

INDEPENDENCE AND COOPERATION

Address

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Before the

Regional Conference

of

The Controllers Institute of America

at

The New Ocean House

Swampscott, Massachusetts

Friday, June 7, 1940, 8:00 P.M.

## INDEPENDENCE AND COOPERATION

Since Judge Healy in early 1935 appeared before your New York Control and sought to answer the questions you had prepared about the new Form 10 and the even newer Form A-2, much has happened. Statements have now been filed with us for six years. We have had to discuss with many of you a great many accounting problems. We have sought your advice in reexamining our requirements and in seeking to improve them. We have “cashed in” on your offer of assistance and cooperation. We have sought also to fulfill our offer to discuss frankly with you your individually vexing problems at any time -- before or after filing.

So much has been written and said in the past few years, and especially in the past few months, about the duties of controllers and public accountant that it is difficult to add wholly new thoughts or novel departures to the discussion. I have therefore sought to summarize, from our point of view, the distribution of responsibility in the joint effort to secure comprehensive and dependable financial statements for investors.

In effect, the two statutes, the Securities Act and the Securities Exchange Act, approach this objective by setting up a Commission with power to prescribe forms and rules of accounting and to review material filed, and by requiring publicly owned companies, whose securities are listed or to be sold in interstate commerce, to file financial statements under appropriate sanctions. Such statements must be certified by independent public accountants. This three-point approach led me to the title of this paper -- “Independence and Cooperation.”

Independence is defined as “freedom from control by others”; cooperation as “operation together for a common object.” Both of these are needed, if the objective is to be obtained: independence, to insure freedom from intentional or unconscious bias, to give due weight to different factors, and to gain a cross-checking of results; cooperation, to secure economy and harmony of effort.

### The Commission

I shall take first the role of the Commission. It seems to me that our contribution lies in the field of providing workable forms and rules, establishing thereby a minimum standard. In drafting the basic rules and forms the experience and knowledge of management and public accountants has been sought and to a very large extent incorporated in the final drafts. Examination of the statements filed is the next step. If specific requirements or generally accepted standards of practice have not been observed, it is our obligation to take exception by appropriate action. Unless the deficiency is remedied, or an apparent deficiency explained away, it is our duty to apply the statutory sanctions of stop-order, delisting and, in appropriate cases, reference for criminal proceedings. A by-product of the duty to prescribe standards is naturally the duty to foster their improvement by research, consultation with registrants and accountants, and adoption of new rules and requirements -- sometimes incorporating advances already won, sometimes resolving conflicts, sometimes initiating improvements which have substantial support but which are impeded by inertia or special interest.

### The Issuer

In any discussion of the responsibility for accuracy and truthfulness in financial statements, it is easy to overlook the fundamental fact that in the usual case it is the corporation itself which is selling securities or furnishing information for others to rely upon. This fact is underscored in Section 11 of the Securities Act which, in specific language, denies to the issuer the defense of reasonable belief in the truth of the statements that is accorded those individuals who sign the statement or who as experts participate in their preparation. However, except for an issuer who is a natural person, and they have been exceedingly rare, it is the officers and directors, individually and collectively, who must see to it that the issuer's interests are protected and its obligations fulfilled by financial statements which are free from misstatements and misleading omissions. This obligation of the management and directors does not spring from these Acts but is fundamental in all corporate law. Realistically, however, the average director, as well as most of the officers, is not in a position to say that particular statements are in fact accurate and complete in their reflection of the business. Gross misstatements might be apparent to him from his general knowledge of the business, or by reason of inconsistency with previous statements he has seen. Or, familiarity with matters directly in his charge might uncover misstatements or omissions in a particular field. But here as elsewhere the greatest reliance is placed on the corporate machinery for the production of information about the business. This department is ordinarily the peculiar province of the controller.

It is not without reason, therefore, that the Securities Act requires the signature of the controller or principal accounting officer and that annual reports which must be signed by an authorized representative of the issuer, are more and more frequently signed by controllers. In practice as well as in theory the division of duties within the company throws upon the officer in charge of accounts and accounting the burden of writing an informative and accurate history of the business. As Judge Healy once said, ". . . it cannot be denied that the controller is the man who holds the key to sound corporate accounting. It is his system upon which adequate corporate reporting ultimately rests." I do not think that controllers have in any way sought to shift this burden. The atmosphere of nearly every conference I have had, including those which were highly argumentative, has been: "These are my accounts; I am proud of them; but if you have any doubts or question any of the principles, let's discuss them; I want to present the most informative and most accurate picture that I can."

In principle, this is the basis upon which Congress and the investing public have come to rely more and more on the controller's work. Such reliance, however, assumes the existence of certain conditions, and raises certain problems in practice. These I should like to discuss briefly.

