

THE SEC AND THE ACCOUNTING PROFESSION--
YESTERDAY AND TODAY

Address of

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a topic something like “The SEC and the Accounting Profession--Where We stand Today.”*

Judging from current discussions of accountants and their work, it may be difficult to reach the conclusion the suggested title seems to require, so I have expanded the title to include yesterday and thereby to suggest a brief review of developments in our joint efforts to solve accounting and financial reporting problems.

While there is only a limited number of treatises devoted to accounting and the SEC, there is a rather extensive list of articles in periodical literature which is readily available to the legal profession. This material is found in law journals and the principal accounting journals, and much of it is easily identified by reference to the “Accountants’ Index” and supplements. At the close of World War II, in an effort to assist accountants returning to practice, the American Institute of Accountants (now American Institute of Certified Public Accountants) published “Contemporary Accounting, A Refresher Course for Public Accountants.” This volume included a chapter on “Requirements of the Securities and Exchange Commission” by William W. Wertz, then Chief Accountant of the Commission, and Edmund B. Rickard of his office and now in a responsible position with Ford Motor Company.

The twenty-fifth anniversary of the Commission was the occasion for a review of the past, particularly by the editors of law journals. Among these is the George Washington Law Review issue of October 1959 which contained articles by SEC Commissioners and staff, both past and present, including a contribution on “Accounting and the SEC” prepared by Elmer C. Koch of my office. Along somewhat similar lines and bringing us down nearly to date is J.

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Arnold Pines' discussion of "The Securities and Exchange Commission and Accounting Principles" in the Autumn 1965 issue of Law and Contemporary Problems published by the Duke University School of Law. Both of these articles in accounting are supported by copious footnotes for those who wish to go to the authors' sources.

Another of these historical surveys was made by Arthur H. Dean, who needs no further identification for New York lawyers. His article appeared in the Columbia Law Review of May 1959. "Accounting Standards" is a caption for a one-page comment in the total of fifty pages. This is found, appropriately enough, is a section dealing with continuing questions and problems. As a basis for the remainder of this brief discussion, it would be difficult to find a more concise summary of the Commission's authority in accounting than in the following paragraphs:

"Under the acts it administers, the SEC has broad authority to prescribe accounting standards. It has exercised this authority by the promulgation under all the acts of regulation S-X, which prescribes the form to be followed in preparing financial statements for use in registration statements, proxy statements, and other documents issued or filed under the acts. In addition to regulation S-X, the SEC has promulgated uniform systems of accounts for public utility holding companies and for mutual service and subsidiary service companies under the Holding Company Act.

"In preparing its accounting standards, the SEC has worked closely with the accounting profession. The over-all result has been an immeasurable improvement in American accounting standards since 1933. The Securities Act specifies in schedule A that certain required financial statements be certified by independent or certified public accountants, and it gives the Commission authority in subsection 19(a) and schedule A to prescribe the detail and form of financial statements, define accounting terms, and prescribe the methods to be followed in the preparation of accounts, the appraisal or valuation of assets and liabilities, the determination of depreciation and depletion, and the differentiation of recurring and nonrecurring income and of investment and operating income. The other acts provide generally similar authority and permit the SEC to require certification by independent accountants, which with minor exceptions it has done. Because of its wide experience and its particularly able staff of accountants, the Commission has exercised increasing influence over accounting standards and presentation." [footnotes omitted]

The third and last paragraph on accounting standards cites two then currently debated issues--the criteria of independence of an accountant and the accounting treatment of rapid depreciation and amortization permitted by the internal revenue code. Some aspects of these problems are still current. The latter is the major subject of an accounting research study published by the Director of Research of the American Institute of Certified Public Accountants under the title "Interperiod Allocation of Corporate Income Taxes."

On the matter of independence the Institute and the Commission are in closer agreement now than when Mr. Dean wrote. As a result of amendments to the code of professional ethics which became effective January 1, 1964, the Institute's rules as to financial interests and involvement with the client as a promoter, underwriter, voting trustee, director, officer or key employee are in substantial agreement with the Commission's rules in these respects. Since I have quoted Mr. Dean, one of his references to the Securities Act should be clarified. The phrase which introduces the concept of independence is found in item (25) of Schedule A of the Act. It reads: "an independent public or certified accountant" not "independent or certified public" as cited. The difference is important since the regulations (Rule 2-01 of Regulation S-X) interpret the item to require both public accounts and certified public accountants to be independent as defined in the rules and in a number of Commission opinions and interpretative releases.

