THE CONCEPT OF INDEPENDENCE IN ACCOUNTING

Address of

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Before the

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Mr. Chairman, Gentlemen:

The last time a member of the Commission addressed the annual meeting of this institute was in 1947. To have been invited again so soon may be interpreted as evidence either of your fortitude or of the number of common problems we have which it is mutually advantageous for us to discuss. I should like to assume that it is our common interests which motivated your decision to invite me today.

In 1947 Mr. Caffrey, then Chairman of the Commission, discussed with you the relationship between rigid independence in accounting and the presentation of the facts of business life. Today I should like to elaborate upon a portion of that theme and discuss the basic concept of independence.

During the early years of accountancy, around the turn of the century, the business world had not yet come to recognize the need for this concept. Generally, an accountant's duties consisted of opening and closing books, detecting frauds upon the owners of the enterprise, and straightening accounts which had become charmingly mixed up by amateur bookkeepers. As one writer expressed it, the general notion seemed to prevail that an accountant was "merely a man of figures, a rapid and unerring calculator who could add up two or three columns of figures at a time, could tell you immediately the square or cube root of any given number, or say off-hand, for example, what one dollar put out at six per cent compound interest per annum at the time Columbus discovered America would amount to today."[1]

Perhaps the greatest impetus to the new profession was given by the passage of the Sixteenth Amendment in 1913 and the War Revenue Act of 1917. Commercial banking institutions and mercantile creditors were quick to avail themselves of the services of the new profession, and it grew. These creditors required audits and verified financial statements. I believe full maturity was reached upon passage of the Securities Act of 1933, which for the first time imposed the legal requirement that statements be certified by independent accountants.

You will remember that General Carter, who testified on behalf of the accounting profession at the hearings upon that bill, experienced some difficulty in persuading the Senate Committee that there were professionally qualified persons who could and would audit accounts of registrants and express an independent opinion upon their correctness uninfluenced by the fee they received. Senator Barkley was frankly skeptical about such a procedure and suggested that if an independent audit were really necessary it might better be obtained by the use of accountants employed by the government.

General Carter then observed, in a statement that I am sure was not justified by some of the incomes enjoyed by public accountants in the early thirties, that the government could not afford to employ the necessary number of qualified accountants. The Committee did not then pursue Senator Barkley's suggestion.

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[1] Anyon, James T., Recollections of the Early Days of American Accountancy, p. 41.

At another point in the hearings Senator Barkley asked whether there was any relationship between the corporate comptrollers, who had testified that they were responsible for the accuracy of the financial statements, and the public accountants. General Carter answered: "None at all. We audit the controllers." Senator Barkley then asked, "Who audits you?" to which General Carter quickly replied, "Our conscience." It is your conscience which is my subject today.

General Carter's reply sums up a substantial part of the concept of independence. It is not tangible, nor even in most instances clearly demonstrable. It represents a state of mind. In the entire field of human relationships it is difficult to find an exact analogy. The independent accountant must combine the impartiality of a judge with the high sense of responsibility of a fiduciary. In addition, he must possess a full knowledge of the tools and methods of his profession. Though hired and fired by management, he must divorce his mental processes from any bias in their direction when making accounting judgments. Such a standard of professional conduct must be maintained if the auditor's certificate is to be more than a snare and a delusion and the public obligation of the accountant satisfied.

Of course, we are all fully aware of the difficulties inherent in enforcing such standards. The influences which may affect accounting judgment are extremely subtle and tenuous. In their most dangerous form it is possible that the accountant himself does not recognize their effect. Under such circumstances an accountant may be lacking in independence despite the highest professional qualifications and the most complete integrity. It is our duty -- both the Institute's and the Commission's -- to guard the public against such unconscious bias.

