

MEETING THE ACCOUNTING REQUIREMENTS OF THE  
SECURITIES AND EXCHANGE COMMISSION

ADDRESS

of

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Before the

ANNUAL MEETING

of

PENNSYLVANIA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

at

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It has been suggested that I discuss some of the difficulties the Commission's accounting staff encounters in obtaining financial statements which meet our requirements. Much has been said and written on this subject and I know that many of you have first-hand knowledge of our procedure for informing your clients - - and you indirectly - - of those matters in financial statements filed with us to which we take exception. If you haven't seen one of our always candid, sometimes lengthy, but usually effective Deficiency Letters it is almost certainly because you haven't had the occasion to participate in the filing of a financial statement with the Commission. It is hoped that my remarks will play some part in reducing the number of such letters which we find it necessary to send out.

Generally speaking, financial statements filed with the Commission under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 are required to be certified by independent accountants. The Commission's requirements pertaining to such financial statements are found in Regulation S-X, in the Accounting Series releases, and in formal Commission findings and opinions issued in cases arising under the various Acts it is charged with the duty of administering.

Regulation S-X is our basic accounting document and is applicable to most of the financial statements filed with the Commission under the 1933, 1934 and 1940 Acts. It contains substantially all of our formal rules governing the form and content of financial statements, including the problems of consolidation, certification and general presentation. Mechanically, it is broken down into 12 articles; 4 articles containing general rules on various subjects, 7 articles each applicable to a different kind of a

company, and one article giving specific forms for certain supplementary schedules. Prior to the issuance of this regulation in 1940, the accounting requirements to be observed by registrants were set forth in the particular form to be filed. As new forms were promulgated, many differences developed between the accounting requirements of the various forms and Regulation S-X was designed for the purpose of integrating these different requirements into a single regulation applicable to all but a few special forms, principal among which is Form X-17A-5, on which registered broker-dealers file their annual statements of financial condition to which I will refer later.

The Accounting Series releases comprise a special series of Commission releases which was started in 1937 for the purpose of contributing to the development of uniform standards and practice in major accounting questions. To date 61 releases have been issued in this series. Many of them have been devoted to a discussion of specialized types of cases which are so unusual or complex from an accounting standpoint that establishment of a general and inflexible rule is deemed inadvisable. Some have dealt with the independence of accountants and actions against accountants which resulted in their temporary or permanent disbarment from practice before us. Others discussed auditing procedures and the evolution of the independent accountant's certificate or opinion. All amendments to Regulation S-X are also announced in this series of releases.

The formal findings and opinions of the Commission issued from time to time under the various Acts it administers contain many important decisions involving accounting matters and expressing the Commission's views thereon.

All of these sources of the Commission's accounting requirements - - Regulation S-X, the various forms and instructions applicable thereto, Accounting Series releases

and current formal findings and opinions - - may be obtained from the Commission upon request. In order to make sure that he is kept currently informed regarding the Commission's accounting requirements, any interested person may have his name placed upon our mailing list and receive all of this data automatically.

In addition to these formal means of keeping the public informed as to the Commission's accounting policies, the accounting staff of the Commission welcomes direct inquiry - - by letter, phone, or, where practicable, by conference - - concerning any accounting matter which appears not to be covered by the published material or which may require clarification.

If, upon review by the staff, financial statements filed are found to have been prepared contrary to generally accepted accounting principles or otherwise fail to meet the requirements of the Commission, a deficiency letter is prepared. This letter is reviewed, as to accounting matters, by the Assistant Chief Accountant in the examining division and, if novel or debatable questions of accounting policy or principle are raised, by the Chief Accountant, before being forwarded to the registrant. These deficiency letters, and the correspondence or conferences with registrants and their accountants that frequently ensue, have proved to be an expeditious means of resolving accounting questions which might otherwise have to be settled through time-consuming and expensive formal hearings.