Before I take a more detailed inventory of where we are today, the comments of one of the early advisers to the Commission warrant some attention here. T. H. Sanders, professor of accounting at the Harvard University Graduate School of Business Administration, was a consultant to the Commission in 1934-1935 and retained his interest in its accounting releases until he died in 1953. His article in Law and Contemporary Problems in 1937 on the

“Accounting Aspects of the Securities Act” was a contemporary appraisal of the early forms which he had helped to draft--particularly Form A-2, designed for seasoned corporations. Those who have commented on the proposed new short form might find that thinking has changed in thirty years. Sanders pointed out that by the adoption of the new form the Commission recognized the need to distinguish between “old-established, reputable corporations with a known position and newer, mostly smaller, promotions still in a speculative stage.” This difference has not been erased with the passage of time.

Sanders, in his discussion of disclosure for established corporations, found two significant problems--those arising from the historical character of the balance sheet and those arising from those aspects of accounting which are largely a matter of the exercise of intelligent opinion. The first of these was recognized by the authors of Schedule A of the Act in the requirement that the balance sheet show “all of the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the Commission may prescribe (with intangible items segregated). . .” In the early days of the Commission this provision posed problems of analysis of old balances in accounts. Today the problem of assigning costs to components of the assets in an acquisition is of the same character. The twenties and thirties saw write-ups based on appraisals and subsequent write-downs--some obviously quite arbitrary. The question of price-level adjustments has been prominent in accounting literature for a generation, and the controversy over historical cost or current value as a basis for financial reporting makes headlines today. The Accounting Principles Board of the AICPA has this topic on its agenda. This is a subject on which the advocates of change seem unable to reach agreement on the solution. Meanwhile, generally accepted accounting principles support historical cost as the basis for financial reporting.

After discussing the Commission's solutions of the problems relating to the historical aspects of the balance sheet, Sanders turned to the problems arising from the judgment element.

He stated these so clearly that a quotation is in order:

“ . . . In very broad terms, these problems consist mainly in the determination of the amounts which may from time to time be carried as assets in the balance sheet, and at what points they become proper and necessary charges against income. Thus the all-important question of income determination is conditioned to a marked degree by intelligent and honest judgment, requiring an extensive knowledge of general business conditions in that area, and of the effects on the financial policies of the corporation of one accounting practice as compared, with another. For any government agency to enter this field with rigid prescriptions is to intrude unduly upon the management of the corporation itself, and can have only the results of the proverbial bull in the china shop. Who can prescribe a depreciation policy for a corporation, without knowing its practices with respect to maintenance, and its risks of obsolescence? Or who can determine an inventory valuation policy without an understanding of the conditions of raw material supply, cost accounting practices, and marketing problems of the particular company?”

Sanders said that careful examination of the accounting requirements under the 1933 Act as embodied in Form A-2 and its instruction book will reflect two principles adopted by the Commission. The first was “that the Commission would not seek to dictate the accounting practices of business corporations in all those matters in which differences of personal opinion and differences of circumstances have shown that optional treatments are permissible and necessary.” The second principle was “that the Commission endeavored to relate its accounting requirements to the general accounting practices of business corporations, so far as these could be ascertained and generalized.”

In applying these principles, we must remember that Regulation S-X, which brought together in 1940 the instructions as to form and content of the financial statements previously found in the various forms, contains Rule 3-06 which reads in part: “The information required with respect to any statement shall be furnished as a minimum requirement to which shall be

added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.” This, brings into the accounting regulations a reference to the penalties imposed by Section 11 of the Securities Act for false and misleading statements.

The specific recognition of the existence of authoritative support for alternative accounting treatments is found in Accounting Series Release Nos. 4 and 96 which state Commission policy consistent with the principles Sanders described. In subsequent years Commissioners and Chief Accountants of the Commission have expressed the policy of support for the profession in solving these problems. So much for yesterday.

Today has a convenient starting point with the Congressional hearings on the 1964 amendments to the Securities Acts. In the closing hours of these hearings the Chairman of the Commission was asked by the Chairman of the Congressional Committee whether it was true that the Commission accepts financial statements from companies following alternative accounting practices with materially different results for similar transactions accompanied by certificates that all of the practices are in accordance with generally accepted accounting principles. The answer to this was “yes” with some explanation along the lines indicated above. The Chairman was then requested to file with the Committee a statement setting forth areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles. This testimony and the statement which was furnished for the record may be found most conveniently in the June 1964 issue of The Journal of Accountancy.