That is by far the most important purpose of our rules and interpretive opinions governing the qualification of accountants. No serious administrative problem arises in the obvious case, where an accountant is plainly derelict, where he certifies to statements he knows to be misleading, or where he consciously and deliberately falsifies the facts.[2]

Even the common law, with its cultural lag, holds the accountant responsible if he should supply a certification when he knows or should know of its inaccuracies. I am sure you are all familiar with the case of Ultramares v. Touche, decided almost 20 years ago by the New York Court of Appeals. In that case Justice Cardozo, then Chief Judge of that court, made clear that every accountant who certifies a financial statement owes a duty to the public. If he should be grossly negligent in the discharge of that duty, he may be compelled to pay damages to any person who relied upon that statement. That was the first complete articulation of the legal concept of independence, which has now been generally accepted by all the courts which have considered the matter.

The legal liability which flows from this concept was extended and enlarged somewhat by the Securities Act. Section 11 of that Act impose upon the accountant the duty to make a reasonable investigation into the truth and completeness of the statements he certifies. This necessarily implies that the audit should be thorough and that the system of internal controls carefully checked. Such matters as depreciation and obsolescence allowances, legal

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2 See, e.g., American Terminals and Transit Co., 1 S.E.C. 701 (1936).

requirements inhibiting dividend payments, and all similar items requiring the assistance of experts should be carefully scrutinized. The accountant is held to the same standard of care as that required of a prudent man in the management of his own property.

Negligence in this report is strong evidence of lack of independence. Or, if an accountant, either directly or through an affiliate, enters into an agreement which attempts to immunize the accountant from liability for his negligent acts, I believe he thereby forfeits his independence.

The self-regulation undertaken by the profession has, of course, outstripped the limit concept of legal liability. Five rules of the Institute relate to this concept. They are: Rule 5, which prohibits false or misleading statements; Rule 9, which prohibits, except in limited circumstances, the use of contingent fees to pay for accounting services; Rule 13, which directs accountants to refrain from expressing any opinion upon the statements of any enterprise in which he may have a financial interest; Rule 3, which prohibits the payment of any portion of an accountant's fee to non-accountants or the acceptance of any portion of the fees or profits received by non-accountants from work turned over to them by accountants as an incident of their services to a client; and Rule 4, which discusses occupations incompatible with public accounting.

The Commission has attempted to adapt the concept of independence to the needs of investors. When a registration statement or annual report is filed with the Commission it is designed for use by the pubic. In lieu of government examinations of each financial statement the certificate of an independent accountant is required. I believe that the duties inherent in furnishing such a certificate impress upon the auditor a fiduciary obligation toward the public as well as toward the client if full confidence in the publicly held securities is to be maintained. The Investment Company Act expressly recognize this obligation by providing that the accountant's certificate "shall be addressed both to the board of directors . . . and to the security holders." If investors are to be fully protected, the accountant-fiduciary must be free of all the entangling alliances which might be engendered by relational or contractual connections with the registrant. He must be free to approach his task with complete objectivity, intent upon a critical examination of all the practices and procedures of the registrants. We have expressed this view in a rule as follows:

> "The Commission will not recognize any certified public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct, or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

> In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationship existing in connection with the filing of reports with the Commission."[3]

To me that rule means two things. First, it states that independence is a question of fact, and if it can be shown as a matter of fact, regardless of the absence of any business or personal relationship, that an accountant's decisions are controlled or influenced by someone else, that accountant is no independent. Secondly, and this is perhaps of more significance, it points to certain relationships which indicate a lack of independence and provides that when these or similar relationships which might influence an accountant's judgment exist, the accountant cannot be considered independent regardless of the amount of proof available that his judgment was, in fact, uninfluenced.

Proof of the actual abdication of judgment to another is nearly always difficult. The coincidence of the result of a decision with the wishes of another can, in many instances, be explained as the result of independent logical reasoning. It is in the selection of the applicable accounting convention, about which there are sometimes great differences of opinion among the authorities, that judgment must be exercised. Even when the decision cannot be logically justified, who can say whether the error was an honest one? It is in this context that independence is particularly important.