I should like to be able to tell you that deficiencies in financial statements are uncommon. However, the contrary is true. A recent review of 100 deficiency letters picked at random and applicable to statements filed under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 produced

only 14 statements without financial deficiencies. The other 86 statements were found to contain 329 deficiencies with respect to the financial statements or the accountants' certificates. While a few of the items requiring correction or amplification were individually of minor importance, a large majority of them, in our opinion, seriously impaired the utility of the statements. The correction of these deficiencies caused the expenditure of considerable time on the part of the companies and their independent accountants and, in the case of some of the 1933 Act statements, resulted in serious delay in obtaining effective registration.

Before discussing the nature of the items which give rise to most of the deficiencies we find it necessary to cite, I think it would be profitable to consider their cause. With respect to the 329 deficient items previously referred to, 180 were due to the failure to comply with specific rules contained, for the most part, in Regulation S-X, and 20 disregarded the Commission's Accounting Series releases; 86 were contrary to generally accepted accounting principles not specifically contained in our rules and regulations; and 43 indicated the necessity for the clarification, or inclusion, of explanatory footnotes.

In view of the fact that a large majority of the deficiencies (200 out of 329) resulted from noncompliance with specific rules or requirements as contained in Regulation S-X or the Accounting Series releases, it would appear that these particular Commission publications are not as well known to the Accounting profession as they should be. It is interesting to note in this connection that of the 1,130 members of the Pennsylvania Institute of Certified Public Accountants listed in the 1946-47 year book

only 336 are on our mailing list or are associated with accounting firms whose names appear thereon.

None of the 100 deficiency letters commented upon above was applicable to financial statements required to be filed by broker-dealers. The form prescribed for these statements - - Form X-17A-5 - - was drafted after extended conferences with national securities exchanges, state regulatory bodies, public accounting firms and other organizations interested in the financial reporting requirements of broker-dealers. The several items of the form, many of which are applicable only to the brokerage business, are required to be shown in a manner designed to produce a readily understandable statement of financial condition. Under certain circumstances this statement must be certified by an independent accountant. Rule X-17A-5, under the Securities Exchange Act of 1934, sets forth the principal requirements governing the accountant's certificate and the form itself contains a statement of minimum audit requirements which must be observed by the certifying accountant. These audit requirements include physical examination of securities and other items on hand and the obtaining of written confirmations with respect to numerous accounts peculiar to the securities business including, specifically, those with customers, partners, officers and directors.

Notwithstanding the specific requirements of the rule and form, we have experienced considerable difficulty in obtaining correctly prepared and properly audited statements. Examination of the reports filed and correspondence conducted in connection therewith has indicated that many broker-dealer audits were performed by accountants unfamiliar with the Commission's regulations and apparently not well-versed in the general requirements of effective auditing procedure as set forth in publications of the

American Institute of Accountants and elsewhere. A discussion of the problem was had with representatives of the American Institute of Accountants early last year following which a program of education was instituted in an effort to improve the work done in this special field. A general editorial entitled "A Warning to Auditors," calling attention to the problem in very strong terms, was published in the JOURNAL OF ACCOUNTANCY in June, 1946.

Some improvement has been noted in the quality of the statements filed on Form X-17A-5 and the accountants' certificates applicable thereto appear, generally, to more nearly meet our requirements. However, as recently as January of this year it was found necessary to deny a public accounting firm and its senior partner the privilege of appearing or practicing in any way before the Commission for a period of one year. The case, which was dealt with in Accounting Series Release No. 59, published January 23, 1947, was based almost entirely on the accountant's failure to comply with generally accepted auditing standards, including those specifically enumerated in the instructions to Form X-17A-5. The accounting firm in this case was not on our mailing list and, I regret to say, the firm was not alone in this respect for, even now, this list contains the names of only 102 out of 743 firms of certified public accountants throughout the country who have certified to one or more Forms X-17A-5.

