

statistics

WHEN CLIENTS GO PUBLIC:

THE PLACE OF THE LOCAL FIRMS

TOPIC: Who is Qualified to Practice?

Remarks of

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The order of appearance this afternoon led me to suggest that my contribution be to set the stage for the speakers who follow me and for the discussion period by considering the question "Who is Qualified to Practice?"<sup>\*/</sup> In doing so, I assume that we are concerned with the accountant's work for firms "going public" in the interstate commerce sense rather than intrastate. Accordingly, I will confine my remarks to the qualification of accountants to practice under the Securities Acts and the general nature of the problems which may be encountered in such practice.

The qualities of competence and independence appeared to be uppermost in the mind of Colonel Arthur H. Carter when he testified before the Senate Committee considering the legislation that became the Securities Act of 1933. For those who are not familiar with this history, John L. Carey relates it in the chapter entitled "Government Intervention in Accounting" in the first volume of his book The Rise of the Accounting Profession. Parenthetically, today some people seem to think there should be more intervention. Senator Barkley raised the motive of self-interest and suggested that a government agency rather than some private association of accountants should do the checking on financial statements. But Colonel Carter responded that the public accountant was better equipped than the average government agency would be. Then follows a colloquy, often quoted in part, which introduced the idea of independence:

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- Senator Barkley - Is there any relationship between your organization with 2,000 members and the organization of controllers, represented here yesterday with 2,000 members?
- Mr. Carter - None at all. We audit the controllers.
- Senator Barkley - You audit the controllers?
- Mr. Carter - Yes; the public accountant audits the controller's account.
- Senator Barkley - Who audits you?
- Mr. Carter - Our conscience.
- Senator Barkley - I am wondering whether after all a controller is not for all practical purposes the same as an auditor, and must he not know something about auditing?
- Mr. Carter - He is in the employ of the company. He is subject to the orders of his superiors.
- Senator Barkley - I understand. But he has got to know something about auditing?
- Mr. Carter - Yes.
- Senator Barkley - He has got to know something about bookkeeping?
- Mr. Carter - But he is not independent....
- Senator Reynolds - Why should your members ask that they be permitted and empowered to check these accounts?
- Mr. Carter - Because it is generally regarded that an independent audit of any business is a good thing.
- Senator Reynolds - All right. Then, after it goes to the Commission they have to check up to see who is right; they have to go through and audit again. There has to be a government audit, as suggested by Senator Barkley. Would it not be creating more difficulty and more expense and more time for the government if auditing organizations interest themselves in these various and sundry corporations? . . . Could they do it more economically than the government?
- Mr. Carter - I think so.

Colonel Carter must have been persuasive, for a requirement was included in Schedule A of the 1933 Act that certain balance sheets and profit and loss statements be ". . .certified by an independent public or certified accountant. . ." These are the certification provisions related to the usual concept of "going public." However, the provisions of the Securities Exchange Act of 1934 should not be overlooked. Section 12(a) of that Act makes it "unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective. . ." Section 12(b) prescribes information to be supplied in the application for registration, including balance sheets and profit and loss statements ". . .certified if required by rules and regulations of the Commission by independent public accountants; . . ." The 1964 amendments extended the requirements of Section 12(b) to certain companies having unlisted securities which are publicly traded (the over-the-counter companies). Section 13(a), which prescribes the filing of reports, gives the Commission the same certification authority for annual reports and the Holding Company and Investment Company Acts also contain comparable authority. With only a few exceptions, this authority to require certification of financial statements has been implemented by rules of the Commission.

The legislative record reveals that Colonel Carter suggested that the financial statements to be included in prospectuses be certified by "accountants qualified under the laws of some state." This concept may now be found in Rule 2-01 of Regulation S-X pertaining to the qualifications of accountants with which all practitioners having clients planning to go

public should be familiar. Paragraph (a) defines who is privileged to practice before the Commission, and paragraphs (b) and (c) deal with independence. Paragraph (b) is substantially the same as Article 1 of the Institute's Code covering financial interests and involvement as officers, directors, etc. Paragraph (c) of our rule covers anything else which may suggest a lack of independence. We should also note that the Commission's Rules of Practice cover non-lawyers as well as lawyers and that Rule 2(e) is similar to professional codes of ethics, in that it deals with the qualifications to represent others, character and integrity, and ethical and proper professional conduct of persons practicing before the Commission.

To illustrate the many different facets of the independence problem we have publicized, through the issuance of two Accounting Series releases, a number of decisions that we have rendered regarding accountants' independence. We plan to issue another release in the not-too-distant future. Sanctions against accountants imposed through proceedings under Rule 2(e) have been rare but in most of the cases, which are reported in Accounting Series releases, the accountant's lack of independence has been a factor.

Our topic today involves a re-examination and updating of the situation which was the cause of much concern in the profession and to the Commission in the "hot issue" period of the early 1960's. Some of you may recall that I was invited to attend the Council meeting in the spring of 1960 for, as The CPA reported it, an off-the-record talk to state society presidents on the subject of substandard reports which were then causing us considerable trouble. J. S. Seidman, who was president that year, used his page in the July-August 1960 CPA to analyze the causes of displacement of the

local practitioner. A general meeting of the New York State Society of Certified Public Accountants in November of that year was devoted to then current accounting and auditing problems with particular reference to new registrants with the SEC.

