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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

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| ARTHUR ANDERSEN & CO., Plaintiff, SECURITIES AND EXCHANGE COMMISSION, Defendant. | Civil Action No. 76 C 2832 (Judge Marshall) |

REPLY MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION


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Dated: Washington, D.C.
February 25, 1977

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REPLY MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION

Preliminary Statement

On July 29, 1976, Arthur Andersen & Co. ("Andersen") instituted this action, challenging a Commission policy statement — embodied in Commission Accounting Series Release 150 ("ASR 150")— which commands Andersen to do nothing, and challenging a separate Commission rule— Instruction H(f) to Commission Form 10-Q 1/ — which is directed not at Andersen, but at approximately 10,000 publicly-held corporations, some of whom are Andersen's clients.

But, this lawsuit is without merit. No amount of hyperbole can change the fact that a statement of policy — issued solely to alert persons who are subject to an agency's jurisdiction of the agency's likely future approach to certain problems — does not have, or purport to have, a coercive legal effect. Nor has any basis been shown for asserting that a Commission rule, properly

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1/ Revised Instruction H(f) to Form 10-Q has since been redesignated by the Commission as Instruction 4(f) to Form 10-Q (see, Securities Exchange Act Release No. 1315, 3 CCH Fed. Sec. L. Rep. ¶ 31,038). To avoid confusion, we will continue to refer to it herein as Instruction H(f).

adopted to furnish stability, consistency and integrity to financial reporting, may be overturned either because Andersen does not share the Commission's high regard for consistency in financial reporting, or because Andersen would have approached the issue differently had it, and not the Commission, been empowered to make such decisions.

Accordingly, we have moved for summary judgment, especially since Andersen concedes "that there is no genuine issue as to any material fact in this action,"2/ and, alternatively, we have moved to dismiss this action for failure to state a claim upon which relief could be granted and because Andersen lacks standing to raise the largely academic policy questions it seeks to litigate here.

Our opening memorandum anticipated and responded to the major positions offered by Andersen in its opposing brief, and there is no need to repeat here our original arguments in those respects. Rather, we respond below to those few points as to which some further explication seems appropriate.

## ARGUMENT

### 1. ASR 150 is a General Statement of the Commission's Policy, Not A Rule; In any Event, No Procedures Attending its Announcement were Required.

As we noted in our opening memorandum (pages 9-13), long before this lawsuit or even the events leading up to it, the Commission determined to issue statements of policy regarding its practice of deferring, in the first instance, to the accounting profession to consider and suggest approaches to financial reporting problems. ASR 150, which Andersen challenges here, was adopted

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2/ Counter-Motion of Arthur Andersen & Co. For Summary Judgment, at p. 1; cf., Securities and Exchange Commission v. American Commodity Exchange, Inc. [Current] CCH Fed. Sec. L. Rep. ¶95,798 at p. 90,883 (C.A. 10, Dec. 13, 1976).

in 1973, three years before this litigation began, as a part of the Commission's policy of deferring, in the first instance, to the private sector to establish acceptable norms.

Although it apparently never occurred to Andersen that ASR 150 was a rule, or objectionable, or both, at the time ASR 150 was published, Andersen seeks to make up for lost time by asserting, first, that ASR 150 is a substantive rule of the Commission, and, second, that the Commission was, somehow, required to have notice-and-comment proceedings before articulating its policy views. But the premises upon which Andersen seeks to reach these conclusions are unsound and, worse, unsupportable.

a. Andersen contends that ASR 150 has a substantial impact on its clients, and their selection of accounting principles, and that the release embodying ASR 150 is a mandate of the Commission which precludes the use of accounting principles which are not set forth in ASR 150 as having substantial authoritative support. But, even assuming that Andersen has standing to raise this issue in its own right, which it does not (see pages 25-27, infra), and even assuming that this issue is ripe for adjudication, which it is not, 3/ the evidence offered by Andersen does not support these assertions, and Andersen's own correct statement of Commission practices (Memorandum of Arthur Andersen & Co. In Opposition at page 10) ("Opp. Mem.") belies the validity of these contentions.

ASR 150, as we already have noted (Opening Mem. at pages 17-20), does not compel anyone to do, or to refrain from doing anything. The federal securities

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3/ Andersen petitioned the Commission on June 15, 1976, to revoke ASR 150. Rather than await a Commission decision on its petition, Andersen instituted this lawsuit. The Commission, however, solicited comments from the public on a number of questions which relate to the concerns raised by Andersen's petition, and held hearings on the matter on January 4, 1977 (See, Accounting Series Release No. 193, Exhibit E to the Commission's opening memorandum). No further action has, as yet, been taken by the Commission.

laws do, it is true, require publicly-held companies, or companies seeking to distribute their shares to the public, to make full disclosure about, among other things, the nature, extent and results of their operations. Central to this scheme of public accountability is the requirement that honest, accurate and complete financial statements regularly be available to the investing public.

If Andersen is contending that its clients may not utilize accounting principles of their own devising, designed to present the results of their operations in a favorable light irrespective of the true situation facing those clients, we agree. But that result does not flow from ASR 150, or its predecessor policy statement -- ASR 4. Rather, the result flows from the federal securities laws themselves, which preclude fraud, deception, material misstatements and material ommissions in financial statements. Only generally accepted accounting principles may be employed in the preparation of financial statements, and even then, not if their utilization would operate as a fraud or deceit upon any person.4/

In this regard, Andersen's claim with respect to ASR 150 is apparently premised on a fundamental misapprehension of the Commission's functions with respect to financial statements filed with it. The Commission does not approve financial statements; rather, its staff informally reviews those statements when filed to determine whether any disclosure problems are presented by the manner in which those statements have been prepared. 5/ If the staff concludes that investors

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4/ See, e.g., United States v. Simon, 425 F.2d 729 (C.A. 2, 1969), certiorari denied, 397 U.S. 1006 (1970).

5/ No affirmative action by the Commission is necessary for a registration statement filed with the Commission to become effective (see, Section 8(a) of the Securities Act of 1933, 15 U.S.C. 77h(a)). Although an order of the Commission is required before an amendment to a registration statement filed after the effective date of the registration statement may become effective, a registrant could always sue the Commission to obtain such an order and the only issue in such a lawsuit would be whether the Commission abused its discretion in concluding that the amendment was incomplete or inaccurate in any material respect (see, Section 8(c) of the Securities Act of 1933, 15 U.S.C. 77h(c)).

might be misled or deceived by a particular aspect of a company's financial statements, it will attempt, informally, to persuade the company to alter its report. It is the company, however, that has the initial choice of whether to conform to the staff's views. If the company chooses to disregard the staff's advice, the Commission may be compelled to institute an enforcement proceeding. But, in such a proceeding, the only issue is whether the particular financial statements are false or misleading, not whether they violate ASR 150. Indeed, nothing in ASR 150 is determinative of the outcome of such a proceeding. Rather, ASR 150 serves only to put Andersen and its clients on notice whether and when the Commission or its staff is likely to raise questions and institute such a proceeding; it does not compel that such a proceeding be brought. Viewed in this context, it should be apparent that nothing compelled the public pronouncement of ASR 150, and that, even in its absence, nothing would change in the Commission's handling of financial statements filed with it.

Thus, it is not surprising that, apart from the general conclusory allegations of its complaint, which are not, and cannot be, supported by specific factual instances, Andersen fails to demonstrate that its clients have been precluded from using generally accepted accounting principles which they would otherwise have used but for the existence of ASR 150. Indeed, Andersen's brief concedes, as is the fact, that companies have deviated from the pronouncements of the FASB without objection from the Commission, where it has been necessary to do so to avoid misleading investors (Opp. Mem. at page 9). Significantly, Andersen also concedes that the Commission policy stated in ASR 150 is not binding on the courts (Opp. Mem. at page 10) --a concession compelling the conclusion that ASR 150 lacks the fundamental characteristic of a substantive rule. 6/

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6/ See, Joseph v. Civil Service Commision, C.A. D.C. No. 75-1647, Slip. Op. p. 25 n. 26 (Jan. 17, 1977); Pacific Gas and Electric Company v. Federal Power Commission, 506 F.2d 33,38 (C.A. D.C., 1974); Koch, Public Procedures for the Promulgation of Interpretative Rules and General Statements of Policy, 64 Geo. L.J. 1047 (May, 1976).

b. Andersen contends, however, that the Commission should have issued ASR 150 in accordance with the notice and publication requirements of the Administrative Procedure Act ("APA") because the release announces a policy which, according to Andersen, has a substantial impact on registrants. But, many activities in which an agency engages can have a substantial impact on the persons to whom its provisions relate without necessarily compelling the conclusion that a rule has been issued. The breadth or force of the impact that an administrative agency's activities may have is not the sine qua non of a substantive rule. Thus, for example, the filing of an amicus curiae brief expressing the legal positions of an agency, or the institution of an agency enforcement proceeding in which the agency expresses an interpretation of the laws which it administers, have a substantial impact not only on the persons involved in the specific proceeding, but also upon other persons not parties to the specific proceeding in which the agency's views are articulated, and the agency's views may cause those persons voluntarily to decide to conform their conduct in a manner consistent with the views expressed by the agency.

The broadly result-oriented approach argued for by Andersen here would, contrary to existing precedents and sound policy, require amicus briefs and enforcement actions to be treated like rules. Insofar as we are aware, no case supports such an approach or result. 7/

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7/ See, Opening Mem. at pages 16-20. As we there pointed out (id. at p. 19 n. 29), where courts have concluded that an agency's activities have had a substantial impact on persons and should have been issued after appropriate notice and publication, the cases involved situations vastly different from the present case.