We come now to a discussion of the nature of the accounting problems involved in deficiencies cited in connection with financial statements other than those applicable to the accounts of broker-dealers. Most of the items found deficient in one way or another recur so seldom as to warrant no comment. However, there are several specific types of items, each involving an important accounting principle or auditing standard, which are

frequently the subject of deficiencies, and each of which I propose to comment upon briefly.

A problem that has been of considerable concern to us for a number of years results in frequent deficiency items in the form of a request for greater clarity in presentation of the facts, and occasionally in a change in balance sheet and profit and loss treatment. I have in mind the question of employees' pensions.

In the great majority of cases the pension plans are voluntary on the part of the company and may be altered or discontinued entirely at the will of the management. As a practical matter I think serious consideration should be given to the proposition that even under voluntary plans in which there is no strict legal liability to continue pension payments a corporate management expecting to remain in business and enjoy good labor relations would not - - if in fact it could - - abandon a pension plan, and a realistic approach is to recognize the liability. However, in the absence of a clear-cut legal liability we have not, as a matter of policy, insisted upon the showing of an actuarially determined liability for the accruing pensions. Instead a clear footnote explanation is accepted.

If the plan provides for the purchase of annuity contracts from an insurance company or the establishment of a trust fund, in either case based on past service of eligible employees or former employees now on pension, we are faced with considerable diversity of opinion as to the proper accounting. The funding of pension costs for past service may be accomplished by lump sum or installment payments to the trustee concurrent with payments covering accruals for the current year. Payments covering the current year are clearly profit and loss charges. Payments based upon past service of

employees currently on the payroll are claimed by some to be proper charges to earned surplus on the grounds that the payment is for service rendered in prior years. We have held in such cases that the payment is actually made for a current benefit in the form of better employee relations, reduced labor turnover and similar benefits currently and in the future and hence the charge should be to profit and loss. However, where the payments were substantial and would have seriously distorted current income figures no objection has been raised to direct charges to earned surplus even in this situation I would prefer to treat these items as extraordinary charges to profit and loss. A variation which has been accepted is the case in which the lump sum payment based on prior years' service has been treated as a deferred charge and transferred to profit and loss by annual installments as the amounts have been claimed as deductions for tax purposes.

A better case for a direct charge to earned surplus can be made with respect to amounts based upon past service of former employees now on the pension rolls. It can be asserted that lump sum payments to fund past service costs in this case yield no present or future benefit to the corporation hence have no relation to current income and therefore should be charged to earned surplus. Until some uniformity in practice is attained in the profession with respect to eliminating all extraordinary charges and credits from the surplus account, we have, in practice, conceded this argument although these payments, I believe, also benefit the company making them, both currently and in the future, because of the wholesome influence of the pensioners on persons still actively employed.

The most serious problems arise in the few cases of company managed plans which create a legal liability. In such cases the liability should be determined on an actuarial basis and given recognition in the accounts. If the irrevocable element of the

plan applies only to those qualified and placed upon the pension rolls the question then arises as to the approaching liability for active employees on the payroll. As I indicated earlier I think a realistic view of the problem would require at least a surplus reserve determined on an actuarial basis although in practice a footnote explanation is all we insist upon. Recent experience with pension plans indicates that the independent accountant should review their terms with the greatest care and question management and counsel closely as to the precise nature of the obligations imposed on the company by the plan, for in some cases the actual liabilities have been substantially understated while in others inadvertent misrepresentation has crept into explanatory footnotes.

Another frequently cited deficiency results from the creation from income of reserves for future inventory price declines and losses. The result, if not the objective, of this procedure, in my opinion, is to improperly reduce current profits and increase profits of subsequent periods. It is our position that provisions made to reserves for inventory losses may be charged against income only to the extent that the losses have actually taken place but have not been realized by use or sale of the materials involved. And any reserve so provided, being a valuation reserve, should be deducted from the inventory on the balance sheet. If it is considered necessary or desirable to provide a reserve for losses which it is expected will occur in the future such provisions, in my opinion, is no more than an appropriation of net income or earned surplus and should be so treated.