Usually, it is only when the accountant has been foolish enough to venture his personal judgment and it can be shown that this is different from that reflected in the financial statements

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3 On July 12, 1950, the Commission promulgated for comment a proposal that the rule be amended to read:

> The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.
>
> In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

This was intended as a codification of the Commission rulings upon independence and not as a change in view.

that absolute proof of lack of independence can be shown.[4] Even when misleading or fraudulent statements are certified there can be only a strong presumption of lack of independence, which must be coupled with other factors if there is to be clear evidence of actual subservience to management influence.

In the only three cases thus far decided involving lack of independence in which the Commission has taken disciplinary action against accountants the mental state of the accountants could be proved. In the first[5] the accountants gave management a private audit report materially different from that furnished the public. The public report failed to disclose, among other things, that the client was carrying a trading account in the name of the accountant. Although the accountant protested, he did not take effective steps to stop the practice for two years.

The second case,[6] a year later, was very much like the first. It differed only in the fact that the accountant knew of the trading account and acted as an accomplice of management in the stock market enterprise. The client and the accountant did not even profit financially from the trading. They suffered substantial losses despite market advice by the president, the secretary-treasurer, and a director of the company. I suppose this proves both the biblical precept that the wicked shall reap no profit from their wickedness and the Wall Street axiom that market speculation should be left only to the professionals.

The third disciplinary action[7] was not until seven years later, when an accountant blandly certified accounts which carried a leasehold at $100,000, which was ninety percent of stated assets of the enterprise, although he knew only $15,000 had been paid for the property the year before and it was assessed at only about $5,000. Since it was also shown that the accountant assisted in the promotion of the venture, the proof of lack of independence seemed conclusive. Three other disciplinary actions against accountants[8] raised questions of independence because of the technical incompetence of the accountants there involved, but the Commission's decisions were based principally upon the omission of specific auditing procedures prescribed by Commission rule. The certificates in those cases represented little more than the loan of the accountant's name. Therefore, insofar as they pretended to be an objective and critical analysis, they were false and misleading.[9]

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4 See Metropolitan Personal Loan Co., 2 S.E.C. 803 (1937); A. Hollander & Sons, Inc., 8 S.E.C. 586 (1941); Associated Gas and Electric Co., 11 S.E.C. 975 (1942).

5 Puder & Puder, Securities Exchange Act Release No. 3073 (1941).

6 Kenneth v. Logan, 10 S.E.C. 982 (1942).

7 Accounting Series Release No. 68.

8 Accounting Series Release No. 48 (1944); Accounting Series Release No. 59 (1947); Accounting Series Release No. 67 (1949).

9 For other examples of such examinations see National Boston Mines Corp., 2 S.E.C. 226 (1937); Red Bank Oil Co., Securities Exchange Act Releases Nos. 3110, 3770 (1946).

The paucity of disciplinary actions and the nature of the offense charged in those cases indicate how reluctant we are to institute such actions. However, I do not believe the profession may assume that appropriate action will not be taken unless there is evidence of corrupt and venal conduct. I believe every accountant is chargeable with the knowledge of the mechanics and the ethics of his profession. They are the rules of the game and their observance is essential if we are both to fulfill our high public trust.

Most of these rules, like those which govern any fiduciary, are prophylactic in nature. They are designed to prevent any conflict from arising between the accountant's duty to the public and his personal interests. Thus, just as a trustee of an estate in reorganization under the Bankruptcy Act may not ally himself with any creditor or stockholder interest in the estate, trade in securities of the estate, or purchase trust property, the accountant may not have any financial interest in a client's enterprise, even if it can be shown that the personal financial stake of the trustee or the accountant will have no effect upon his judgment. As a matter of fact, persons sensitive to their obligations may lean over backwards and act in opposition to their personal interests.

Nevertheless, I believe it is a salutary principle which arbitrarily denies to fiduciaries or people in a quasi-fiduciary position such as accountants the right to risk their independence. Not all people are strong enough to resist temptation, particularly when it may easily be hidden behind a convincing rationalization. Even if there is no conscious attempt to favor a personal interest, unconscious pressure may cause a shift in the normal judgment exercised by the accountant. For both these reasons, and because the public will have greater confidence in certifications when they know there is no conflict between personal desires and professional opinions, the accountant must carefully scrutinize his relationships with his client.