What is a controller. Because of its newness the business and legal position of the controller is by no means settled. In one company, the controller is indeed the chief accounting officer; in another his functions may be narrow and his authority slight or ineffective. In defining what his position should be, opinions differ. Some ascribe to him a position wholly managerial in viewpoint, others would divorce him from actual management, so that he becomes a reporter and a critic of the way in which management has exercised its discretion. Some ascribe to him special duties and responsibilities to stockholders and creditors, others maintain that he has no such special duties and relations, that he is an employee of the corporation, which

alone has duties and responsibilities to outsiders. While it is too soon to predict the outcome of these conflicting proposals, some of the essentials to any solution seem clear.

First, the controller or person charged with responsibility for the accounts should be an officer. His duties and powers should be so described in the by-laws that his position will not be subject to arbitrary modification or emasculating interpretation by his co-officers. He should be an elected officer, or one appointed, not by some other officer, but by the directors.

Second, his duties and his authority should be commensurate with his responsibility, in order that he may have at hand the tools with which to work.

Third, incompatible functions or duties should not be combined in his office. Inevitably a person who is directly charged with the administration of particular operations and is responsible for their profitable conduct is not in an unprejudiced position when he comes to record and report on the results of his department.

Fourth, he should be independent of other management officials in his determination of how the records should be kept, what checks and safeguards are necessary for reliable accounts, what accounting principles should be followed, and, perhaps most important of all, in his determination of what the actual results of operation are. To secure such independence, his general reports should be rendered to the board without change by other officials. To my mind this concept of his duties is not at all incompatible with requirements for rendering service to management by the preparation of special reports, nor with the obvious necessity of cooperation and consultation on mutual problems. What must be maintained, it seems to me, is the finality of his considered judgment on the matters mentioned, subject of course to the review of the board of directors.

Fifth, the controller's staff should be adequate. This is not of the same order as the first four points, but it is not less important. The very increase in the scope of the controller's duties carries with it a possibility of danger that only the controller himself may properly guard against. I have in mind the possibility that in discharging his manifold duties he may become personally so engrossed in the details of his numerous activities or be occupied with so many varied roles as to lose sight of the forest. As an executive officer one duty that cannot be minimized is that of integrating the various portions of his work so that the whole may be harmonious. In some recent cases we have found that this danger is only too real.

### The Independent Public Accountant

The problem of distributing responsibility between the issuer and its controller on the one hand and the certifying accountant on the other is often summed up in the question: "Whose balance sheet is it?" This has been the subject of much discussion. Accountants who take the position that the balance sheet is that of the company have frequently pointed for support to the opinion of the Commission in the Interstate Hosiery Mills case where it was said:

"The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the

investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."

Others have urged that the public accountant often draws up the statements, sometimes indeed supervises or carries out much of the detailed work of adjusting or even preparing the underlying records, and that as a result the statements are his. I think the problem cannot be intelligently discussed in terms of such a question, which is at best ambiguous, and which fails to state the real issues -- who is responsible for misstatements and omissions and what is the extent of that responsibility. While it is obviously possible for an independent accountant to start from scratch and prepare statements which represent throughout his own judgment and his own appraisal of conditions, this is not frequent. Ordinarily, the company's internal accountants have drafted the statements or are responsible for the raw data that the independent accountant recasts in the form of statements. In these cases, the original decisions are those of the issuer and its internal accountants, not those of the certifying accountant who operates in a reviewing capacity but who, I am told, sometimes challenges those decisions. It is this usual case that I think is contemplated when the status speaks of "certified financial statements," for then the principle of cross-check by separate and independent examination is in full operation.

Placing responsibility for the statements upon the issuer does not in any way lessen the obligations of the accountant. Other paragraphs in the Interstate opinion, not quite so frequently quoted by accountants, make this abundantly clear. The representations made by the accountant who permits his name to accompany financial statements included in reports to the Commission are to my mind these:

First, that he is a public accountant in good standing and entitled to practice as such in the place of his residence or principal place of business; that he has met those requirements of training and experience which are prescribed by law; and that he is therefore entitled to represent himself as one whose profession gives authority to a statement made by him.

Second, that he has made an audit which in scope and procedures followed would be recognized by members of his profession, generally, as an adequate basis upon which to rest a professional opinion as to the fairness with which the statements represent the business, and that except as specifically noted otherwise there has been no omission of any procedure which independent accountants would ordinarily employ for the purpose of presenting comprehensive and dependable financial statements.

Third, that he has expressed his professional opinion as frankly and fairly as he can.