It would be difficult to prepare a complete list of all alternative accounting methods, even all which produce materially different results, as these could vary with different industries and depending on whether the compiler is more concerned with the balance sheet or the income

statement. The memorandum discussed the following subjects: 1. Valuation of inventories; 2. depreciation and depletion; 3. income tax allocation; 4. pensions; 5. research and development costs; 6. goodwill; 7. when is income realized; and 8. “all-inclusive” versus “current operating performance” profit and loss or Income statement. In addition, other topics were named without elaboration. These were intercorporate investments, long-term leases, principles of consolidation, business combinations, income measurement in finance and small loan companies, and intangible costs in the oil and gas industry.

After, this memorandum prepared the Council of the AICPA in October 1964 unanimously adopted recommendations of a special committee that members should make certain that departures from opinions of the APB (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure) are disclosed, either in footnotes to financial statements or in the accountants’ audit reports in their capacity as independent auditors. This action of Council was intended to emphasize the authoritative character of the Board’s opinions and hence to hasten the harrowing of area of differences in the application of generally accepted accounting principles. Concurrent with the announcement of this requirement Council also directed the Board to review existing bulletins and opinions before December 31, 1965, to determine whether any of them should be revised or withdrawn. This was done and the results were published in October 1965 as Opinion No. 6. Opinion No. 5 on “Reporting of Leases in Financial Statements of Lessee” had been published in September 1964 and Opinion No. 7 on “Accounting for Leases in Financial Statements of Lessors” appeared in May 1966. Thus one highly controversial topic mentioned in the memorandum to Congress has been dealt with but with a recognition of inconsistency between Opinions 5 and 7 and a promise by the Board to continue consideration of the question.

The APB had been unhappy with two of its early accounting research studies as being the authors' concepts of the future logical development of accounting thought rather than a statement of postulates or principles to guide current practice. To provide such a statement, Paul Grady was induced to prepare an "Inventory of Generally Accepted Accounting Principles for Business Enterprises." This was completed and published as Accounting Research Study No. 7 and is a valuable reference on the present state of affairs in accounting. The Board has indicated, as stated in the preface, that this study can also be the basis for future progress in financial accounting and reporting.

Some evidence of this progress may be seen in three recent opinions of the Board. No. 10, "Omnibus Opinion - 1966," initiates a series which the Board expects to issue periodically to deal with amendments of prior Opinions, affirmation of accounting principles or methods which have become generally accepted through practice and which the Board believes to be sound and thus to prevent the possible development of less desirable alternatives, and conclusions on subjects for which a separate opinion is not warranted.

This opinion deals with a number of matters on which greater uniformity of practice is desirable. It endorses the equity method of reporting for unconsolidated domestic subsidiaries (foreign subsidiaries will be considered in another opinion), the inclusion in consolidation of real estate subsidiaries, which lease their properties to the parent, the restatement of financial statements following a pooling of interests; it prohibits off-setting securities against taxes payable except for rare situations; and it clarifies several other miscellaneous matters.

Opinion Nos. 8 and 9 deal in a comprehensive manner with difficult problems which have been the subject of earlier bulletins and which have been the subject of study and debate for

many years. Both subjects were included in the memorandum to Congress and have been considered as of the highest priority for solution.

Opinion No. 8, published last November, entitled "Accounting for the Cost of Pension Plans," is based upon an accounting research study by Ernest L. Hicks and supersedes accounting research bulletins on the subject. The prior bulletins permitted the use of alternative accounting practices resulting in substantial differences among different companies and variations in accounting for costs depending upon funding practices. The new opinion is a compromise solution but, nevertheless, adoption of the practices recommended, particularly the setting of minimum and maximum limits, will eliminate certain erratic accounting which has been permissible under existing bulletins. The opinion recognizes that the subject requires continuing study.

The subject is too complex to allow full discussion here, but attention should be called to the disclosure requirements of the opinion. The exposure draft was published in the September 1966 issue of The Journal of Accountancy. Paragraph 45 (46 in the final draft) included a subparagraph 2 with four definite suggestions as to disclosure. As adopted, only the introductory sentence as exposed is retained--that a note include, among other things covered in other subparagraphs, "a statement of the company's accounting and funding policies." Disclosures consistent with the requirements of Rule 3-19(e)(3) of Regulation S-X would have been provided by the omitted instructions (c) and (d) as follows:

“(c) If past and prior service cost is being amortized, the amount of the amortization for the year and the number of years remaining in the amortization period

“(d) If past and prior service cost- is not being amortized, the total unamortized amount of such cost”

In filings with the Commission, we would expect disclosure to be made along these lines, consistent with our rules.