I recognize the impracticality of restricting or denying all intercourse between accountants and their clients. Nor do I believe this is either necessary or desirable. The accountant cannot be an ivory tower examiner, inaccessible to his client and remote from the market place. The nature of his business demands constant communication with management and recognition of all creditor and stockholder interests. In our opinions and interpretations at the Commission we have tried to stake out the safe and unsafe areas which the accountant who wishes to protect his independence should observe.

I assume that all of you are familiar with Accounting Series Releases 22 and 47, in which there are summarized Commission decisions and informal rulings upon the question of independence. Since 1944, when Release 47 was published, five Commission decisions and some one hundred staff opinions have dealt with this problem. Apparently there is still some need for clarification and delineation.

The problems fall, roughly, into three groups. First, there are those instances in which the accountant has a managerial or financial interest in his client such as when he is an officer, director or partner, or when he owns stock in the enterprise. Secondly, there are those instances in which there is a family relationship between the accountant and the client; and thirdly, there are those instances in which the accountant also acts for the client in some capacity other than as an accountant. Many problems, of course involve more than one of these relationships, and within each classification a single factor may not disqualify an accountant but it may raise sufficient doubt so that if any other similarly inconclusive factor is present the accountant should be disqualified. I believe we may best discuss these problems by referring to our rulings under each of these classifications.

The question most frequently asked us is what constitutes a financial interest. Seven of the twenty illustrative cases which appear in Release 47 deal with this problem. Until recently we have analyzed that interest and if it was substantial we have decided the accountant could not be independent. An interest which exceeded one per cent of the personal fortune of the accountant was considered substantial. Experience has demonstrated, however, that even less than a one per cent financial interest may result in a conflict of interest. For instance, the percentage of net worth might be less than one per cent although the proportion of income represented by the holdings might be substantial; persons may be affected differently by losses or gains or comparatively small sums; often exact values cannot be calculated. Accordingly, we take the view that any financial interest in a client, no matter how small, will disqualify the accountant and it is proposed that Rule 2-01 be revised to reflect this viewpoint. This financial interest may be in the form of a contingent fee contract, or a contract which is expressed in terms of a fixed fee plus a percentage of sales, or an investment in an underwriter, a promoter, an affiliate, a parent or a subsidiary of the client, for the definition of financial interest should be broad enough to insure the complete objectivity of the audit. In this connection I believe it would be wise to adhere strictly to Polonius' injunction, "neither borrower nor lender be" to any client, even if the borrowing or lending is only of office space.[10]

Nor can a firm of accountants be insulated from the holdings or acts of any partner, even if that partner should separate himself from any connection with the audit. Thus, an accounting firm was held to be lacking in independence where the partner who held stock in the client did not participate in the audit and the certificate was signed jointly by the partner who had performed the audit and the firm.[11] Nor would the situation be remedied by the sale of these shares subsequent to the audit.

This disqualification will extend even to the audit for years prior to the date when the stock was acquired when a registration statement is filed which included financial statements for those years, for a certification speaks also as of the date the registration statement becomes effective. Consequently, a financial interest at that time would interfere with the complete objectivity of the entire audit.

Similar problems are presented when an accountant or a partner in an accounting firm serves as a promoter, underwriter, voting trustee, director, or officer of a client, or administrator or executor of an estate with an interest in a client. It seems to me obvious that an accountant should not certify accounts which cover the period of time when he held office. I am continually amazed at the number of requests for an opinion in these circumstances.

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[10] See Southeastern Industrial Loan Co., 10 S.E.C. 617 (1941).

[11] See Richard Ramare Gold Mines, Ltd., 2 S.E.C. 377 (1937).