There is one class of cases in which the significance of the cross-check by issuer and accountant becomes particularly plain. Occasionally, it will be found that statements have been prepared by the accountant and that the accountant has been charged by the company with the duty of supervising its accounting system and selecting and applying its accounting principles -- in brief, the primary accounting duties of the management have been delegated for performance

to an outside accountant. Perhaps the company's employees may perform some of the physical work of preparing the records, and in a general way the officials may review the final statements, but essentially the accountant is doing the work and making the decisions ordinarily attributed to the officers of a company. To my mind there is grave doubt whether statements accompanied by a certificate of the accountant involved would satisfy the statutory standard of certified financial statements. If the work be attributed to the accountant as an independent public accountant, then the obligations of the issuer have not been discharged; if the management be considered to have discharged its duties through delegation to a competent agent, the accountant, then the requirement of certification by an independent public accountant is not met, for the same accountant cannot be two men, nor can he play both roles. I do not think this issue has ever been as sharply raised as the hypothetical case cited; but in not a few instances the line of separation has been blurred. Nearly the same point is raised by the grosser cases involving lack of independence on the part of the certifying accountant. The purpose of the statutory requirement of independence is clear. As opposed to subservience, there is no question that it is essential, if any true cross-checking is to be obtained. In short, the greatest benefit for the issuer and for the persons who are asked to rely on the certified statements will not be obtained unless the auditor's approach is completely objective, free from bias, and devoid of any entangling affiliation.

### Cooperation

I have sought to outline briefly the roles assigned to each of the participants in the joint quest of comprehensive and dependable financial statements -- the issuer, the independent certifying accountant, and the Commission. I have alluded briefly to some of the ways in which the cooperation of issuers and accountants has been sought and found valuable by the Commission in the discharge of its duties. There remains the question of cooperation between the issuer, usually in the person of the controller, and the public accountant. As to this, I would like to point out a few specific problems in the solution of which effective cooperation would prove most helpful in reaching the joint objective.

Recent events have resulted in the glittering generality that investors should be educated as to the limitations inherent in certified statements. For a considerable number of years accountants have sought to spread information as to the character of the work they do in the course of a normal audit, its advantages and its limitations. I have also seen attempts by companies to do this. Included in one annual report was a brief description of what the management had asked the accountants to do and a non-technical description of the nature of the work which the accountants did, both with a view to aiding the reader to understand the purpose of the annual audit and its significance. Since investor education is vital to a sound financial and investment community, cooperation to that end is essential and practicable.

Recent events have also resulted in a great deal of discussion on how to prevent gross irregularities, such as those that appeared in the McKesson, Interstate, Monroe Loan, and similar cases. The problem has been debated before professional societies of accountants, controllers, and others, in educational circles and in accounting forums. Many specific suggestions have been made of procedures designed to prevent the recurrence of such irregularities. Some of these have been incorporated in reports by professional accounting societies and the New York Stock

Exchange. The Commission itself is engaged in preparing a general report based upon the McKesson case, which will likewise include specific recommendations.

Nowhere to my mind does the possibility of close cooperation between controller and public accountant appear more clearly than in designing an efficient method for recording and analyzing the transactions of a company in such a manner as to insure the dependability of the accounting records. To this problem the controller brings primarily, it seems to me, his intimate knowledge of the company's way of doing business, the personalities involved, and a thousand and one other details of the particular company. To this problem the independent accountant brings an objective outside point of view tempered by his experience with other clients and by his knowledge of what he needs in order to be able to give an informed opinion as to the financial condition and the results of operations. The decision as to what is necessary to insure reliable reporting in the particular case must rest ultimately with the controller. However, since the public accountant must in a large corporation rely extensively on the information produced by the accounting system, one of his first duties in making his examination of the company's affairs is to review anew the accounting system of the company and its methods of insuring the reliability of its records. This review, since it encompasses not only a study of the procedures designed but also the actual way in which those procedures have been carried out and the results which they have produced, should result in an intelligent appraisal of the company's methods. This in turn should serve as a basis for further cooperation between the controller and the independent accountant looking toward the strengthening of weak points that have developed, toward the introduction of new procedures to care for new conditions, and toward the general streamlining of the company's accounting methods.

In recent months this subject of internal check and control has received so much consideration that an historical digression may not be out of place. Present interest in the subject is so lively that the uninitiated might believe that internal check and control is a new discovery. However, a volume published in 1892 reproduced an audit program of one David Chadwick, F. C. A., an accountant of fifty years' practical experience. One item in the list of twenty-two on this gentleman's program is perhaps of interest, since it advised the auditor to "ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid."