In a number of instances statements have been filed reflecting the use of a novel inventory method and involving a reserve for future losses. Each such method has been examined into to determine whether it gets the same results as, or is in fact only a variation of, one of the generally accepted inventory costing or valuation methods such as

first-in-first-out, last-in-first-out, etc. I think it will be of interest to describe briefly one of these innovational methods and indicate our reasons for considering it to be unacceptable. One of the basic principles of this method was that the current high prices of certain raw materials will not be maintained and that, for example, a specific item which is now obtainable at 35¢ per pound, will “stabilized” sometime in the near future at, say, 22¢ per pound. The proposed method would cost inventories on the FIFO basis provided the resulting average cost per unit in periods of temporarily increased or increasing prices is not considered to be in excess of a unit cost at or about which such costs may be expected to stabilize. If the average unit cost on the FIFO basis exceeded such estimated “stabilized” cost, a reserve would be established by charges to income, sufficient to equal, after allowance for the effect of applicable income taxes, if any, the excess of FIFO cost over the estimated “stabilised” cost times the number of inventory units which, from time to time, would be determined to be the “normal” inventory quantity required by the particular business. Charges to set up the reserve would not be shown in the income statement as a part of cost of sales, but would be deducted as the last item on the income statement just before arriving at net income for the year. By means of similar charges the reserve would be adjusted annually should an increase therein be necessary, but would be transferred to surplus to the extent it was found to be excessive or not needed. The reserve would be considered to be a specific reserve to be used for no purpose other than future inventory price declines down to, but not below, the estimated “stabilized” cost; it would not be deducted from inventories in the balance sheet, but would be shown as a miscellaneous reserve on the liability side. It would be explained

by a footnote which, however, would not disclose the estimated “stabilized” cost per unit or the average FIFO cost per unit.

We objected to the use of the proposed method principally because:

- (1) The operative criteria are subjective and not reviewable.
- (2) It allows extremely wide latitude in the determination of inventory amounts and profits which thus permits and indeed, in our opinion, invites improper equalization of earnings.
- (3) It is not internally consistent with respect to determination of cost of sales, profit and loss presentation, and treatment of the reserve on the balance sheet - - in part the method appears to be dealing with the concept of a present loss associated with the current revenues, in part with a possible future loss due to conditions which may come to pass, and in part with the financial conservatism reflected in a retention of current profits against possible lean years in the future.
- (4) The distinction between regular losses (drops below the estimated stabilization price) and temporary inflationary increases from and declines to the estimated base price is not supportable, in principle.
- (5) It permits the permanent understatement of net profit by returning unused reserves direct to surplus.

The accounting for the establishment and use of war, post war and general contingency reserves has given us considerable trouble since early in the war. Briefly stated our practice, as outlined in Accounting Series releases Nos. 42 and 54, has been to require with respect to reserves a full disclosure of their source, nature and disposition

and to the greatest extent possible a demonstration that the cost or expense under consideration is directly or fairly allocable to the income of the year in which the provision is established by charges to profit and loss. Recent practice in this regard has been to require a positive statement in a footnote relating to the reserve that the account will not be used in such a manner as to relieve the income account for any future period of a charge that should properly be made thereagainst. In my opinion charges creating reserves for unforeseen contingencies of future periods have no place in the determination of net income. Such reserves, where required in the opinion of management to reflect sound business judgment, should be appropriated from (not charged against) either net income or earned surplus.

One of the recent and most widely discussed of the Accounting Series releases has been No. 53, "In the Matter of 'Charge in Lieu of Texas.'" The conflicting opinions among accountants which were revealed in the course of the Commission's discussions with representatives of the profession prior to the issuance of this release still persist in some respects and registrants continue to file statements which we find necessary to have amended to comply with the release. The Commission's position is summarized in its Twelfth Annual Report in this language:

"This opinion dealt with a practice which had been growing up for some time, a practice tolerated by some accountants and sincerely advocated by others, pursuant to which the current income account is charged, under the heading of income taxes or charges in lieu of income taxes, not only with the actual amount of income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year. This additional charge

against income is, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The amount of the estimated reduction has been colloquially termed a 'tax saving' and the general problem loosely referred to as the 'treatment of tax savings.' The principal conclusions announced in the opinion were that:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws;
2. The use of the caption 'charges or provisions in lieu of taxes' is not acceptable;
3. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off."