In one instance a member of a firm of certifying accountants, although not an officer, consulted with management on accounting matters and exercised some supervisory powers with respect to the corporation's accounting procedures. We held that despite the lack of a formal title, the accountant acted in the capacity of controller and he and his firm were therefore disqualified from certifying the financial statements.

A more difficult problem is presented after the accountant disposes of the financial interest which has disqualified him and resigns his office with the company. It has been urged that since he has cured his disability he should be henceforth fully qualified to exercise an impartial judgment. I believe that if he participated in the formation of significant accounting policies which persisted beyond the year in which he resigned or gave up his financial interest, he should not be permitted to place himself in a position to audit those decisions. A variation of this question is presented where another firm audits the accounts for the years when he was connected with the company and he attempts to rely upon this audit in submitting a certificate covering those, as well as subsequent years, when he had no connection with the client. The Commission has hold, properly, that such a certification will not be accepted. The accountant may not rely on others, for part of his certification unless he would be fully qualified to perform that audit himself and did, in fact, supervise it.

This does not mean, however that these earlier years may not be covered by a separate certification by others.

The second category of cases dealing with the independence of accountants on which we are frequently asked to express an opinion deals with family relationships. The typical case is one in which the accountant is the father, son, husband, brother, cousin or uncle of an officer, director, or bookkeeper of a registrant.[12] In accordance with well recognized legal doctrines governing fiduciaries, we have taken the position that such a relationship disqualifies the accountant. Obviously, if the persons involved live under the same roof and are part of the same economic unit, the accountant has a direct interest in the finances of his client. To the extent that the client pays the officer, it contributes directly to the support of the accountant's household. Even if the relative is not part of the same household it would be very unrealistic not to recognize the strong influence exerted upon the accountant by virtue of a close relationship.

Disqualification because of family relationship extends also to instances in which the relative has a financial interest in the client's enterprise. Thus, we ruled that where the wife of an accountant had a 47-1/2 per cent interest in one of three principal underwriters of a proposed issue, the accountant could not be considered independent.

The third category of rulings we have rendered dealing with independence involves non-financial relationships. It is clear, I believe, that membership in the same civic, fraternal or social organization as a client does not disqualify an accountant. I fully realize that many young

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[12] See Examiner's report adopted by the Commission in American Metal Mining Co., Securities Exchange Act Release No. 3537 (1944), where the wife of the accountant was bookkeeper for the registrant.

men must get their start by enlarging their circle of acquaintances, and membership in organizations is a well-accepted method of accomplishing this. Even when it was shown that an accountant and his client became joint obligors, together with others, upon a mortgage to secure a clubhouse, and that this accountant prepared personal income tax returns and audited the personal books of the principal stockholders of a registrant, it was not considered controlling by the Commission.[13] The possibility of improper influence arises when the relationship becomes more closely connected with either the finances of the accountant or his duties as an auditor.

In one case the stocks and bonds of a registrant, an investment company, were kept in a safety deposit box in a bank, and the members of the accounting firm were given exclusive custody of the key to the box. We ruled that the custodian of portfolio securities could not be considered independent for the purpose of certifying the financial statements. In another instance, it was found that a registrant who proposed to issue preferred stock was indebted to a bank in a substantial sum and the member of the bank's examining committee which reviewed loans requiring special attention was a partner in the accounting firm which proposed to certify the financial statements. I believe the Commission properly ruled that the accountants could not be considered independent.

Finally, included in this category are those cases in which the accountant engages in an occupation incompatible with the concept of independence. Thus, he may not serve as a securities salesman and audit the accounts of brokerage houses or serve as a partner in a law firm engaged by one of his accounting clients to pass upon the legality of securities being registered.

These are the general problems with which we are presented upon the question of independence. They admit of many ramifications, permutations and combinations. Not all are easy of solution.

All of the factors which might possibly influence the accountant's judgment are considered. Often it is clear that any one factor would be insufficient to affect the honest discharge of an accountant's duties, but that, when taken in combination with others, it would be ground for disqualification. In such circumstances I cannot offer you the certainty of a rule of thumb. I can only suggest several of these to you as pitfalls to be avoided.