It is obvious that professional auditors in examining the accounts of modern industrial empires cannot practicably scrutinize all the numerous transactions. The question then is not whether independent public accountants may rely upon internal control, but what is internal control, how is it set up, how may it be strengthened, how can management periodically ascertain whether it is being faithfully carried out, and, most important in the preparation of certified statements, how can the auditor ascertain whether in a particular case there is justification for relying on it. Cooperation of the controller and the auditor in this field is perhaps more essential than in any other, for, if internal control fails, the financial statements and the opinion of the auditors are of doubtful value. Designing a system of internal control, checking that system to test its efficiency, and revising it to meet shifting conditions are peculiarly within your own province. Subjecting it to an impartial independent and expert analysis is peculiarly within the province of the independent accountant. His is the duty of determining by actual observation that the internal check and control is adequate. He must watch the system work and he must test

the paper results it produced against the physical facts so far as he is capable, and so far as that is practicable. Unless he has done this, he is not justified in accepting its product, and a good part of the value of his opinion is lost. Designing the system and maintaining it in good working order seems to me a joint undertaking of the internal accountant and the outside accountant to assure that under modern complex business conditions comprehensive and dependable financial statements may be obtained for investors and stockholders.

No discussion of the relation between controllers and public accountants would be adequate without some mention of cooperation in the planning of the audit. At the outset it seems to me that direct field-contact between the controller and the accounting partner in charge of the engagement should be much more extensive than has apparently been true in many cases. Frank discussion with the controller and direct observation should enable the experienced partner to appraise the particular controller and the system he controls. It should also aid in eliminating friction and misunderstanding. In short, the product should be an effective audit program fashioned to fit the particular case, utilizing internal reports and internally prepared schedules and analyses to the full extent practicable and reasonable and substituting intelligent checking for expensive and laborious duplication of the work of the internal audit staff so far as may be consistent with the auditor's professional responsibilities. I need not discuss specific details -- that has been well done elsewhere and in individual cases is a subject of some difference of opinion. But the principle is clear.

Nor should the atmosphere of cooperation be confined to the period of the audit. If the auditor is appointed or elected early in the year, as he by all means should be, there is a sound basis for continuous cooperation in the solution of difficult and unusual accounting problems faced by the company.

A final problem in the preparation of dependable financial statements and in the administration of the registration requirements under the Securities Exchange Act of 1934 is the determination of the most appropriate fiscal closing date. The concept of the natural business year is not new to members of your organization. Nevertheless the problem of concentration of fiscal closings at December 31 is so acute and so important both to controllers and public accountants that I feel justified in discussing it with you who should be in the best position to do something to improve the situation.

The most recent compilation of registrants with the Commission shows that of nearly 2500 annual reports filed with us, approximately eighty per cent report on the calendar year basis, about five per cent close their fiscal years at the end of June, and two and one-half per cent at the end of each of the months of January, March, September, and October. The heavy concentration at the end of December descends on the Commission in the last week of April and the first week in May and necessitates the employment of temporary clerks merely to record and file the reports. We do not employ extra examiners to review the reports as received but schedule the work over the entire year. As a result, the examining staff is constantly employed but some of your reports may be in our hands for many months before they are reached for review.



About ten per cent of the calendar year registrants ask for extensions of time in which to file their reports. Sometimes the reason given is that the firm's independent accountants have not had time to complete the audit on which their certificate is based and sometimes the reason offered is that we have just issued a deficiency notice regarding last year's statement which will require a revision in the statement then in preparation as well as in the offending report. We are sympathetic to such requests, in the latter circumstance especially, but we are powerless to improve the underlying difficulty without employing temporary help to clear the log jam or perhaps by making rules requiring certain industries to file reports on a natural business year basis. Neither of these methods appeals to me as a proper means of dealing with the problem.

Some of the public accountants who testified as expert witnesses in the McKesson & Robbins hearings indicated a reluctance on their part to urge adoption of the natural business year more vigorously than they have in the past because of a feeling that their motive appeared self-serving. All public accountants agree that the adoption of natural closing dates by business generally would improve conditions in the profession by spreading the work and thus relieving mental and physical strain now prevalent in the first quarter of the year and of still more importance it would provide continuity of employment for a better trained staff. I am convinced that improvement along these lines would be of lasting benefit to the client as well as to the accounting profession.

I sincerely believe that this is one of the most important problems to be faced in carrying out your avowed purpose of observing "the highest ethical standards in corporate accounting practice in the preparation of reports of financial and operating conditions of corporations to their directors, stock holders, and other parties at interest, in such manner that all concerned may know the actual conditions in so far as such reports may assist in the determination thereof." With your increasing authority in corporation affairs, the responsibility naturally falls to you to convince your companies' officers and directors that December 31 is not a mandatory closing date.