At that time we found and we find again today that much of the accountant's difficulty stems from his uncritical appraisal of his competence to undertake work which may involve the liabilities of the Securities Acts and a failure to recognize that he may be deemed not independent under our rules. It is surprising to us that some members of the Institute do not seem to be aware that its rules relating to independence were brought into substantial agreement with ours in 1964. The members should know that we feel free to discuss independence problems with the Institute's Committee on Independence and with the Institute's Director of Professional Ethics. This has been very helpful as a check on our reaction to new situations. Now and then we check with state boards to determine whether the accountant is in good standing and qualified to practice.

Members of our accounting staff and I discuss these problems at every opportunity in order to alert the small accountants who do not currently have any public clients to the need to improve their competence and to protect their independence in anticipation of their clients "going public." If they get an opportunity to participate in an SEC filing and they encounter problems, we urge them to seek advice from experts in the large accounting firms and from us through pre-filing conferences and telephone consultations. The observations of the Institute's Committee on Practice Review on page 29

of Practice Review Bulletin No. 2, issued in 1968, are also pertinent with respect to the question of independence.

The Institute undertook a program of continuing education in the problems relating to "going public" in the spring of 1963. We participated then and have continued to do so. This work and that of other organizations have made the experience of skilled practitioners available to the uninitiated accountants and we have had considerable evidence that this has been effective.

Programs such as these aid the small accountant in developing the competence to do the job which, in turn, may enable him to convince a doubtful client or underwriter that he has the competence.

However, some who need help the most apparently fail to seek it. The accounting firm that does not build up its audit capability to cope with the growth of its clients may lose the clients when they go public. Of course in many instances the small accountant is replaced because the underwriters may prefer a national firm, especially when the securities are to be sold outside the area where the local practitioner is known. While this is not, strictly speaking, an accounting matter, it is a problem warranting your committee's attention.

As in the early 1960's, we still encounter practitioners who have not kept up with the literature of the profession and who fail to realize that when their clients enter the public domain we expect the financial statements to reflect generally accepted accounting principles, which may be different from those reflected in books kept for the purpose of preparing tax returns. In the field of auditing, practices followed by the

independent accountant that are satisfactory to the owners of a close corporation or even to its bankers may not be acceptable for the purpose of rendering an opinion on financial statements for a registration statement. At the spring Council meeting in 1968, I said that, so far as I could judge, in comparing the situation with 1960 the problems then were more in the area of presentation of the financial statements in accordance with generally accepted accounting principles than in auditing. In the auditing area we were encountering problems of missing books and records (in one case they had been burned by the auditors!), restricted audit programs for early periods and the withholding of information by top management officials as well as the furnishing of false information. Over the years most of the serious cases of false financial information have been due to the conduct of top management. Ultrasonic, Thermoid and Londontown are well-known cases of the past. More recently there was the "Great Salad Oil Scandal." These cases--and each year seems to add new ones--are a constant reminder that auditors must not relax their vigilance no matter how confident they are of the integrity of management.

The independent accountants are often criticized by the financial press because of the differences resulting from the choice of alternative accounting procedures. Some writers have charged the certifying accountants with being captives of their clients because it is assumed that the accountants have accepted procedures selected by management to improve its image rather than to present the financial statements fairly in accordance with generally accepted accounting principles. It cannot be denied that some



reports convey this impression, and in some of these cases accountants have differed on the propriety of the solutions reached. To some of our critics this raises the question of advocacy. To maintain his independence the accountant must have strong powers of resistance to the improper suggestions of management. The accountant must take a stand for what he believes is the right accounting interpretation of the facts, within the framework of the standards established by the profession, whether favorable or unfavorable to the client. This is sound professional practice. Support of an unsound position to gain what may be only a temporary benefit for the client is improper. The dividing line between the sound and the unsound position is often hazy—the long debates over the investment credit and the criteria for pooling-of-interests accounting are examples of the difficulties of drawing the line which will not be soon forgotten. The efforts of the profession to solve difficult problems such as these must be continued and supported as public evidence of the competence of accountants to practice their profession in the manner in which it has been represented to the public for nearly one hundred years in this country and longer in Great Britain from where many of our early leaders came. I find it reassuring to reread the words of some of these founders and particularly those of a native American who spoke at the fiftieth anniversary meeting of the Institute held in this hotel in 1937. Robert H. Montgomery's closing sentences on that occasion seem pertinent today:

"Let's fight for sound business practices. Don't let's wait until unsound practices creep in, are reflected in balance-sheets and embarrass the accountants who are asked to certify them.

"Let's fight any tendency, private or governmental, to break down the independence of the certified public accountant by rules or regulations or business pressure.

"Let's fight for honest accounting, clear financial statements and full disclosure of all essential facts.

"Let's fight anyone who seeks the assistance of a certified public accountant in the issuance of any kind of misleading statement.

"Let's fight anyone who thinks that one certified public accountant will supplant another who has done a good job.

"Let's fight for easily understood accounting terms. Let's fight weasel words.

"Let's fight bunk whenever and wherever it appears."