Moreover, in the cases relied upon by Andersen (Opp. Mem. at pages 17-22, 25), not only was it apparent that formal regulations had been issued by the agencies involved, but those agency regulations all had the effect of denying persons fundamental, constitutionally conferred, rights and protections.

(footnote continued)

In any event, whether or not ASR 150 has a substantial impact on registrants, and we submit that it does not, that release is not a substantive rule since, as we have seen, it does not create a "'binding norm' * * * [which] is * * * finally determinative of the issues or rights to which it is addressed." Pacific Gas and Electric Company v. Federal Power Commission, supra, 506 F.2d at 38.

c. Relying upon an isolated request contained in a letter sent to the Commission by a representative of the FASB, a statement not endorsed or adopted by the Commission, however, Andersen urges this Court to disregard not only the substance of what the Commission accomplished in publishing ASR 150, but

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7/ (footnote continued)

Thus, in Columbia Broadcasting System, Inc. v. United States, 316 U.S. 407 (1942), the orders in question had a serious chilling effect on the petitioner's first amendment right of free speech and also constituted a substantial deprivation of property without due process of law. Columbia, moreover, did not deal with the question of whether the agency statement was a substantive rule or statement of policy. The same was true of Writers Guild of America, West, Inc., v. Federal Communications Commission, C.D. Cal. No. CV 75-3641 F.

Similarly, Texas, Inc., v. Federal Power Commission, 412 F.2d 740 (C.A. 3, 1969), Pharmaceutical Manufacturers Association v. Finch, 307 F. Supp. 858 (D. Del, 1970), and Seaboard World Airlines, Inc. v. Gronouski, 230 F. Supp. 44 (D. D.C., 1964), involved substantial deprivations of property without any due process rights afforded to the plaintiff.

In Pickus v. United States Board of Parole, 507 F.2d 1107 (C.A.D.C., 1974) the plaintiff was potentially subject to continued incarceration without the benefit of fundamental due process considerations. And, in Lewis Mota v. Secretary of Labor, 469 F.2d 478 (C.A. 2, 1972), the complainant was potentially subject to expulsion from the United States, again without the benefit of due process rights and protections. Finally, in Nader v. Butterfield, 373 F. Supp. 1175 (D. D.C. 1974), the regulations in question, which authorized x-ray searches of airplane passengers' baggage, involved serious Fourth Amendment, search and siezure, considerations, but had not been adopted with prior notice and an opportunity for comment.

also the Commission's perceptions of, and statements about, what it did in releasing ASR 150. Such an approach has no sanction in law, and is inconsistent with the actual facts pertaining to this matter.

Thus, in determining whether ASR 150 is a substantive rule or a general statement of the Commission's policy, this Court

> "'must necessarily look to the administrative construction of the regulation * * * [T]he ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regultion.'"

Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268 (1969), quoting Bowles v. Seminole Rock Co., 325 U.S. 410, 414 (1945). Accord, Udall v. Tallman, 380 U.S. 1 (1965).

In this instance, the Commission's interpretation of ASR 150 is not some recently contrived defense to this litigation, as Andersen's memorandum seems to suggest, but is an interpretation to which the Commission subscribed at the time of its issuance of ASR 150. As Anderson points out at page 3 of its memorandum, prior to the issuance of ASR 150, the FASB, through its counsel, had suggested that the Commission adopt a rule stating that

> "Financial statements * * * filed with the Commission * * * shall * * * be prepared in accordance with accounting principles and standards of financial accounting and reporting for which there is substantial authoritative support. For purposes of the foregoing, Statements of Financial Accounting Standards and Interpretations of Statements of Financial Accounting Standards issued by the Financial Accounting Standards Board shall be deemed substantial authoritative support unless and until the Commission provides otherwise in general, or in any particular matters, by rule or regulation." 8/

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8/ See Document No. 18 produced by the Commission in response to Andersen's Interrogatory No. 6, annexed to the Affidavit of Leonard S. Schifflett, dated December 29, 1976, submitted in support of Andersen's Counter-Motion For Summary Judgment (Schifflett Affidavit) (emphasis supplied).

The Commission, however, determined only to issue a general statement of policy and thus authorized its "Chief Accountant to discuss a proposed statement of policy describing the Commission's relationship with the Financial Accounting Standards Board with Marshall S. Armstrong, Chairman of the Board, which release would reaffirm the Commission's support for the Board." 9/

Rather than adopt mandatory requirements, as had been suggested by counsel for the FASB, the Commission issued a release which was identified as a "Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards" 10/ which made clear that the Commission was merely reaffirming its historical "policy of looking to the private sector for leadership in establishing and improving accounting standards and principles * * *." 11/ In accordance with this policy, and in the context of its review of filings, the Commission stated in its release that accounting standards which were "contrary to * * * FASB promulgations will be considered" by it and its staff not to have substantial authoritative support and, that, financial statements which employed such contrary principles would be "presumed to be misleading."

While the use of an accounting principle which was contrary to a principle enunciated by the FASB or one of its predecessor organizations might lead the staff to take the position that a registrant's financial statements would be misleading, ASR 150 did not, and does not, create a right of action in the Commission, or any other person, if such contrary principles should, in

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9/ Minute of Commission meeting dated October 4, 1973, Document No. 19 produced by the Commission in response to Andersen's Interrogatory No. 6 and annexed to the Schifflett Affidavit (emphasis supplied).

10/ (See, ASR 150) (Ex. A to the Commission's Opening Memorandum).

11/ Id.

fact, be followed. And, that statement of probable staff or Commission reaction is not binding upon, or determinative of the rights of the Commission, its staff, or registrants that file financial statements. Indeed, as Andersen recognizes, ASR 150 did not establish a binding norm for the staff's review of financial statements, but instead allowed for "ad hoc decisions by the SEC staff [which are] * * * not binding on the courts." (Opp. Mem. at page 10). 12/

In contrast, the earmark of a substantive rule is its establishment of a standard which is "finally determinative of the issues or rights to which it is addressed," Pacific Gas and Electric Co. v. Federal Power Commission, supra, 506 F.2d at 38, a standard which is enforceable by, and binding on, the courts. Joseph v. Civil Service Commission, supra, Slip. Op. pp. 24-25 n.26. Moreover, a substantive rule establishes a conditional imperative to which the Commission and its staff are also bound. Hence, if ASR 150 were a binding substantive rule, departures from its precepts would not be permissible, as Andersen concedes they now are (Opp. Mem. at page 10), by convincing "the staff of the SEC that its interpretation is incorrect * * *."

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12/ Andersen suggests (Opp. Mem. at page 10) that the Second Circuit's recent decision in Arthur Lipper Corp. v. Securities and Exchange Commission, [Current] CCH Fed. Sec. L. Rep. ¶95,796 (C.A. 2, Dec. 10, 1976), lends some support to its theory that ASR 150 is a substantive rule of the Commission. In fact, however, Lipper expressly rejects the notion that statements in Commission expressions of general policy may be enforced as rules:

> "Insofar as the Commission would attribute legal force to these statements in PPI [a Commission report to Congress entitled Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess.] we must disagree * * * [I]t constituted information for the legislature, not a rule having the force of law for the industry, as would a regulation adopted pursuant to 5 U.S.C. §553."

Id. at p. 90,865. In an observation particularly pertinent to this Court's consideration of ASR 150, the Second Circuit added that, "[w]e regard the quoted statements from PPI as doing no more than warning the industry of what position the Commission would be likely to take * * *."

The presumption that the Commission acted properly and in accordance with the law in issuing ASR 150 "is such a strong presumption that it is overcome only by clear and convincing evidence." Chaney v. United States 406 F.2d 809, 813 (C.A. 5), certiorari denied, 396 U.S. 867 (1969). 13/ One consequence of the existence of this presumption of regularity is that "the party complaining of an agency's failure to adhere to [the APA's notice and publication] * * * requirements" has the burden of demonstrating that the agency statement in question is a substantive rule imposing legally enforceable "rights and obligations on them." See, e.g., Carpenters 46 County Conference Board v. Construction Industry Stabilization Committee, 393 F. Supp. 480, 492 (N.D. Cal., 1975). 14/

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13/ Chaney involved a selective service board draft classification determination.

14/ Despite Andersen's assertion that the Commission has the "heavy burden" of proving that ASR 150 is a statement of policy, the cases it cites (Opp. Mem. at page 15) simply do not support this contention. Detroit Edison Company v. United States Environmental Protection Agency, 496 F.2d 244 (C.A. 6, 1974) makes no mention of the proposition for which Andersen cites it. Rather, it stands for the proposition that an agency's characterization of a statement as an interpretative rule is not dispositive of whether the publication and notice requirements of the APA are applicable. As that court emphasized, however, 446 F.2d at 248:

> "It is well settled that an agency's interpretation of its regulations is properly entitled to deference by the courts unless it is plainly erroneous or inconsistent with the regulations. Udall v. Tallman, 380 U.S. 1, 85 S. Ct. 792, 13 L. Ed. 2d 616 (1965)"

Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953), and Schlemmer v. Buffalo, Rochester & Pittsburgh Railway Co., 205 U.S. 1 (1907), also relied on by Andersen, merely recite the "general rule of law" (205 U.S. at 10) that those who claim the benefit of a special exception to an act must establish it. We deal here, however, with an interpretation of an agency statement by the agency itself, and, thus, in determining the effect of the statement, this Court must consider the presumption of regularity which attaches to agency activities, the agency's own interpretation of its statement, and the label which the agency affixes to its statement.

