

**THE CANADIAN ACCOUNTING PROFESSION
AND THE S.E.C.**

Address of

ANDREW BARR

**Chief Accountant
Securities and Exchange Commission
Washington, D. C.**

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THE CANADIAN ACCOUNTING PROFESSION AND THE S.E.C.

The invitation extended to me by your president, Mr. J. A. de Lalanne, to attend this meeting and to speak to you on a subject which Mr. J. R. M. Wilson was good enough to suggest and to support with helpful ideas was accepted with the cordial approval of the Securities and Exchange Commission.^{1/} I have been asked to talk about everyday problems affecting your work for clients with business before the Commission. This subject fits perfectly with a recent request from Mr. James E. Newton, our regional administrator in Seattle, that I have someone prepare a memorandum which would be helpful to his friends in your western provinces. Such a project is similar to efforts we have made through conferences with lawyers and accountants in several cities in the United States to help practitioners in their work before the Commission. Many of you have visited us in Washington, so I feel that I am among friends, which makes me particularly pleased to be here today.

Before taking up the problems our regulations present to you, we might first look briefly at the broader field of business and economic relations between Canada and the United States. A study by the Royal Commission on Canada's Economic Prospects published in July 1957 indicates the parallel development of our economies. The report says that within the framework of Canada's extensive economic relationships with the outside world, the United States has traditionally occupied a position of great importance and more recently has emerged as the preponderant

^{1/} The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

external influence shaping the course of Canadian economic affairs.^{2/} As of 1952 the United States bought some 54% of Canada's merchandise exports, supplied 74% of its imports, held 78% of all non-resident capital invested in Canada, and accounted for 92% of Canada's inflow of direct investment in foreign controlled enterprises.^{3/}

The report goes on to cover many of the dangers and adverse features of the closeness of our economic relationships, but those are beyond our present consideration. It is the 78% of all non-resident capital invested in Canada by citizens of the U. S. and the prospects of further investments which bring the S.E.C. close to the Canadian accounting profession. The actual contact of the Canadian accounting profession with the S.E.C., of course, comes from certifying financial statements included in registration statements and annual and other reports filed with us.

The Acts administered by the Commission with which you are most concerned are the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. A general discussion of these Acts and the work of the Commission under them seems unnecessary for this audience as I assume that all of you have read, or have available, The Canadian Chartered Accountant for July 1956 which contains the article by Mr. G. Kenneth Carr on "The Securities and Exchange Commission in Relation to Canadian Accountancy." What I have to say today will supplement this excellent discussion.

^{2/} Irving Brecher and S. S. Reisman, Canada - United States Economic Relations (1957), p. 1 of Preface.

^{3/} Ibid., pp. 48-50.

The Securities Act of 1933 requires certified financial statements of companies registering securities for public sale. The other Acts permit the Commission to require certification, and with minor exceptions our rules do contain the requirement. This recognition by the Congress of the value of the review by an independent accountant is a great expression of confidence in the profession. As stated in the editorial "Growing Up--Not Growing Old" in the June 1958 issue of The Canadian Chartered Accountant, "Nothing can possibly be of more importance to a profession, therefore, than the standards of competence and integrity of individuals of which it is composed." The editorial points with justifiable pride to the progress made in establishing standards of competence and to the increase in the number of practitioners. It ends with a plea for careful nursing of the quality of the professional practice in view of such rapid increase in quantity.

The independent status of the certifying accountant is perhaps the most important accounting matter in any filing with the Commission. Experienced practitioners are well aware of this. It should have first attention by the sponsors of a new registrant with the Commission, particularly if the parties involved are unfamiliar with our rules. Discovery after a filing has been made that the certifying accountant is not independent under our rules can result in a substantial delay and interference with well-laid plans as an audit by new accountants will be necessary. Determination of the accountant's status before undertaking the engagement may avoid embarrassment and expense as well as delay.

The term "independent accountant" appears in the Securities Act as a result of testimony by a prominent certified public accountant before the Committee on Banking and Currency of the United States Senate.^{4/} The concept of independence was not a new idea^{5/} but this may be the first use of the term in such legislation. This use of the term "independent" in the Act led inevitably to interpretations of it in Commission decisions and to its definition in the rules.