There have been, since issuance of this release many cases in which its application to varying facts was involved and which, I think, have demonstrated that the Commission's announced position is sound and practicable, and produces an informative and useful presentation of financial facts.

Another release which caused considerable debate at the time it was in preparation and which has continued to be a subject of discussion in some of the many recent financing operations is Accounting Series Release No. 45. The question treated by that release was whether a premium paid on the redemption of preferred stock, in excess of the amount paid in thereon, may properly be charged against paid-in surplus contributed by another class of shareholders or whether, when earned surplus is present, the excess premium should be charged there-against to the extent available. The release

indicated that the amount paid in redemption of preferred stock in excess of the amount originally paid in thereon should be charged to earned surplus.

We have applied this principle as well to the situation in which a new class of stock, preferred or common, is sold for cash at a premium and the proceeds used to retire an old issue at a premium. This is treated as two separate transactions in which the premium on retirement is not to be charged to premium received on the new issue. A distinction has been drawn, however, in the case of a direct exchange of new stock for old. In such a case existing paid-in surplus on the old issue may be considered to be directly transferred to the new issue given in exchange.

From time to time accountants' certificates which accompany financial statements of public utility companies filed with the Commission contain the following qualification, or one similar thereto:

\*\*\*\* Subject to the adequacy of the provision and the reserve for depreciation, as to which we are not in a position to express an opinion, the accompanying balance sheet \*\*\* presents fairly \*\*\*\*

Ten years ago this might have been a proper reservation for an accountant to make in his certificate covering the accounts of a public utility company. It has been that many years since depreciation accounting has generally displaced the retirement reserve or other methods of providing for the exhaustion of the service life of utility property. During this period accountants have had much opportunity to familiarize themselves with the property accounts and depreciation problems of utilities and there is no doubt in my mind that they have taken full advantage of this opportunity. It seems to me that under these circumstances there is little, if any, justification for accountants to avoid the

assumption of full responsibility for the adequacy of depreciation provisions or reserves of these companies except, perhaps, in very unusual situations. If, in the opinion of the accountant the depreciation reserve is inadequate I can see no reason why he should not so state in his certificate. While it may not always be practicable for him to determine the extent of inadequacy, the amount, if known, should be stated. In any event the reader of the certificate should be left with no doubts as to whether the depreciation reserve as shown on the balance sheet and the provisions for depreciation included in the income statement are, within reason, adequate.

More often than would be expected, accountants have indicated in their certificates that they have not confirmed accounts receivable or have not verified inventory quantities. Under these circumstances it is felt that a review of our requirements in this respect may be helpful. While auditing procedures performed by independent accountants have been discussed in Commission opinions on a number of occasions, the most notable of which is that of McKesson & Robbins, Inc., the Commission has prescribed no rules relating to the subject. Many phases of auditing practice were reviewed in that case, with particular emphasis on receivables and inventories. Prior to the publication of the McKesson opinion, the American Institute of Accountants had adopted and published, in October, 1939, its Extensions of Auditing Procedure as the first of its Statements on Auditing Procedures. This bulletin, among other things, requires the auditor to be present at the inventory taking and, where the aggregate of notes and accounts receivable represents a significant portion of the assets, requires confirmation by direct communication with debtors; in each case wherever practicable and reasonable. The same bulletin recommended a new form of certificate.

In introducing it, the bulletin said, referring to the auditor: "If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report." The Commission's conclusions in the McKesson case published in December, 1940, commended the profession for adopting these extensions of procedure and expressed its confidence that the profession would maintain and improve its standards and that such procedure was to be preferred to the adoption of specific rules by the Commission.