Andersen does not begin to meet this burden and, in fact, the only evidence it has proferred is supportive of the Commission's position. Thus, Andersen states that the Commission has been enforcing ASR 150 as if it were a rule (Affidavit of George R. Catlett, dated December 28, 1976), filed in support of Andersen's Counter Motion, at ¶9) ("Catlett Affidavit"). In support of this assertion Anderson refers to the fact that, in the past three years only three registrants have, in their filings with the Commission, departed from principles established by the FASB or one of its predecessor bodies. This is not suprising, however, since, as we noted in our opening memorandum at page 14, Rule 203 of the revised Code of Professional Ethics adopted by the AICPA requires AICPA members to follow FASB pronouncements or to demonstrate that departures from such principles are in conformity with generally accepted accounting principles, and, thus, ASR 150 should have no effect on the evaluation of generally accepted accounting principles by members of the AICPA. Andersen's suggestion( Opp. Mem. at pages 1,13) that it is not bound by Rule 203 since accounting <u>firms</u> are not eligible to be members of the AICPA is disingenous; individual members of accounting firms are members of the AICPA, and all, or substantially all, of Andersen's domestic partners are members of the AICPA, who have agreed to be bound by Rule 203.

While the Catlett Affidavit suggests that, as a result of the issuance of ASR 150, many of Andersen's clients, as well as other registrants, have, on numerous occasions, been precluded from departing from principles enunciated by these authoritative bodies, in direct contradiction of this suggestion that same affidavit establishes that, in the 35 years between the issuance

of ASR 4 in 1938 and Rule 203 in March 1973, there were only "some occasions" in which "Andersen and its clients deviated from such pronouncements" (Catlett Affidavit at ¶ 10), and, in the eight months between the issuance of Rule 203 and ASR 150, there were no instances in which any of Andersen's clients sought to deviate from the pronouncements of these authoritative bodies (id.). The only fair inference that can be drawn from these facts is that registrants which file financial statements with the Commission, and their accountants, in large measure apply generally accepted accounting principles and, that the authoritative bodies established by the accounting profession are a leading source of such principles.

Andersen's contention that ASR 150 created new, legally enforceable rights and obligations by precluding reference to all other sources of generally accepted accounting principles (Opp. Mem. at page 14) is equally unavailing. The very terms of the release belie this contention. The policy discussed in ASR 150 is addressed only to those situations where the FASB or one of its predecessor authoritative bodies has promulgated a standard. The Commission's policy embraced in ASR 150 does not pertain when the accounting principles are ones which have neither been promulgated by, nor rejected by, one of these authoritative organizations. Nor do those organizations have a corner on the accounting principles market. "AICPA accounting interpretations, ACIPA industry audit gides and accounting guides * * * industry accounting practices * * * AICPA statement ments of position, pronouncements of other professional associations and regulatory agencies, such as the Securities and Exchange Commission, and accounting textbooks and articles" are all sources of established accounting principles. 15/ Thus, even the policy approach with which ASR 150 is concerned has no bearing on

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15/ See AICPA Statement on Auditing Standards No. 5, ¶6

the utility of any of those sources of accounting principles, unless reliance upon such a source would result in the use of an accounting principle which is directly contrary to principles promulgated by the FASB or one of its predecessor authoritative bodies. And, even in the latter situation, ASR 150 does not prohibit or prevent the use of such a contrary principle. At most, it alerts Andersen to the fact that the Commission's staff may raise a question about the use of that principle. Thus, despite Andersen's assertion that its failure to follow ASR 150 could result in the imposition of criminal or civil liability (Opp. Mem. at page 13), an assertion with which we strongly disagree, even Andersen does not dispute that no person has even been charged, in a civil or criminal proceeding, by the Commission or by any other person, with violations of ASR 150 (Burton Affidavit, ¶ 22). 16/

d. In a final attempt to attack Commission policy, Andersen sets forth the bald assertion that the publication of ASR 150 failed to comply with the the Commission's own rulemaking procedures (Opp. Mem. at page 6). But, as we have seen, ASR 150 is not a rule; and, even if it were, the alleged procedures

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16/ While the motives for Andersen's institution of this action attacking the Commission's policy in ASR 150 have been questioned by various of the amici which have participated at earlier stages in this proceeding, an attack to which Andersen lends credence by using this legal proceeding to impugn the integrity and independence of the FASB (see, e.g., Opp. Mem. at pages 3,4,22-24), we intimate no view as to those motives.

We are constrained to point out, however, that, despite Andersen's assertion that one of its major concerns with respect to ASR 150 is that it has been deprived of fundamental due process rights as a result of the FASB's adoption of accounting principles (Opp. Mem. at p. 24), the FASB's procedures for promulgating accounting principles are replete with protections and opportunities for persons to present their views, and are entirely consonant with the notion of due process. (See, Opening Mem. at p. 12).

to which Andersen refers only apply to the "adoption of substantive rules;" (17 C.F.R. 202.6(a) (emphasis supplied)). While some accounting rules are substantive rules "materially affecting an industry or a segment of the public" (id.), others, such as statements of policy or interpretative rules, simply are not. Unlike the cases cited by Andersen (Opp. Mem. at page 6), in which the relevant question was whether the activities in question came within, and were required to conform to, the agency administrative procedures, 17/ in the present case this Court must first conclude that ASR 150 is a rule, and then that it is a "substantive" rule, before the Commission's rulemaking procedures would be arguably operative.

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17/ See Vitarelli v. Seaton, 359 U.S. 535 (1959) and Rodway v. United States Department of Agriculture, 514 F.2d 809 (C.A. D.C., 1975) (Opp. Mem. at page 6).

Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268 (1969), also cited by Andersen, (id.) does not even allude to, much less support, the proposition for which Andersen cites it.

2. Instruction H(f) to Form 10-Q is a Rational and Lawful Exercise of the Commission's Broad Rulemaking Authority

In our opening memorandum we discussed at length the historical background of Instruction H(f) (Pages 22-32) and the manner in which the rule operates (id. at pages 32-40). We stressed that the determination required by the rule was to be based on the circumstances of each case, and that it was not a static determination to which registrants were bound for all time, in all circumstances. We also emphasized that Instruction H(f) cannot be viewed in isolation, but rather, must be read in context with its logical corollary — the precise statement in APB Opinion No. 20 that generally accepted accounting principles mandate consistency in reporting. Andersen does not, and could not, dispute the need for, or even the desirability of, consistency in accounting treatment; instead, it completely disregards it. But, to ignore the presumption of consistency set forth in APB No. 20 is to distort the circumstances under which Instruction H(f) operates.

Thus, without mentioning the underlying rational of the rule, Andersen argues, for example, that Instruction H(f) operates in a discriminatory fashion, since it applies only to business entities that elect to change the accounting principles they employ and not to entities that continue to use the same accounting principles (Opp. Mem. at page 42). 18/ But, even if a rule like Instruction H(f) could be

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18/ The cases which Andersen cites in support of this proposition (Opp. Mem. at page 42) are inapposite. In Hughes Air Corp. v. Civil Aeronautics Board, 482 F.2d 143 (C.A. 9, 1973), in making subsidy determinations, the CAB would reduce the amount of government subsidy paid to air carriers by certain tax loss carrybacks incurred by the carriers. The subsidy determinations, however, often took years to process and were processed in essentially a random fashion. Thus, notwithstanding that two carriers might have applied for subsidies at the same time and have sustained tax losses in the same year, if one carrier's subsidy determination was made after the tax loss had been carried back, his subsidy would be reduced by the

(footnote continued)

applied to all financial reporting situations, there is nothing that compels the Commission to do so. Naturally, the Commission hopes that registrants will, at all times, apply only those accounting principles which result in the fairest presentation of an entity's financial picture, but Instruction H(f) does not reach that far, nor must it. It was adopted to promote the meaningful use of comparative accounting data from year-to-year, by ensuring the consistent application of accounting principles from one accounting period to another. Instruction H(f) does not prescribe the original selection of an accounting principle, since that was not a problem with which the Commission felt compelled to act. The rule comes into play only when a change in accounting principles is to be made since that was a problem both the Commission and the accounting profession itself felt compelled to treat.

a. Among other things, Instruction H(f) was intended to prevent a return to the "go-go years" of the late 1960's when an increase of earnings per share was often the singular objective for a switch to a new accounting principle. Andersen displays its different value preference by effectively urging a return to that era of "creative accounting." It argues, in that regard, that "[s]o long as an alternative principle remains a generally accepted accounting principle, no

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18/ (continued footnote)

amount of the carryback, whereas if the second carrier's subsidy application was processed before the tax loss had been carried back, his subsidy was not reduced by the amount of carryback. Accordingly, determinations involving millions of dollars hinged on purely arbitrary and fortuitous circumstances. Interstate Contract Carrier Corp. v. United States, 389 F. Supp. 1159 (D. Utah, 1974), and Dixie Highway Express, Inc. v. United States, 268 F. Supp. 239 (S.D. Miss., 1967), merely stand for the proposition that an administrative agency may not, without good reason, grant to one person the right to do that which it denies to another person in the same or similar situation. Instruction H(f) applies, without exception, to all registrants.

business enterprise should be prohibited from adopting or changing to it for reasonable business purposes * * *" (Opp. Mem. at page 40). In Andersen's view a desire "to obtain * * * Federal income tax advantages" (Opp. Mem. at page 35), is one example of a business motivation for a change in accounting principles. That is a view to which Andersen subscribes, as is its right. The Commission does not share Andersen's view, however, since under it companies could, yearly or even quarterly, alter the principles upon which their financial statements are based soley to maximize their tax benefits, while investors and shareholders would be left to grope for some basis upon which to determine if the company's financial fortune actually had improved or worsened.