The Commission's experience in this area is reported in a number of Accounting Series releases,^{6/} and we are now working on another to bring the public record of administrative rulings up to date. An early case^{7/} cited in Release No. 22 held that the certification of a balance sheet prepared by an employee of the certifying accountants, who was also serving as the unsalaried but principal financial and accounting officer of the registrant, and who was a shareholder of the registrant, was not a certification by an independent accountant. Here we have the officer situation as well as financial interest.

In another release (No. 37) in the development of the present rule the Commission said: "Perhaps the most critical test of the actuality of an accountant's independence is the strength of his insistence upon full disclosure of transactions between the company and members of its management as individuals; accession to the wishes of the management

^{4/} Hearings before the Committee on Banking and Currency, United States Senate, 73d Congress, 1st Sess., on S. 875, p. 55.

^{5/} See J. E. Smyth, "Notes on the Development of the Accountancy Profession," The Canadian Chartered Accountant, November and December 1953, pp. 200-210 and 283-292.

^{6/} See particularly Accounting Series Releases 22, 37, and 47.

^{7/} Cornucopia Gold Mines, 1 SEC 364 (1936).

in such cases must inevitably raise a serious question as to whether the accountant is in fact independent." This is the accountants' conscience test which our rules and, I understand, your Companies Acts supplement with more tangible tests. Mr. Denis Goodale summed up, in part, his discussion of "Professional Ethics"^{8/} in two sentences pertinent here: "Independence or objectivity is an attitude of mind and its application to auditing is perhaps best expressed by the statement in the preface of Montgomery's Auditing (7th ed.). The primary purpose of auditing, according to that standard text, is 'the discovery and disclosure of truth.'" Perhaps some of you heard, with me, Colonel Montgomery's "Let's fight" presidential address at the 50th Anniversary celebration of the American Institute of Accountants in New York. Among other things he said, "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."^{9/}

^{8/} The Canadian Chartered Accountant, June 1956, pp. 483-488. See also J. E. Smyth, "Notes on the Development of the Accountancy Profession," The Canadian Chartered Accountant, November 1953, p. 208: "In a period in which practice precedes theory the public accountant's major contribution must be in the integrity and independence which he brings to his work." Cf. the last paragraph of "Independence of the Certified Public Accountant," A Statement by the Executive Committee of the American Institute of Accountants, The Journal of Accountancy, July 1947, p. 51, and reprinted in John L. Carey, Professional Ethics of Certified Public Accountants (American Institute of Accountants, 1956), p. 31: "Rules of conduct can only deal with objective standards and cannot assure independence. Independence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."

^{9/} Robert H. Montgomery, "What Have We Done, and How?" The Journal of Accountancy, November 1937; cited in J. E. Smyth's articles referred to above.

For convenient reference the Commission's rule on independence is reproduced in the margin of this page. ^{10/} The present revision was made effective April 8, 1958. In it we recognize the impact on accounting practice of mergers and the growth of corporations through widespread affiliations. The emphasis in the rule has been changed to make it clear that where the relationships described in the rule exist the Commission finds that an accountant is in fact not independent with respect to the company involved but does not find that he is in fact independent in instances where it fails to find that one of these ^{11/} relationships exists.

10/ Regulation S-X: "Rule 2-01. Qualifications of Accountants.

"(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.

"(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 be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

"(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Assuming that there is no independence problem, another frequent cause for delay in meeting the Commission's requirements as to financial statements is an inadequate audit. The problem arises in connection with registration statements for the sale of securities, applications for registration on a securities exchange, and periodic reports on Form 8-K reporting the acquisition of a business. This is a problem for American registrants as well as Canadian. In many initial filings the registrant has been a closely-held company and is coming to public attention for the first time. In these circumstances we often find that the scope of the independent accountant's audit has in the past been limited and either no certificate or a qualified one has been furnished. All initial filings, except for Regulation A Offering Circulars, must be accompanied by income and surplus statements and certain supporting schedules, all certified for three years or for the life of the company and predecessors if less. The alert accountant should anticipate, if possible, the needs of his client for three to five years ahead and urge that audits of a proper character be authorized. If an emergency does arise, the timing of the filing should be adjusted to permit all normal audit procedures to be applied for the final period and alternative procedures to be applied to prior years. The principal problems usually arise in the observation of inventory taking and confirmation of receivables.