However, following recommendation contained in the McKesson report, the Commission revised its rules with respect to the accountant's certificate to require that it "(i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedure generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." Nothing in this rule is to 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” as to the financial statements.

In No. 12 of Statements on Auditing Procedure published in October, 1942, the Institute recognized that the difference between the A.I.A. and S.E.C. disclosure rule made it appear that accountants had a double standard of performance between listed and unlisted companies, whereas it was felt that the majority of practitioners actually applied the S.E.C. rule to all companies. To correct this unsatisfactory situation the Institute’s Committee on Auditing Procedure recommended that thereafter “disclosure be required in the short form of independent accountant’s report or opinion in all cases in which the extended procedures regarding inventories and receivables set forth in ‘Extensions of Auditing Procedure’ are not carried out, regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods.” Our present practice is to demand a very strong showing that the prescribed extensions are not practicable and reasonable before other methods will be accepted as the basis for a satisfactory certificate.

Following the passage of the Investment Company Act of 1940 a number of changes were made in Regulation S-X and in January, 1942, a special Article (No. 6) applicable to financial statements filed by unit investment companies under the 1933, 1934 and 1940 Acts was added. A complete restatement of this article was published as Accounting Series release No. 57, in November, 1946. This restatement was undertaken after a critical review of financial statements filed by management investment companies indicated that such statements might be prepared in a manner which would bring more forcefully to the attention of investors the special characteristics of this type of company

and the significant aspects of its financial condition and results of operation. The restatement was adopted only after discussions with representatives of investment companies, the National Association of Investment Companies, accountants, attorneys, and other interested persons, which extended over a period of more than two years and culminated in a public conference and a reconciliation of the principal differences in views prior to publication.

It is not unusual that a completely revised regulation should result in the filing of some statements which fail to comply therewith in all respects. However, deficiencies in statements to which the new Article 6 is applicable have been far more numerous than was expected. And again, in most cases, the deficiencies appear to have resulted from unfamiliarity with the regulations. In fact a number of statements have been filed in conformity with old Article 6 and the accountants who certified these statements indicated that they did not know of any change in the regulation.

Previously I referred to the Accounting Series releases and stated that 61 have been published to date. No. 61, which was issued on May 15, 1947 is entitled "NOTICE OF PROPOSAL TO ISSUE A RELEASE IN THE ACCOUNTING SERIES REGARDING THE USE OF PUBLIC ACCOUNTANTS' NAMES IN CONNECTION WITH SUMMARY EARNINGS TABLES INCLUDED IN REGISTRATION STATEMENTS FILED UNDER THE SECURITIES ACT OF 1933." It has always been our practice to submit all proposed Accounting Series releases expressing an opinion concerning accounting principles to the various professional accounting societies and to a considerable number of public accountants and other interested persons for comments and suggestions. In the case of one release (No. 57) a public conference was held for the

purpose of obtaining the views of such persons. Because of anticipated general interest in the subject by registrants, bankers and lawyers, as well as accountants, we believe it desirable to publicize the proposed release in the same manner as is required, by the recently enacted Administrative Procedure Act, for general rules such as, for example, amendments to Regulation S-X. Thus we included in the announcement a statement that copies of the proposed release would be furnished on request, and an invitation to submit comments and suggestions thereon. In addition, following our usual custom, we sent copies of the release in the form in which it was proposed to be issued to approximately 600 individuals, firms and associations for comment.

The proposed release deals with a problem which is comparatively new. For the past two or three years there has grown up a practice of including in registration statements filed under the 1933 Act and in the applicable prospectuses summary earnings tables covering a period usually of ten years. These tables are not required by any rule or regulation of the Commission but they are desirable and, we think, necessary in most instances as a means of comparing the operation of a business in the pre-war, war and post-war periods. However, there have been unusual cases where such violent and radical changes in the business of the registrant have occurred that a long summary of past earnings might well be<sup>3</sup> misleading and in several such cases the registrant has been requested either to delete the summary entirely or to furnish only a brief statement of the overall, aggregate results without a breakdown as between the several years.