In any event, Andersen contends that, because Instruction H(f) shifted the determination of preferability from management's business judgment to the independent auditor's professional judgment, such changes are now somehow precluded. Apparently, in Andersen's view, without Instruction H(f), these changes would be permissible. But, this assertion is contrary to the relevant accounting literature. In its Interpretation No. 1, the Financial Accounting Standards Board concluded: "In applying APB Opinion No. 20, preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of income tax effect alone." As FASB Interpretation No. 1 recognizes, preferability is not, and never has been, an exclusive function of management's judgment that an accounting change may be justified by reference to some self-serving purpose, but is related, instead, to whether an accounting change will result in an "improvement in financial reporting," a decision which the independent public accountant is well suited to make.

The Commission's concern with improvements in financial reporting has also been reflected in the steps it has taken to stiffen the resolve of the

independent public accountant in its dealings with its clients. When a registrant changes its certifying accountant, for instance, the Commission requires that it must explain in Commission Form 8-K whether there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure. The registrant must also obtain a letter from its former accountant in which the accountant indicates whether it agrees with the registrant's statements. 19/ Rule 3-16(s) of Commission Regulation S-X requires disclosures by registrants, in certain circumstances when accountants have been dismissed or resigned, which have similar salutary effects. 20/ In view of the significant steps which the Commission has taken to promote the independence of accountants, it is somewhat surprising that Andersen would now suggest that Instruction H(f) somehow compromises its independence by supposedly fostering accountant shopping by registrants (Opp. Mem. at page 45). Indeed, Instruction H(f) was adopted in part to prevent such shopping — the shopping for accounting principles which would result in the highest possible earnings.

b. Andersen also argues that the Commission's notice of proposed rulemaking regarding Instruction H(f) is marked by a "fatal flaw," since that notice failed to recite APB Opinion No. 28, and APB Opinion No. 20, in their complete texts (Opp. Mem. at page 30). And yet, the APA requires only that the notice of proposed rulemaking set forth "either the terms or substance of the subjects and issues involved." 5 U.S.C. 553(b)(3). The failure to set forth the complete text of provisions which are well known to, or readily ascertainable by, interested members of the public, does not render the notice defective. See generally, Buckeye Cablevision, Inc.

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19/ See Item 4 to Commission Form 8-K, 3 CCH Fed. Sec L. Rep. ¶31,003 at p.22,003.

20/ Regulation 210.3-16(s), 4 CCH Fed. Sec. L. Rep. ¶ 69,190 C.

v. Federal Communications Commission, 387 F.2d 220, 226 (C.A. D.C., 1967); National Industrial Traffic League v. United States, 396 U.S. 456, 460, (D. D.C., 1975)(Three Judge District Court). In its release announcing its proposed rule-making (Securities Act Release No. 5549, annexed as Exhibit F to the Commission's opening memorandum), the Commission expressly mentioned and discussed the applicability of APB Opinions No. 28 and 20 (See Exhibit F, 5 SEC Docket page 728). And, Instruction H(f) as proposed in that release, also expressly referred to APB Opinion No. 28, which incorporates APB Opinion No. 20 (id. at 5 SEC Docket page 731).

In any event, while "the action of the administrative agency will be set aside" when the "absence of notice has resulted in prejudice to a complaining party," Florida Citrus Commission v. United States, 144 F. Supp. 517, 521 (N.D. Fla., 1956), affirmed, 352 U.S. 1021 (1957), the assertion that there was a "failure to give formal notice" will not be heard, and "no prejudice is shown where, as in this case, the party complaining had actual knowledge of and participated in the administrative proceedings * * *." Andersen, one of the largest accounting firms in the world, unquestionably had actual knowledge of the texts of APB Opinions No. 20 and 28, and, in its comments to the Commission regarding the proposed rule, Andersen discussed in some detail the proposed rule's relationship to, and effect upon, those APB Opinions (See, Comments of Arthur Andersen & Co., March 14, 1975, to the Securities and Exchange Commission at pages 3, 11, annexed to the attached affidavit of Charles A. Moore ("Andersen Comments").

c. Although Andersen concedes that the standard of review in this action is whether the Commission acted arbitrarily or capriciously, or abused its broad discretion, in adopting Instruction H(f) (Opp. Mem. at page 39), it predicates its position in that regard on the argument that there are certain situations in which Andersen could not form a professional opinion as to whether a change is preferrable, and in which it could conclude that a change is preferable

only by intruding into the business decisions of management (Opp. Mem. at page 44). 21/

We do not dispute that circumstances may arise in which an accountant will not be able to form a professional opinion as to whether a change is preferable. But, as we explained in our opening memorandum at pages 37-38, an explanation which Andersen completely ignores, if for any reason, an independent accountant is unable in good faith to form a professional judgment that a change is "preferable under the circumstances," he is not expected to indicate his concurrence in managements' conclusion that the change is preferable. One of the purposes of the rule is to preclude such changes when it cannot be concluded that the change in question is preferable to the usual need for consistency.

d. Andersen also devotes a large portion of its memorandum to a new contention, not addressed in Andersen's complaint, nor before this court previously — that the adoption of Instruction H(f) was flawed by the Commission's failure to consider the competitive impact of the rule as required by Section 23(a)(2) of the Securities Exchange Act of 1934 (Opp. Mem. at pages 32-39). 22/ Even if such an argument properly should be entertained by this Court, a dubious proposition, it is without merit.

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21/ Andersen belatedly urges (Supplemental Memorandum at 3) that this Court should take "judicial notice" of the opinion of two individuals set forth in their personal correspondence with the Chairman of the Commission. Even if that letter were otherwise probative of any of the issues in this case, which it is not, Rule 201 of the Federal Rules of Evidence precludes such an approach. Similarly untenable is Andersen's argument that the recent issuance of a staff interpretative bulletin, Staff Accounting Bulletin 14, establishes that Instruction H(f) is so vague and ambiguous as to be invalid. Such an assertion would mean that any time experience is had with an agency rule that raises some questions on the part of those persons who must comply with it, the agency's staff is effectively precluded from addressing those issues for fear of a determination that the rule is presumptively arbitrary and capricous. To state the proposition, however, is to refute it.

22/ 15 U.S.C. 78W(a)(2), as amended by the Securities Act Amendments of 1975, Pub. L. 94-29, §18, 89 Stat. 156 (June 4, 1975).

Section 23(a)(2) of the Securities Exhange Act, which Andersen incorrectly paraphrases, does not, as Andersen urges, require the Commission, to state, when adopting a rule, what conclusions it has reached regarding competition (Opp. Mem. at page 34). Were it otherwise, even where a rule had no competitive impact, the Commission, according to Andersen, would affirmatively be required to explain a negative conclusion that might, as here, be wholly irrelevant to the true questions raised by the proposed rule.

But paraphrases aside, Section 23(a)(2) only requires the Commission to "consider * * * the impact" that rules or regulations adopted under the Securities Exchange Act "would have on competition." It carefully avoids requiring the Commission to state that a rule does not effect competition. Rather, it is only when the Commission seeks to adopt a rule which it has determined would impose some "burden on competition", that the Section requires that "[t]he Commission shall include in the statement of basis and purpose [for such rule], the reason for the Commission's determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of * * * [the Securities Exchange Act]."

There is no basis to assume that the Commission did not consider the competive effects of its proposed rule, particularly since the agency must be presumed to have acted regularly, see p. 11, supra. But even beyond presumptions, and disregarding Andersen's assumptions, the uncontested fact of the matter is that the Commission properly fulfilled its statutory function. 23/

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23/ Although paragraph 2 of the affidavit of John Michael Ryan, dated January 4, 1977, submitted in support of Andersen's counter-motion, states that

> "[n]one of the documents produced by the SEC * * * contained any statement with respect to the effect the proposal to revise Instruction H(f) of Form 10-Q would have on competition * * * ,"

that statement is simply not true.

(footnote continued)

In any event, the only question of importance, if the issue were germane, is whether the rule does impose a burden on competition. In light of the fact that the rule applies equally and across-the-board to all publicly held reporting companies if they seek to change accounting principles upon which their financial statements are based, Andersen's contention that the rule burdens competition should be viewed as nothing more than the last-minute makeweight that it is. Nevertheless, Andersen belatedly argues that Instruction H(f) burdens competion in essentially three ways:

> —first, that a company precluded from changing to an accounting principle which would offer it certain tax advantages is thereby placed at a competitive disadvantage with competitors who may have changed to that principle prior to the adoption of Instruction H(f) (Opp. Mem. at pages 35-36);
>
> —second, that an accounting firm that refuses to acquiesce in a registrant's determination that a change is preferable may lose its clients to another accounting firm (Opp. Mem. at page 45); and,
>
> —third, that the costs of compliance with the rule exceed any benefits that may flow from the rule (Affidavit of Robert D. Neary, dated December 29, 1976, submitted in support of Andersen's Counter-Motion, at ¶9).