With the adoption in April of this year of C.I.C.A. Research Bulletin No. 15 on Confirmation of Receivables and the application of the instruction in C.I.C.A. Bulletin No. 7 as to observation of inventory taking with respect to companies filing with the S.E.C., these procedures

now should be standard practice and hence no longer a cause for concern. At least it should not be necessary to inquire of the S.E.C., as one company representative did some time ago, as to what is accepted auditing procedure in Canada! I understand that Bulletin No. 7 is being reexamined by your committee.

These procedures were adopted in the United States as a result of the McKesson & Robbins affair in which a part of the fictitious operation was represented as being carried on through companies in Canada. Another conclusion drawn from the McKesson case which seems to be fading from the memory of some accountants was that the review of the system of internal check and control at the principal offices of McKesson & Robbins was carried out in an unsatisfactory manner. As to this the Commission said that an examination should not exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted.^{12/} Some accountants recently have advocated a more restricted review.

For the benefit of those who are unfamiliar with S.E.C. rules and forms I should say at this point that accountants and registrants who are embarking on a first experience with the Commission should acquaint themselves with pertinent sections of the law, general rules and regulations, the form on which the filing is to be made, and of course Regulation S-X, which prescribes the form and content of all required financial statements

^{12/} In the Matter of McKesson & Robbins, Inc.--Summary of findings and conclusions. Accounting Series Release No. 19, at page 35 in March 10, 1956, compilation of releases.

except the reports required of brokers and dealers in securities. A letter to the Commission saying that you are contemplating a filing and explaining the nature of it will produce the needed forms and regulations. The forms, incidentally, are instructive and not blanks to be filled in for filing.

It should be noted that the forms describe the information required, including the prescribed financial statements under a variety of conditions. If none of these conditions seem to fit your case, there is a provision under which we can work out an appropriate solution. Regulation S-X does not purport to define accounting principles. It describes the extent of the detailed information required in conventional terminology consistent with present accounting practice. It was worked out with the advice and cooperation of the accounting profession and is under constant revision in the same spirit of cooperation.

A sure way to create unnecessary delay in a filing is to ignore the requirements of the form and to send in a collection of audit reports which are found to be in the files. This happens now and then, we suspect, without the accountant's knowledge. Such reports are often of the long form designed for management and bank credit purposes and the financial statements usually are in greater detail than is required or desirable for public reporting purposes. About all we can do in this situation is to advise the registrant to prepare an amendment in proper form.

Staff consideration of financial statements required to be filed with the Commission may be obtained at various stages in the preparation

of the filing. Questions may be answered by telephone or letter or in conference prior to the filing of material. If you are new to this area of practice, requirements which seem complicated to you may be clarified in a brief telephone conversation--a much less expensive process than doing unnecessary work. In complicated cases, such as a merger of several companies with different fiscal years, a pre-filing conference may result in a solution which will save valuable space in the prospectus or other document. Experienced practitioners usually know when they have a controversial matter of accounting principle. In such cases a discussion before filing may avoid later delaying correspondence or conferences when time is vital to the success of an offering.

After the filing of the registration statement, application, proxy statement or report, the staff examines the material and issues a letter of comment which contains, when necessary, suggestions for changes in the financial statements included in the filing, and may request additional information in support of the accounting reflected in the statements. In the case of annual and other periodic reports we may suggest that changes in presentation or more precise compliance with our regulations be followed in future filings. This latter course is taken when the form of the financial statements could be improved or the failures to comply completely with the instructions are of relatively minor significance and do not result in a misleading report of income or loss or misleading classification of accounts in the balance sheets and income statements.