These summary tables are not required by the Commission's rules to be certified by independent accountants. It is, nevertheless, common practice to introduce the summary with language indicating that it has been "reviewed" by independent

accountants. This use of an accountant's name in connection with the summary is designed and tends to give added authority to the material presented. It is important, therefore, that there be a clear understanding and disclosure of the scope of the examination made by the accountant in such cases and the extent of the responsibility which he as an expert accountant assumes. This is the purpose of the proposed release which state, in brief, that in my opinion “. . .it is generally improper and misleading for an accountant to permit his name to be used in connection with an earnings summary or to undertake to express his professional opinion as to the fairness of the representations made in an earnings summary unless he has made an examination in accordance with generally accepted auditing standards applicable in the circumstances. \*\*\*In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with an earnings summary . . .it would appear that the accountant's certificate thereon should assume a comparable form [to the certificate required by Rule 2-02 of Regulation S-X7], and might be included with the summary or at a later point in the prospectus, perhaps along with or as part of his report as to the three-year certified statements.”

The volume of response to our requests for comment and suggestions has been very gratifying and practically every correspondent – whether he be a public accountant, banker, lawyer, comptroller or investor-has expressed agreement with the principles of the release. Many helpful suggestions have been received and have been considered in the preparation of the release as it will be issued finally (which should be soon). The most frequently raised point in the comments received concerned the procedure to be followed when a corporation had employed two or more independent accountants during

the period for which the summary of earnings is furnished. It is contemplated that in such a situation certificates covering the appropriate periods would be furnished by the accountants who had performed the audits for the years in question. This situation has been encountered and apparently solved successfully in the case of certified statements covering three years which are required to be included in a registration statement. And I have seen one example in which three years of a ten years earnings summary were covered by the certificate of one accountant, one year by another accountant, and the earliest six years were not certified. It should be noted that part of all of the earnings summary may be furnished uncertified, a procedure which we anticipate may be followed to a considerable extent, especially when the corporation is preparing a registration statement for the first time and has not had its accounts audited in the past.

This leads me to the only other frequently recurring question raised in the comments received which is as to the character of the auditing work required on a first engagement if the accountant's certificate is to cover the entire earnings summary of, say, ten years operations. I think the point is well taken that it is impossible to make the same audit for each of the earlier years that is required in respect of the latest year for which a certified profit and loss statement is furnished. Even if it were possible the cost would in my opinion not be justified. However, what is intended is that if the accountant is to certify the entire summary he should apply to the earlier years the same procedures employed by him as a basis for his opinion on the first two years of the three years statement of earnings required to be certified. Exceptions, if any, required to be made under these conditions presumably might extend to earlier years also. However, if because of the greater antiquity of the figures the necessary exceptions became so

extensive as to negative an opinion, the earlier years should be furnished by the company without audit.

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A final thought I should like to leave with you is to emphasize my sincere desire that the cooperative relationship existing between the accounting profession and the Commission's accounting staff will continue. In an address at the annual meeting of the Pennsylvania Institute of Certified Public Accountants in June, 1943, Ganson Purcell, then Chairman of the Commission, said, in part:

“I think the most outstanding feature of the relationship between the Commission and public accountants has been the existence of a spirit of cooperation and a resulting long-continued record of cooperative efforts to obtain better financial statements.

“I want that record to continue. I want to feel free to call upon accountants for their view and to ask for the benefit of their experience. Conversely, I want accountants always to feel free to bring to us whatever questions they may have as to accounting policies followed by the Commission. Finally, I hope accountants will feel not only free but, indeed, obligated to continue to bring to our attention changes and improvements in our requirements that their knowledge and experience indicate ought to be made.”

No words of mine could express my feelings more clearly on this point.