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23/ (continued footnote)

Andersen's own comments on the proposed rule, one of the documents produced by the Commission, discusses one suggested competitive effect of Instruction H(f); and other Commission documents furnished to Andersen and attached to Mr. Ryan's and Mr. Schifflet's affidavits generally discuss competive effects of the rule and of ASR 177, of which Instruction H(f) was an important part. See, e.g., Andersen Comments at 14; Exhibit B to the Commission's Opening Memorandum at 2, 4, 5, 6, 7, 8, 12 and 14; Memorandum from the Chief Accountant and the Division of Corporate Finance to the Commission, dated April 9, 1975, at 2-3, Document No. 70 produced by the Commission in response to Andersen Interrogatory No. 7 and attached as part of Appendix A to the Schifflet Affidavit ("April 9, 1975 Memorandum to the Commission); Attachment to the April 9, 1975 Memorandum to the Commission at pp. 2-5.

These arguments, however, are unavailing. Thus, Andersen's so-called tax-advantages argument— that is, that some firms changed accounting principles prior to the adoption of Instruction H(f) solely for the tax benefits such changes might engender, while competitors could not today make such changes— even if Andersen had standing to assert it, which it does not, 24/ flies in the face of the FASB's interpretation of APB Opinion 20, which directed accountants not to concur that a proposed change in accounting principles was preferable if the change was predicated "on the basis of income tax effect alone."

Similarly ill-founded is Andersen's concern that it might lose clients if it refused to concur that a proposed accounting principle change was preferable under the circumstances. As noted above, management disagreements with, and changes of, independent auditors are required to be disclosed promptly and publicly on Commission Form 8-K. Such a report would alert the Commision and its staff to the dispute over preferability, and might raise questions concerning the independence of the second accounting firm's statement that the proposed change was preferable. Certainly, in such a case, the second accounting firm would be on notice that its predecessor had not been able to satisfy itself of the preferabiltity of the proposed change, and that the Commission's staff would look with interest at the second firm's conclusions regarding preferability. Alternatively, if the second accounting firm appropriately could reach an independent professional conclusion that the proposed changes was preferable, Instruction H(f) would not have been the cause of the termination of the first firm's client relationship; rather, a lack of adaptability, skill and ability on the part of the first firm would furnish the real reason for its loss of a client.

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24/ See pp. 25-27, infra.

And, finally, Andersen's assertion— and that is all that it is— that the costs of implementing Instruction H(f) far outweigh its benefits, is simply not supportable. In this Court, no more than before the Commission (before which it did not even consider the argument sufficiently dignified to raise), Andersen points to no significant independent costs associated with compliance. In any event, ASR 177, which adopted Instruction H(f), is unique in this regard, since the release plainly evidences the Commission's sensitivity to cost-benefit analysis.25/

3. Andersen Has No Standing To Maintain This Action

Despite the Commission's direct challenge to Andersen's standing to maintain this action, Andersen continues to rely on the general conclusory allegations of its complaint as a basis for standing. Andersen, argues that, "taking all such allegations as true," (Opp. Mem. at page 46) it has alleged "specific and perceptible harm." (Opp. Mem. at page 47) When a party's standing to sue is raised in issue, however, it is not enough to conclude that the complaint contains general allegations of harm and injury. If such allegations were sufficient, artful pleading alone would be sufficient to confer standing. As the Supreme Court observed in United States v. SCRAP, 412 U.S. 669,688-689 (1973), however,

> "pleadings must be something more than an ingenious academic exercise in the conceivable. A plaintiff must allege that he has been or will in fact be perceptibly harmed by the challenged agency action, not that he can imagine circumstances in which he could be affected by the agency's action. And it is equally clear that the allegations must be true and capable of proof at trial."

As it has in the past, Andersen continues to assert, without more, that "it is directly affected in its practice as an independent public accountant by ASR 150 and Revised H(f)" (Opp. Mem. at page 49), and "that it will be

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25/ See, e.g., Exhibit B to the Commission's opening memorandum at pages 2, 4, 5, 6, 7, 8, 12 and 14.

harmed by ASR 150 and Revised H(f) unless they are declared null and void and their enforcement enjoined" (id. at page 50). But, "[a]bsent the necessary allegations of demonstrable, particularized injury," Warth v. Seldin, 422 U.S. 490,508 (1975), standing will not lie.

In Warth, for instance, the petitioners challenged a town zoning ordinance, alleging in general terms that the ordinance effectively excluded peitiioners, persons of low and moderate income, from living in the town and therefore violated petitioners' constitutional rights. The Supreme Court concluded that standing would not lie because the petitioners had relied "on little more than the remote possibility, unsubstantiated by allegations of fact, that their situation might have been better had respondents acted otherwise, and might improve were the court to afford relief." Warth v. Seldin, supra, 422 U.S. at 507.

Similarly, Andersen has not, and could not, demonstrate that its situation would improve if this Court were to grant the relief requested. Enjoining the operation of ASR 150 would have no effect, particularly since Andersen's partners, who are members of the AICPA, are bound by Rule 203 of the AICPA'a Code of Ethics to follow accounting principles enunciated by the FASB and its predecessor bodies. Similarly, since Instruction H(f) must be complied with by registrants and not their accountants, enjoining its operation does not permit or require Andersen to do or to refrain from doing anything.26/

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26/ Although Andersen argues that ASR 150 and Instruction H(f) have an indirect effect on its activities (Opp. Mem. at page 48), the cases upon which Andersen relies are inapposite.

Thus, in Columbia Broadcasting System, Inc. v. United States, 316 U.S. 407 (1942), the agency action in question resulted in the wholesale cancellation of the plaintiff's contracts with its affiliated broadcasting stations. In contrast Instruction H(f) will not produce such a result. And, even if it could be assumed that Andersen might lose a client over a question of preferability, standing would not lie, since, as we have seen (p. 24, supra), that injury could not fairly be traced to the actions of the Commission,

(footnote continued)

In short Andersen has not alleged, nor could it prove, a single instance in which the operation of the policy embodied in ASR 150, or the mandate of Instruction H(f), has caused it any direct or indirect harm, has had any measurable effect on Andersen's client relationships, or has caused it to sustain any economic losses. Absent the requisite demonstration of particularized injury, Andersen lacks standing to maintain this action.

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26/ (continued footnote)

rather than Andersen's own actions. Simon v. Eastern Kentucky Welfare Rights Organization., 96 S.Ct. 1917, 1926 (1976).

Finally, Writers Guild of America, West Inc. v. Federal Communication Commission, supra, Slip Op. 107, upon which Andersen also relies, is of no precedential value on the issue of standing. There, the defendants had stipulated that the plaintiffs had standing to sue. And, the plaintiffs there possessed the requisite standing to sue, in any event, since it was directly the result of the Federal Communication Commission's action that the plaintiffs' television scripts had been modified, censored and, in some instances, rejected.

## CONCLUSION

For the foregoing reasons, as well as the reasons set forth in our opening memorandum, this Court should grant the Commission's motion for summary judgment or, in the alternative, should dismiss this action for failure to state a claim upon which relief can be granted, or for lack of standing.

Dated: February 25, 1977
Washington, D.C.

Respectfully submitted,

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Affidavit

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

| | |
|---|---|
| ARTHUR ANDERSEN & CO., Plaintiff, v. SECURITIES AND EXCHANGE COMMISSION, DEFENDANT. | Civil Action No. 76-C-2832 (Judge Marshall) AFFIDAVIT |

City of Washington )
: ss:
District of Columbia )

CHARLES A. MOORE, being duly sworn, deposes and says:

1. I am the Records and Privacy Act Officer of the Securities and Exhange Commission.

2. On December 19, 1974, the Commission issued Securities Act of 1933 Release No. 5549 (Commission File No. S7-542) in which it proposed and requested comments on certain rules relating to accounting matters, including a revision to Instruction H(f) to Commission Form 10-Q.

3. Attached is a true copy of the Comments of Arthur Andersen & Co. on those rule proposals, without the appendices to the comments, found in the Commission's public file No. S7-542.

Executed at Washington, D.C. the 25th day of February, 1977.

Charles A. Moore

Subscribed to and sworn before me this 25th day of February, 1977

Notary Public

My comm. expires
5-14-81

# To The

# Securities and Exchange Commission

In Response to Request for Comments on Proposed Amendments to Regulation S-X and Form 10-Q Providing for Certain Changes in Reporting Quarterly Financial Information

(Release No. 33-5549 - File No. S7-542)

Comments of

ARTHUR ANDERSEN & CO.

March 14, 1975

## INTRODUCTION

In Securities Act Release No. 5549 (the "Release," reproduced as Appendix A hereto), the Securities and Exchange Commission has proposed amendments to Regulation S-X and Form 10-Q to expand its quarterly reporting requirements and to require the inclusion of summarized quarterly financial data in a note to the annual financial statements. If adopted in their present form, the proposals also would significantly increase the involvement of independent public accountants with interim financial data reported by their clients.

The expressed purpose of this Release is to increase the reliability of interim financial data reported by publicly owned companies. In it, the Commission points out that "quarterly data have been reported on an extremely abbreviated basis and annual financial statements have generally been presented without regard for or disclosure of trends occurring within a year." The Commission states that, in its view, an understanding of the patterns of performance within a year may be vital to an interpretation of the significance of a full year's results, but that a basis for such understanding is not now provided. By expanding current quarterly reporting requirements and requiring the inclusion of selected quarterly data in notes to the audited annual financial statements, the Commission believes that "this information deficiency can be remedied and that the reliability of interim data can be enhanced." The Commission also believes that it would be useful to investors to have companies draw on the reporting expertise of their auditors in this respect and that "the involvement of the independent accountant will increase the reliability of such reports even though no audit opinion is issued on the interim financial report."