Opinion No. 9, entitled “Reporting the Results of Operations,” in the first part deals with a problem having a long history. The reporting of extraordinary items was one of the most widely debated post-World War II accounting problems, and it was the subject of Commission studies and conferences with representatives of the accounting profession and others. At one point the Commission’s staff and Institute representatives were very close to agreement on the proposed content of ARB No. 32, “Income and Earned Surplus,” now Chapter 8, of Accounting Research Bulletin No. 43. The relative merits of the all-inclusive income statement advocated by the Commission’s staff and the current operating performance concept, believed by its supporters to be more useful as an indication of future earning capacity of a company, are discussed in this chapter and the latter concept is endorsed. The debate unfortunately reached an Impasse on the classification as between income and earned surplus of a few items, and we parted company. Having objected to various aspects of the bulletin in the course of its preparation, the Chief Accountant of the Commission wrote the Director of Research of the Institute that “the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32.” This letter and the bulletin were published in the January 1948 issue of The Journal of Accountancy.

About this time work was begun on a major revision of Regulation S-X, including adoption of the principle of the all-inclusive income statement. At the conclusion of the rule-making process the all-inclusive income statement controversy was compromised by including the now well-known Item 17 (Special Items) in Rule 5-03 of Regulation S-X. Compliance with

Opinion No. 9 will cause this item to fall into disuse, as the new form of income statement recommended in the opinion will meet the requirements of the regulation. The impact of the opinion should be a more determined effort to arrive at a more meaningful annual net income figure as its determination is affected by the inevitable estimates of changes in corporate life, future use of properties subject to depreciation and amortization, collectibility of accounts and obsolescence of inventories. Two recent prospectuses reported extraordinary items arising from one or more of these factors in every year of the summary of earnings. These could be described as situations involving regularly recurring, nonrecurring items. The record of such companies cannot be judged properly without taking these items into account.

It has been a common complaint that extraordinary items of income seem to appear in the income statement but the extraordinary charges go directly to surplus. This is not a new phenomenon of corporate reporting. Sanders observed that something, could “be learned about a company and its management from the kind of accounting they do when left to themselves, provided their accounting can be clearly seen. This is especially true,” he said, “of a practice like the base stock inventory method, which implies a conservative and long-range view of income determination, and of charges to surplus rather than to income, which tend to imply the reverse.” How would he have judged the company which a year ago reported “special income” of a substantial amount in the income statement but this year charged a similar item directly to retained earnings with a footnote reference while retaining the special income in a comparative statement?

The second part of Opinion No. 9 resolved a number of difficult problems relating to the reporting of earnings per share, particularly the computation of this figure when some of the new hybrid convertible preferred stocks are involved.

One more topic requires a brief note. The merger movement of the last several years has resulted in widely diversified companies whose operations include a number of distinct lines of business or classes of products or services. Chairman Cohen has discussed the reporting problems in speeches before financial analysts and accountants. The result has been the launching of studies by the Financial Executives Institute and the Accounting Principles Board while the staff is surveying material in the Commission files. The National Association of Accountants also has a project under way which will include certain aspects of the subject. And of course the appropriate committees of the Financial Analysts Federation have an interest, too, and have conferred with the staff. The results of these efforts should afford a basis for reexamination of some of the Commission's reporting requirements and should encourage more informative reporting to stockholders.

Arthur Dean provides a conclusion for this discussion. He concluded his article, noted earlier, by referring to doubt he had expressed in a Fortune Magazine article in 1933 as to whether the 1933 Act was workable and practicable, a view shared by others, and the change in his views a year later after amendments of the Act. He concluded that "responsible underwriters, issuers, dealers, directors, officers, and experts would all be justified in proceeding with securities issues under the act, provided they were diligent and used what they each considered to be reasonable care in applying subjective and objective tests of honesty.

"The past twenty-five years have justified this conclusion, and, although further statutory refinements undoubtedly will be made, in the absence of a fundamental change in the role of our government in society, the writer believes that the standards set forth in the acts are likely to remain for years to come. Of course, particular abuses will always call for new legislation."