THE ACCOUNTING PROFESSION AND THE INVESTOR

Address

of

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before the

District of Columbia Chapter

American Society of Women Accountants

at the

Ambassador Hotel

Washington, D. C.

Wednesday, March 11, 1953

The subject of what I have to say this evening has been announced, I think, as The Accounting Profession and the Investor. It should be expanded to include a seldom mentioned person – the Speculator. It has been said that an investor is a speculator whose security holdings have not materially increased in value. In any event, there is an element of risk in any project engaged in for profit, and, generally speaking, only time will tell whether those who furnish funds for such projects are speculators or investors.

Whether he be an investor or speculator, the supplier of risk capital must look to financial statements for information upon which to base his determination to take a stake in an enterprise or, having taken that step, whether to increase, decrease or withdraw such stake.

While management is primarily responsible for the preparation of informative financial statements, it is upon the accountant who reviews and certifies these statements that the public relies for clear, unequivocal and unbiased presentation, presentation which will draw no conclusions as to the investment or speculative aspects of the enterprise but which will disclose all the facts.

This responsibility has long been recognized and accepted by the accounting profession. Prior to the enactment of the various statutes administered by the Securities and Exchange Commission, this responsibility was looked upon perhaps more as a moral than a legal one. However, the Congress left no doubt as to the status of the accountant with respect to financial statements made available to the public pursuant to the various Acts affecting security transactions. Although these statutes place the responsibility for making certain that the investor or speculator gets a run for his money (insofar as this can be accomplished by making available to him understandable financial statements) jointly with corporate management, the accounting profession and the S.E.C., the Securities Act of 1933 provides that the financial statements required to be filed with the S.E.C. shall be, and the Securities Exchange Act of 1934 and the Investment Company Act of 1940 each require that they may be required to be, certified by independent public or independent certified public accountants (and our rules under the 1934 and 1940 Acts require certification).

It will be noted that Congress made no distinction between public and certified public accountants but required that both be independent. Since the statutes contain no definition of "independent," it was necessary for the Commission to adopt a rule on this point. This rule (Rule 2-01 of Regulation S-X) reads as follows:

> "(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.
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> "(b) 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.
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> "(c) 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."

Each of the statutes referred to provides for civil action against any one (and this would, of course, include the certifying accountant) who furnishes data to be included in a statement filed with the Commission which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact. In addition each statute imposes criminal responsibilities upon any person who willfully furnishes false or misleading information.

Nor do the consequences of furnishing accounting misinformation fall only upon the public or certified public accountant; for under the 1933 Act a registration statement is required to be signed by the officers of the registrant including specifically the <u>comptroller or principal accounting officer</u> and each signer thereof may be sued by any person acquiring securities covered by the registration statement "in case any part of the registration statement * * * contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading * * *."

In enacting the above mentioned statutes the Congress, as is its custom, more or less enumerated those things which the Commission may do and those which it may not do in their administration. One very clear statement of authority vested in the Commission, contained in both the 1933 and 1934 Acts reads as follows:

> "the Commission shall have authority, for the purpose of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. . ."

You will note that no standards are mentioned in this statement of authority. There is no reference to "generally accepted accounting principles" or any other kind.

Much thought was given by the Commission to the best manner in which to carry out its part of the responsibility to obtain proper financial statements for investors. It considered and rejected as inappropriate or undesirable, first, the promulgation of specific rules and regulations pertaining to all accounting matters, i.e., a statement of accounting principles, which might have involved classifications of accounts for types of companies or by industries, or by size; and, next, the treatment of each filing as a separate proposition the accounting aspects of which would be viewed in light of the existing circumstances.

A third approach was to study the individual statements as filed to determine whether the accounting principles reflected therein and the methods followed in their preparation were generally recognized and, if not, to require that the statements be amended in accordance with sound and generally accepted accounting principles. It is this latter course which the

Commission chose to follow and, as a consequence, we have refrained, so far as possible, from prescribing specific accounting rules.

In the early days of the Commission such rules and regulations pertaining to accounting matters as it was found necessary to promulgate were contained in the numerous forms prescribed for use under various circumstances or in the Commission's general rules and regulations applicable to each statute. Beginning in 1937 these rules and regulations were implemented by the issuance of the Accounting Series Releases. The first of these releases, of which there are now seventy-three (73) was dated April 1, 1937 and was announced as the beginning of "a program for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."

One of these Accounting Series Releases – No. 4, dated April 25, 1938 – announced as an administrative policy of the Commission that:

> "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

In 1940 the Commission issued Regulation S-X – Form and Content of Financial Statements – which gathered together the various rules, regulations and instructions pertaining to the form and content of financial statements which previously had been contained in the various forms and general rules and regulations of the Commission. This regulation was substantially revised in 1950. It consists of twelve (12) sections or articles, Nos. 1 through 4 of which are of general application (including definitions, certification and consolidated statement requirements); 5 through 10 apply to specific types of companies; Article 11 prescribes the content of statements of surplus, and 12 the form and content of supporting schedules.

Regulation S-X, as originally promulgated and as revised, and the accounting series releases (except those which are purely administrative), and, in fact, the Commission's first forms and general rules and regulations as they pertained to financial statement requirements, were all submitted to representative individuals and groups identified with or directly interested in financial statements for public use, for their comments and recommendations. These included certified and non-certified public accountants, corporate controllers, accounting instructors, the American Accounting Association, the American Institute of Accountants, the Controllers' Institute, and the American Petroleum Institute. Many of the recommendations of these persons and groups are reflected in the rules and regulations as finally adopted. In addition several proposed releases were ultimately abandoned because of meritorious objections received from those asked to comment upon them.

From the foregoing it will be seen that the Commission, in determining whether financial statements contained in registration statements and other reports filed with it accomplish the purposes intended by the applicable statutes, has depended, in a large measure, upon the accounting profession to establish and make use of accounting principles which are sound and which may be considered to the generally accepted accounting principles underlying the preparation and presentation of financial statements.

It has been my privilege, during the 18 years that I have been a member of the Commission's staff, to have had some part in the promulgation of every rule or regulation of the Commission pertaining to accounting, and to have participated in the many discussions with the accounting profession incident to the profession's constant endeavors to formulate a body of generally accepted accounting principles. I can assure you that the activities of both the profession and the S.E.C. in this field have been governed by the desire to obtain informative, unequivocal, consistent and comparable financial statements for investors.

Industry today more than ever before cannot exist – certainly it cannot progress – without obtaining additional capital from time to time. Those who supply this capital must be fully informed as to the financial condition and earnings record of the particular enterprise seeking their financial support. This can be accomplished only through the presentation of fully adequate financial statements. Complete responsibility for such statements rests with the accounting profession – with the accounting staff of the company whose statements are involved in the first instance and finally with the independent certifying accountant.

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