Among the most troublesome case are those dealing with employees of an accounting firm as distinguished from partners. Adequate review procedures should be maintained to guard against employee inefficiency or deliberate falsification.[14] For a lapse in this regard I believe the firm is responsible. Either it has been negligent or it does not have the minimum knowledge of auditing procedures required of independent accountants. However, when the employee is both efficient and honest but it appears he has some disqualifying interest in the client, a more difficult problem is presented. If he should participate in the audit, it would, of course, invalidate

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13 A. Hollander & Sons, Inc., 8 SEC 586, 616 (1941).

14 See Inter-state Hosiery Mills, 4 S.E.C. 706 (1939), where the employee forged checks, falsified the statement of assets and made unverified summaries instead of applying generally accepted auditing procedures.

that audit. Assuming, however, that he does not participate in the audit, what should be the effect of his interest? The employee is not in a policy-making position. Presumably, therefore, he has no influence over the accounting judgments exercised. On the other hand, the firm should not be placed in the position where it audits the actions of one of its employees. Certainly the firm may not loan an employee to a client to do bookkeeping, and then be permitted to audit that work. Even when the bookkeeping consisted simply of posting general ledger entries and making closing entries covering a month's work, we have refused to consider the firm employing that accountant independent. The same considerations are applicable where the employee has served as a director or officer of the client. If the accounting firm must audit his decisions, it cannot be independent.

In these cases the employee's interest is considered as one factor and all the surrounding circumstances are examined to determine whether there is any possibility that the accounting judgments might have been swayed. For instance, if another employee was a second cousin of an officer of the client the two factors together might invalidate the audit although neither, alone, might be sufficient. Similarly, if it is shown that the wives of partners in an accounting firm engaged in speculative transactions in a registrant's stock prior to the audit, that fact would adversely affect, if not destroy, the firm's independence. Certainly, if there were also other borderline factors present the firm could not be considered independent.

I know that you in the accounting profession agree with our concept of independence. In fact, credit for the inclusion of that concept in our laws belongs largely to the profession. Nevertheless, some of my friends in the profession have said:

> "Oh yes, we believe wholeheartedly in this ideal of independence but it is sometimes impractical. If a client refuses to permit us to verify inventories or if an inactive partner happens to own a few shares of a client's stock do we have to give up the account? Why can't we simply make full disclosure of the limited nature of the audit or the financial interest in our certificate? The public can then assess those factors for themselves in analyzing the accounts."

To me, that represents a completely erroneous viewpoint of the nature and purpose of the concept of independence. I am reminded of a poem I once learned which ran something like this:

> There was a little dachshund once,
>   So long, he had no notion
> How long it took to notify
>   His tail of his emotion
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> And thus it was that while his eyes
>   Were filled with tears and sadness,
> His little tail kept wagging on
>   Because of previous gladness.

If a qualified certificate were permitted we might very well have a certificate filled with tears and sadness while the financial statements express only the previous gladness. Moreover, it seems to me that such a certification would be no better than no certification at all, for there would be no independent audit such as the Acts and rules of the Commission require. I remember one case in which the certificate had so many exceptions that all but $35,000 of total stated assets of $9,000,000 were excluded from the purview of the certificate.[15]

On all these matters which I have discussed the Commission has proceeded slowly, with an eye to the needs of the investing public and a full realization of the effects of its rulings upon the accounting profession. We are thankful for the full measure of support and cooperation you have given us. Without it, I believe our task would be well nigh impossible. We could easily have a system in which accounting was the handmaiden rather than the measure of management. That we do not have such a system is a great credit to a young profession. I will hazard the guess that even Vice President Barkley, who as a Senator was skeptical of the practicality of using an accountant's conscience as his guide, has been convinced by the uniformly impressive achievements of the past seventeen years.

[15] Resources Corporation International, 7 S.E.C. 689, 739 (1940).