## SUMMARY OF OUR RECOMMENDATIONS

A summary of our views and recommendations on the proposed amendments, as discussed in detail herein, is as follows:

1. It is clearly in the public interest that interim financial information released by publicly owned companies be as factual, reliable and timely as possible. On the other hand, accounting is not an exact science; it includes many estimates and judgments, particularly of future costs and expenses. The accuracy of these estimates and judgments is sharply reduced as the period being reported upon is shortened. The limitations on the level of precision that is attainable in assigning the results of a company's operations to short periods are severe and may not be understood clearly by investors. We recommend improved disclosure in interim reports of the tentative nature of such reports and of the inherent problems associated with significant estimates and judgments made at interim dates, to caution investors and others when using such data for comparative and predictive purposes.

2. The role and responsibility of the independent public accountant with respect to interim financial data must be carefully evaluated before any amendment to Regulation S-X in this regard is adopted. The existing framework of auditing standards

and financial reporting responsibilities does not permit auditors to issue unqualified reports on annual financial statements that include quarterly financial data in notes thereto unless they apply substantive auditing procedures to such data. The Release states that the data cannot be designated as "unaudited." Investors would be misled if the positioning of the data would lead them to believe such data are audited where, in fact, they are not. Furthermore, application of the necessary auditing procedures would substantially increase the cost of audit services and would frequently delay the release of interim financial data.

If the Commission believes that a useful purpose is served by supplying relevant interim financial data in annual reports, we recommend that these data be presented elsewhere than as part of the annual financial statements. Managements and/or boards of directors are increasingly requesting independent public accountants to review interim financial information before it is published, and we believe that this practice would further increase if quarterly data for the year were required in the text of annual reports. Involvement of independent public accountants in this manner would tend to minimize the possibility that data reported quarterly might need later revision.

3. We urge the Commission to reconsider our petition dated October 22, 1974 (reproduced as Appendix B hereto), in which we requested the Commission to promulgate an Accounting Series Release prohibiting registrants from publishing or publicly referring to reports of independent public accountants that provide "negative assurance" on unaudited interim financial data. The public issuance of such reports is unprofessional and potentially misleading to investors, and we believe such a practice would be inconsistent with the Commission's desire for more substantive auditor involvement with interim financial data reported in annual financial statements. An auditor, once having stated on the basis of a "limited review" that he had no adjustments to suggest to the interim data, would be in a difficult position if he then discovered errors therein as a result of applying audit procedures in connection with his later examination.

4. Although the Release states that "the Commission does not propose to require registrants to restate retroactively quarterly results at the end of the year to reflect quarterly earnings as seen from the perspective of the end of the year," it also states that "[i]f registrants believe that the trend of business operations would be more easily understood by showing in columnar form the amounts originally reported, adjustments based on subsequent events and a pro forma adjusted figure for each quarter, they may do so." This provision is subject to broad misinterpretation and possible misuse unless criteria are established for such pro forma presentations, since many if not most restatements (except for poolings of interests and, possibly, ac-

counting changes and errors) ordinarily would have to be made on an arbitrary basis. Further, it is likely that the Financial Accounting Standards Board would have to amend Accounting Principles Board Opinions No. 20 and No. 28 to accommodate such criteria. We do not believe previously reported quarterly data should be restated except to reflect poolings of interests, even on a pro forma basis, unless it is clear that an error or a change in accounting practices has occurred that can be identified with a specific period.

5. The proposed amendments to Form 10-Q would require registrants to furnish comparative income statements, balance sheets and statements of source and application of funds on a quarterly basis, following the form of presentation specified in Regulation S-X, except that footnotes need not be included "unless . . . required to make the financial statements not misleading." Footnotes are an integral part of financial statements that purport to present financial position and results of operations and cannot be separated therefrom except on an arbitrary basis. It is not clear how the Commission would distinguish between quarterly and annual reports in this respect, nor how it would expect registrants to apply the "not misleading" criterion to short-period reports. Furthermore, although the Commission believes that quarterly data now are reported on an "extremely abbreviated basis," the Release does not explain why full financial statements filed on a quarterly basis are necessary to remedy the asserted deficiency. Perhaps expanded interim reporting requirements (but not full financial statements) would meet investors' needs adequately, while avoiding the erroneous implication that interim data are prepared with the same degree of precision as the year-end financial statements.

6. When a company changes an accounting method, the Commission proposes to require the independent public accountant to state that in his judgment the change is to an alternative that is "preferable under the circumstances." Section 546.04 of Statement on Auditing Standards No. 1, issued by the American Institute of Certified Public Accountants, requires only that the auditor be satisfied that "management's justification for the change is reasonable." Notwithstanding the provisions of Accounting Principles Board Opinion No. 20, decisions with respect to the "preferability" of one accounting principle over another are subjective and vary not only with facts and circumstances, but also with the personal views of individual accountants. Differing opinions regarding alternative accounting principles can be held in good faith by knowledgeable practitioners, and it would be unfortunate to insert personal preferences into an obviously unsettled area. The solution to the problems created by the existence of alternative practices lies not in the personal preferences of individual accountants, but in the elimination of alternatives by action of an authoritative body such as the Financial Accounting Standards Board. We urge that no changes be made to the current reporting requirements of independent public accountants regarding changes in accounting as set forth in Form 10-Q.

## IMPORTANCE AND LIMITATIONS OF INTERIM REPORTING

Interim financial information issued by publicly owned companies most frequently takes the form of quarterly reports to shareholders and regulatory agencies. This information may include financial statements somewhat similar to those issued on an annual basis, but more usually is comprised of summary operating data such as sales, extraordinary items, income taxes, net income and related per share data for the current quarter or other period, year-to-date and comparable prior periods. Some companies whose business is seasonal, or that have experienced unusual changes from one year to the next may also present such data by quarter for the current year and for the full prior year.

We are fully aware of the importance of interim financial reports to the investor's decision-making process. Investors, governments and businessmen are all anxious to receive early signals of changing economic conditions, both within a particular company or industry and in the economy as a whole. Much of the interim information released by public companies rapidly enters into statistical data used to develop important conclusions regarding not only investment decisions, but also governmental policies and tax and trade regulations. Therefore, it is clearly in the public interest that interim financial information released by publicly owned companies be as factual, reliable and timely as possible.

Accounting, however, is not an exact science and users, particularly of interim financial information, should not be led to believe otherwise. The ability to make reliable estimates and judgments on a timely basis in areas such as possible inventory obsolescence, uncollectible receivables and significant accruals is even more difficult for short periods within a year than it is for annual periods. The nature of the company's activities and the relative seasonality of its business can also have a significant impact on interim data.

As an example of the problems involved, many companies that have changed to the LIFO method of pricing inventories will find it difficult to make the required estimates of year-end inventory levels and levels of inflation that will be necessary to determine cost of goods sold for short periods. For instance, if a partial liquidation of a LIFO layer has taken place at an interim date, the company must judge whether it will be replaced by year end. Reported interim earnings will be significantly affected by the judgment made.

The provision for income taxes is another important area where major problems may arise in reporting interim results. Such problems are most likely to result where computations of the income tax provision are dependent on amounts included in the registrant's income statement for its entire statutory taxable year. Events occurring in subsequent interim periods (which are not subject to accurate estimation in advance) may materially affect the tax provision recorded in earlier interim periods—e.g., the utilization of foreign and investment tax credits, the limitation on the computations of percentage depletion, the utilization of capital and ordinary losses, the amount of minimum tax on items of tax preference and the characterization of gains and losses incurred on the sale or disposition of certain assets.

Furthermore, many companies are not structured internally to close their accounts and prepare interim financial statements on what is regarded as a timely basis with the same degree of care and accuracy applied to annual statements. To do so would often entail significant costs and delays in the issuance of interim reports. There is a definite cost-benefit relationship to be considered, with cost in terms of time and money for greater reliability to be measured against the benefits of reasonably prompt communication.

The limitations that circumstances impose on the level of accuracy attainable in assigning the results of a company's operations to short interim periods are severe. The best practicable job should be done, of course, to make the information reliable within reasonable time and cost constraints. Even when a company has met its interim reporting responsibilities in an optimum manner, however, we believe the public interest can best be served by clearly informing investors and others that the information is tentative in nature and relies upon estimation and judgment, rather than by implying a greater degree of accuracy, through public involvement of auditors or otherwise, than is justified. The proposed instructions to Form 10-Q require the inclusion, where appropriate, of statements calling attention to such items as the seasonality of the company's business, major uncertainties, significant events, significant accounting changes or new arrangements with creditors. We recommend that these instructions be expanded to require a clear and concise explanation of the tentative nature of interim reports and the inherent problems associated with the need to make significant estimates and judgments for short periods at interim dates. Appropriate language for this purpose might include something similar to that in the Release, where the Commission stated that it "recognizes that interim data are necessarily more tentative than annual financial statements since these data are usually quickly prepared without the information and documentation normally available during the preparation of annual statements."

## ROLE OF THE INDEPENDENT PUBLIC ACCOUNTANT WITH RESPECT TO INTERIM FINANCIAL DATA

Two different proposals—one from the Commission in this Release and another from a firm of independent public accountants—have recently been advanced that would increase auditors' involvement with interim financial reports. We are deeply concerned about these proposals, both of which would have significant ramifications that appear not to have been adequately recognized by those making them.

