could be inserted at the end of subdivision (i) in lieu of the Commission’s suggested language quoted above, the following:

“including the opinion of the accountant as to whether any generally accepted auditing procedures with respect to significant items in the financial statements which are applicable to the particular case have been omitted and if so a specific designation of such procedures and of the reasons for their omission.”

Subdivision (b) would then read:

“(b) The accountants’ certificate (i) shall contain a reasonable comprehensive statement as to the scope of the audit made, including the opinion of the accountant as to whether any generally accepted auditing procedures with respect to significant items in the financial statements which are applicable to the financial statements under review have been omitted and if so a specific designation of such procedures and of the reasons for their omission; (ii) shall state that the audit made was not less in scope or procedures followed than that deemed necessary by the accountant under the circumstances of the particular case; and (iii) shall state that the audit made was not less in scope or procedures followed than that which, in the accountant’s opinion, reasonably prudent independent public accountants would deem necessary under the circumstances of the financial statements under review, after giving appropriate consideration to generally accepted auditing standards which independent public accountants would ordinarily employ for the purpose of expressing the opinions required by paragraph (c) of this rule.”

The above suggestions could undoubtedly be improved from a drafting standpoint and they are subject to considerable polishing and refinement of language.

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