The approach under the Release would not publicly involve independent public accountants with interim financial data when originally released. Instead, the Release proposes to have companies include specified quarterly information for the two most recent years in a note to the audited annual financial statements. Although the Release asserts that such information need not be audited, it takes the anomalous position that the data cannot be designated as "unaudited." The result of this position is that the auditors would have some

sort of vague responsibility for the interim data.* There is no precedent for this ambiguous and potentially misleading position, nor is there support for the Commission's assertion that the work required could be performed by the auditors "at relatively modest incremental cost." The fact is that auditors must take unequivocal responsibility for data with which they are associated, and the cost under this proposal would be substantial.

The second proposal would have a company's independent public accountants make a limited review—but not an audit—of quarterly financial data and issue a formal report to the public on the basis of such review. Such a report would not include an opinion on the interim financial data; rather, because of the nebulous and highly limited scope of the procedures, auditors would, of necessity, have to resort to giving only "negative assurance" (i.e., to state that nothing had come to their attention). In our opinion, investors would not understand the limited scope of work performed or the severely limited reliance that can be placed on negative assurance; as a result, they would likely be misled by reports issued that follow this approach.

We believe that both of these proposals introduce problems that are far more serious than those they purport to solve. In our view, a more sensible approach giving consideration to actual circumstances and conditions is needed.

**Proposal in Release for Quarterly Data in Annual Reports**

The amendments to Regulation S-X proposed in the Release would significantly increase the involvement of independent public accountants with interim financial data, at least on an end-of-the-year basis. The Release states that "the Commission does not believe that the auditor will have to audit each interim period as a separate period to fulfill his professional responsibilities." Curiously enough, however, it also states that the Commission is not prepared to have the summarized quarterly financial data proposed to be included in a note to the annual financial statements designated as "unaudited"; rather, it asserts that "the auditor must satisfy himself that the interim data reported in the note are a reasonable reflection of the trend of operations within the year in conformity with generally accepted accounting principles."**

We are deeply concerned about the lack of understanding that this assertion implies of the responsibilities independent auditors undertake with respect to the financial statements (of which the notes are an integral part) on which they report. The Commission's proposal

*The extent of the responsibility auditors would have with respect to notes setting forth these interim data is further clouded by the unanswered question of whether such data would be considered essential to a fair presentation of financial position and results of operations in accordance with generally accepted accounting principles.

**In a later portion of the Release, it is stated that the auditor must be satisfied that the interim information "fairly presents results for interim periods as evidence of the trend of operations within the year." The distinction, if any, between the phrases "fairly presents" and "are a reasonable reflection" is not clear.

brushes aside in an almost cavalier way the ethical and legal consequences that auditors would face if they expressed an opinion on financial statements accompanied by important note disclosures to which they have not applied substantive audit procedures but which are not designated as "unaudited." For auditors to follow the approach suggested in the Release would be professionally irresponsible. We are apprehensive that the language in the Release may cause its readers to pass over this matter and to assume that the benefits of auditor attestation can be obtained at very little cost.

While the Release appears to distinguish between the responsibility an auditor would assume following an audit of interim financial statements and some lesser form of responsibility based on the relationship of interim financial data to the financial statements for the full year, we believe it is impossible to make such a distinction on a logical basis that anyone could understand. A reader of financial statements has a right to, and will, presume that summarized financial data included in a note to audited financial statements are audited unless otherwise indicated. Furthermore, we do not consider it desirable to establish a practice of including data such as interim financial information in audited statements on an unaudited basis even if the Commission were to permit the data to be designated "unaudited."

The Release states: "It would appear that the current methods of estimating costs could largely continue to be used, and that it would not be necessary, for example, to observe physical inventories and confirm receivables within each interim period." In addition, the Release indicates that "it is reasonable to expect that an independent public accountant who has substantial familiarity with a company through an audit relationship over time would be able to perform appropriate reviews and tests at relatively modest incremental cost . . . ." We believe that the assertion concerning necessary audit procedures is not valid, and that the statement that they can be done "at relatively modest incremental cost" is not true. To our knowledge, no study has been made to support these assertions; in fact, we do not see how one could have been made since there are no agreed-upon procedures.

The effect of the proposed amendment to Regulation S-X would be to require independent public accountants to apply substantive auditing procedures to interim financial data in connection with their examination and report on the annual financial statements of a company. The use of hindsight and the information provided in connection with the audits of the annual financial statements at both the beginning and end of the year would make the application of auditing procedures to interim information easier from the perspective of the year end than would be application of necessary auditing procedures on a timely basis at the end of each interim period. Nevertheless, if the auditors are to take audit responsibility for interim data, they must employ those procedures considered necessary in the circumstances to discharge that responsibility.

While the proposal of the Commission is directed toward annual audited financial statements, we understand that the principal intent is to encourage auditor involvement throughout

the year when interim financial information is released. If this is the intent, we are concerned about the indirect method the Commission appears to be taking. Some lawyers have concluded that the Commission is taking this course because of questions regarding its authority to mandate direct quarterly involvement of auditors. If so, we do not believe that it is in the public interest for the Commission to attempt to gain by way of the back door what it cannot obtain through the front door; further, it is unfair to adopt a devious approach that places independent public accountants in an ambiguous position with respect to their professional responsibilities. The Commission should not encourage independent public accountants to abandon their professional standards and personal convictions regarding the degree of responsibility they must assume for data included in audited financial statements in order to lend an appearance of greater feasibility to its own proposals. The potential legal liability for erroneous interim financial data in notes to financial statements upon which independent public accountants express an unqualified opinion is as real as for any other erroneous data in the financial statements.

We agree that the proposal of the Commission would generally result in auditor involvement with interim data prior to release, since registrants would want to minimize the risk of differences between quarterly data as initially reported and quarterly data included in a note to the annual statements. However, if auditors are expected to be in a position when quarterly information is released to give registrants reasonable assurance that the information will not require change when it is later presented as part of the year-end financial statements, they will need to apply substantive auditing procedures prior to initial release of the information. It must be recognized that this would generally delay the issuance of interim data.

Our firm is ready and willing to be of assistance to our clients in meeting whatever regulatory requirements the Commission may establish under its statutory authority. If our firm is to undertake the responsibilities that flow from the conclusions set forth in the Release, however, clients will incur substantially higher fees and, generally, will experience delays in the release of interim data.

**Proposal for Interim Reporting by Independent Public Accountants**

In September 1974, Coopers & Lybrand proposed to make limited reviews of clients' quarterly financial statements and to issue negative-assurance reports with respect to published quarterly financial data. Our firm petitioned the Commission on October 22, 1974, to prohibit registrants "from publishing or publicly referring to reports of independent public accountants that provide 'negative assurance' on the basis of 'limited reviews' with respect to unaudited financial data taken from financial statements presenting financial position and results of operations." (Appendix B)

The Commission denied our petition on December 19, 1974 (see Appendix C attached hereto), stating in part:

> "The Commission believes that the involvement of independent public accountants with interim financial reports is a development which could be expected to increase the reliability of such reports and that appropriate standards should be developed to cover such involvement. In that connection, it was pleased to be advised that the Auditing Standards Executive Committee of the AICPA is working on a statement which will propose standards for reviews of and reports on interim financial information and that such statement is expected to be approved for public exposure and comment at its January, 1975 meeting. It is anticipated that the exposure draft produced by that Committee will provide an appropriate forum for discussion of the impact on public understanding of reports such as those proposed by Coopers & Lybrand."

The AICPA committee has not yet approved a draft for public exposure, and one of the reasons is that the Commission issued its own proposal on the same date as the comments quoted above were made in connection with the denial of our petition. This introduction of a different proposal—in some respects incompatible—blurred the focus and put an entirely new dimension on what was being considered by the AICPA committee.

The proposal for limited reviews contemplates inquiries involving matters of accounting principle and specific problem areas and transactions. The independent public accountants involved would rely heavily on inquiry of management and other company personnel. Time and scope constraints would permit the application of only a very limited part of the audit procedures that would normally be undertaken in connection with an examination of financial statements.

Financial statements that purport to present financial position and results of operations, and financial data derived from such statements, frequently depend more on the application of accounting principles than they do on the principles adopted. Thus, deficiencies in quarterly reporting may stem more from problems of application than from the adoption of wrong accounting principles. Meaningful assurance that the principles adopted by a company have been properly and consistently applied can be based on nothing less than substantive tests of the accounting records and other auditing procedures. Furthermore, without an audit accountants can have no assurance that they have become aware of all significant matters of principle or of unusual items or transactions.

We do not have any confidence that effective standards can be developed on how to perform a "nonaudit" and issue a public report that provides investors with assurance that is substantive but does not create excessive expectations. The publication of "negative assurance" reports based on "limited reviews" by independent public accountants is certain to be misleading to a great many investors, and reports of this type could cause a serious erosion of confidence of investors with respect to reports of independent public accountants resulting

from regular examinations of financial statements. When undetected errors and deficiencies are later disclosed with respect to such interim financial data, and the independent public accountants take refuge under their presumed limited responsibility, an undermining of the credibility of independent public accountants would occur.

We urge the Commission to reconsider our petition at this time and to prohibit registrants from publishing or publicly referring to reports of independent public accountants that provide "negative assurance" with respect to unaudited financial data taken from financial statements presenting financial position and results of operations.

**A Practical Solution**

If the Commission believes that a useful purpose is served by supplying specified interim financial data in annual reports, we recommend that these data be presented elsewhere in the report than as a part of the annual financial statements, in a manner similar to that for information relating to lines of business. While independent public accountants would not have a public reporting responsibility for such data, they would have a relationship similar to that for other financial data in the annual report that is not included with the financial statements.

Managements and/or boards of directors of an increasing number of companies, as a part of carrying out their responsibilities for interim financial data, are requesting that their independent public accountants review such data before they are published. We believe that this practice would increase further if the Commission were to require quarterly data for the year to be presented in the text of annual reports. Prudence would lead to the involvement of independent public accountants in some manner in connection with the release of quarterly information to reduce the possibility that data reported quarterly might need later revision.

Auditors' involvement of this type is desirable, from the standpoint of both companies and investors, where the scope of the procedures and an appreciation of the inherent limitations of the findings can be readily understood. The procedures and the manner in which results are communicated to managements and directors can be arranged to fit the needs of the individual company in the light of its own situation, without risk that investors and other readers of the financial data will misunderstand the extent of the auditors' involvement and thereby be misled concerning the reliance to be placed on it.

In our view, auditors' involvement with interim financial data is an extremely sensitive matter—one that can result in delays and substantially increased cost and that is fraught with risk of serious misunderstanding by the investing public if it is not established on a sound basis. The consequences of any decision reached in this respect must be weighed carefully.

## RESTATEMENTS OF INTERIM DATA

Because of the inherent difficulties in making estimates for interim periods during the year, the criteria for reporting changes and refinements in such estimates must be clearly understood by both the preparers and the users of financial statements.

The proposed amendments to Form 10-Q indicate that the "financial statements to be included in this report shall be prepared in conformity with the standards of accounting measurement set forth in Accounting Principles Board Opinion No. 28 . . . ." Further, the Commission specifically "endorses the approach to interim reporting set forth in paragraph 26 of APB 28 which requires changes in accounting estimates to 'be accounted for in the period in which the change in estimate is made.' " Despite this endorsement of Accounting Principles Board Opinion No. 28, however, the Release also states that "[i]f registrants believe that the trend of business operations would be more easily understood by showing in columnar form the amounts originally reported, adjustments based on subsequent events and a pro forma adjusted figure for each quarter, they may do so."

Accounting Principles Board Opinion No. 20 clearly states that "a change in accounting estimate should be accounted for in . . . the period of change . . . [and] should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods." Although it might be argued that this standard applies only to annual and not to interim financial statements, we find no persuasive support or logic for such a distinction and believe the proposal allowing pro forma adjusted figures for each quarter is clearly contrary to the Opinion.

While we generally favor the restatement of accounting data following a change in accounting principle, to make the information reported for several periods more comparable and to portray a more meaningful picture of the trend of operations, we do not favor restatement of accounting data resulting from the application of estimates. Such restatement is particularly impracticable for short periods. Further, it is not clear how this exercise, imperfectly carried out, will benefit users of financial statements. It will lend an air of spurious accuracy to interim data that is not warranted and may be misleading. Accordingly, we recommend that interim financial data previously reported to the public not be permitted to be restated except for poolings of interest, for material matters that are obviously error corrections (e.g., application of an unacceptable accounting principle or clerical error), or for changes in the application of an accounting principle, that can be assigned to prior periods on a reasonable basis. We believe that this approach would comply with Opinions No. 20 and No. 28.

## PROPOSED AMENDMENTS TO FORM 10-Q QUARTERLY REPORTING REQUIREMENTS

The proposed amendments to Form 10-Q effectively would require registrants to file a complete set of financial statements with the Commission on a quarterly basis. Comparative balance sheets, income statements and statements of changes in financial position would be required to be included for each quarter, prepared in accordance with the requirements of Regulation S-X. Comparative income statements would be required for the most recent quarter, as well as for the year to date, while comparative statements of changes in financial position would be required on a year-to-date basis only. (This latter requirement seems to be contrary to Accounting Principles Board Opinion No. 19, which requires a statement of changes in financial position for each period for which an income statement is presented.)

Although the amended Form 10-Q would require "complete" financial statements, the summary of accounting policies required by Rule 3-08 and the detailed note disclosures set forth in Rule 3-16 would not be required unless considered necessary "to make the information called for not misleading." The Release does not explain, however, how to distinguish between note disclosures that are required and essential for a fair presentation of financial position and results of operations and those that are necessary to make the financial statements "not misleading." In our view, the set of financial statements that the proposal would require should be, and will be, interpreted by users as presenting the financial position and results of operations of a company. If complete financial statements are presented, all notes required under generally accepted accounting principles are an integral part of the financial statements and cannot be separated therefrom except on an arbitrary basis.

The Release states that "quarterly data have been reported on an extremely abbreviated basis" in the past and that the "Commission believes that these are deficiencies in the financial reporting framework," but it contains no explanation why the Commission believes it is necessary for registrants to file complete financial statements on a quarterly basis in the future to remedy the situation. There could be alternatives. Management's discussion and analysis of a comparative summary (or statement) of earnings would in itself seem to alleviate much of the Commission's concern over disclosure of trends and potential problem areas. This, coupled with some form of "exception reporting" on unusual risks and business uncertainties, might well provide as much or more useful information than full financial statements, without the awkward necessity to justify the omission of some, but not all, note disclosures.

We also are concerned with the conclusion expressed in the Release that the requirement for complete financial statements in the Form 10-Q should not necessarily lead to expansion of summarized quarterly financial data now included in published quarterly reports to shareholders. Such a policy would place registrants in the difficult position of judging what

information the Commission considers to be essential for shareholders when no criteria for such reports have been developed.

## PROPOSED CHANGE IN LETTER FROM AUDITORS ON CHANGES IN ACCOUNTING PRINCIPLES

The Commission proposes to require the independent public accountant to indicate in a letter, filed as an exhibit to Form 10-Q when there has been a change in accounting principle, that "the change is to an alternative principle which in his judgment is preferable under the circumstances." The current instructions to Form 10-Q require the independent accountant to furnish a letter "approving or otherwise commenting on the change." These instructions have generally been interpreted in the past to mean the accountant agrees that the change is to an acceptable method.

Section 546.04 of SAS No. 1, issued by the AICPA Auditing Standards Executive Committee, provides for the auditor's evaluation of the "justification" for a change in accounting principle (not the "preferability" of the new principle) and states that the auditor need take exception to the change only where the company has failed to provide reasonable justification for it. Decisions regarding the preferability of one alternative accounting principle over another are subjective and vary not only with facts and circumstances, but also with the personal views of individual accountants. Thus, whether a change in accounting principle is deemed to be to a preferable method might depend, among other things, on which independent public accountant is involved. Reliance on the personal preferences of individual accountants, however, cannot be a workable solution to the problem of alternative accounting practices.

To illustrate the point, prior to the recent issuance of Statement on Financial Accounting Standards No. 2 by the Financial Accounting Standards Board, accounting practice for research and development costs was divergent. Some companies deferred such costs to be amortized over future periods, while many others expensed them as incurred. The discussion memorandum prepared by the FASB on this subject last year clearly pointed out the existing alternatives and expressed reasons why each might be considered preferable. Written comments submitted in response to the discussion memorandum expressed many differing points of view, both within industry and among members of the accounting profession. In general, these represented legitimate differences of opinion on a very complex subject. Although the question was resolved by Statement No. 2, the fact is that prior to its issuance the determination of whether a change in accounting principle for research and development costs was to a "preferable" method depended on which independent public accountant was involved and not on any objective criteria that he could cite and apply.

Presumably some accountant currently in practice would regard as preferable each and every alternative principle that exists in practice. To insert the question of personal

preference in the Form 10-Q requirement could only lead to "shopping" for accounting principles among various accountants, a practice we believe the Commission would clearly want to avoid. Thus, it is both unrealistic and unproductive to look for an answer to the problem of alternative accounting principles in the individual views and preferences of different independent public accountants. Rather, the solution must come through the elimination of alternative principles by an authoritative body, as was accomplished by the FASB in its Statement on accounting for research and development costs.

## OTHER MATTERS

We have the following additional comments and suggestions regarding specific aspects of the proposed amendments to Regulation S-X and Form 10-Q:

1. The proposed amendment to Form 10-Q refers to the requirement for a statement of source and application of funds. The common description of such a statement, as indicated in Accounting Principles Board Opinion No. 19, is a "statement of changes in financial position," and we have used this terminology in this brief. We suggest that the amendment to Form 10-Q, if adopted, and other references to this statement in Regulation S-X and the instructions to the various forms use the same terminology, to be consistent with current accounting literature.

2. Proposed Rule 3-16(v) of Regulation S-X requires disclosure in the notes of "net sales, gross profit . . ., income before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income, and net income for each quarter . . . ." We presume the Commission also would expect registrants to report quarterly net income per share as well as the amount (and per share effect) of extraordinary items and the cumulative effect of accounting changes; however, these do not appear to be required by a literal reading of the proposal.

3. The Release states that the proposals, if adopted, would be expected to be made effective for *filings* made with the Commission subsequent to July 15, 1975. The proposed amendments to Regulation S-X require footnote disclosure of summarized quarterly financial data "for the two most recent years for which income statements are presented." As a consequence, such disclosure would be required for fiscal years ended in 1974, and possibly even in 1973. For example, if a registrant that reports on a calendar-year basis were to file a registration statement in the latter part of 1975, it would be required by this proposal to include summarized quarterly financial data in a footnote to its financial statements for the years ended December 31, 1974 and 1973.

We have previously expressed our view that an auditor cannot, under existing standards, express an unqualified opinion on annual financial statements containing footnote disclosure of quarterly financial data without applying substantive audit procedures to such data. Because of the difficulty of applying such procedures with respect to prior years, we believe that to require such data in financial statements on any extensive retroactive basis would impose hardships on many registrants.