Following receipt of the letter of comments the registrant may feel that the questions raised warrant reconsideration either in light of

additional information which may be furnished or because of the controversial or unique nature of the problem. Such reconsideration may be by telephone, study of material furnished by letter, or in conference. Conferences, whether before or after a filing, may include representatives of the registrant, underwriters, counsel for both of these, and representatives of the accountants who are to certify the financial statements. On strictly accounting matters it is essential that a complete understanding be reached with representatives of the registrant who are responsible for the financial statements and with the accountants who are to express their independent opinions with respect to them.

The accountants' certificate is a subject for comment perhaps more frequently than it should be. The standard short form of certificate meets the requirements of Rule 2-02 of Regulation S-X in most cases. When more than one accountant is relied upon, it is sometimes necessary to issue a reminder that certificates and consents of all the accountants are required. If the principal accountant assumes full responsibility for the work done by other accountants on divisions or subsidiaries of the registrant, his certificate should be clear on the matter as required by Rule 2-05. Whether or not the principal accountant assumes the responsibility for the work of the other accountant, he does, of course, assume responsibility as a part of his audit of the parent company for the propriety and consistency of the accounting principles and practices followed by the subsidiary and for the adequacy of the audit program and standing of the other accountants. Certification by accountants of

recognized standing known to the principal accountant presumably would require minimum or no inquiries; however, upon first contact with unknown accountants appropriate inquiries must be made.

Ambiguous opinions have caused some trouble over the years. The phrase "subject to" is mentioned in our Accounting Series Release 7 which listed frequently cited deficiencies. These words are rarely acceptable. If an exception is intended, it should be clearly stated. If an explanation is being highlighted, the wording should be clear that no exception is being taken. "Subject to" may be used with reference to some problem which cannot be resolved, such as the effect of pending court or regulatory agency proceedings fully explained in the certificate or in a note to the financial statements to which reference is made.^{13/} Before leaving the certificate it may be well to reemphasize that anything the accountant wants to say about the financial statements or his audit should be said in the certificate. The financial statements, including the notes, are considered to be those of the management, hence the notes should not contain language written from the point of view of the auditor-- such as references by him to management or explanations of auditing procedures employed.

Many of the points raised in our letters of comment result from failure to conform with our rules and regulations because of unfamiliarity with them. In many instances the comments pertain to procedural matters rather than questions of accounting principle.

^{13/} For a discussion of some of the problems connected with the accountant's certificate in Canada, see Gertrude Mulcahy, "Accounting Research," The Canadian Chartered Accountant, March 1958, pp. 255-260.

A common deficiency found in many filings is the failure of the accountants to identify the statements covered and to date and manually sign their certificates and consents. There have been instances, also, in which the certificate did not cover all the financial statements and the summary of earnings, although it was apparent that all were intended to be included in the certification.

In some cases deficiencies have been cited because of the failure to include required exhibits and schedules such as statements of surplus or schedules of fixed assets and related reserves for depreciation. There have been instances in which the significance of an item on the financial statements was such as to require an explanatory footnote-- for example, a large accounts receivable balance in an oil company which was not yet in the producing stage. Conversely the absence of an inventory when one would normally be expected has led to a request for additional information.

A Canadian company being organized to engage in uranium mining stated in a footnote to its financial statements that it had contracted for the sale of a large amount of uranium-bearing concentrates over a five-year period. After review and comment by us, the statement was qualified to indicate that there was no certainty that the quantity and quality of the ore to be produced would meet the contract terms. This follows our general policy of rejecting projections of income and other statements relating to future revenues.

The foregoing are examples of deficiencies which in the past have resulted in delaying the processing of registration statements. We have

had more difficulty in cases in which accounting principles or the degree of disclosure were at issue partly because of differences between practice in the United States and Canada. For example, it seems to be Canadian practice to charge non-recurring gains or losses directly to earned surplus, or even in some cases to capital surplus, while we require that such amounts be reported through the income statement.

An important difference in reporting practice is our requirement for the inclusion of sales and cost of sales in earnings statements. Such disclosure is generally accepted practice in the United States today but this was not always the case and still is not followed by some unlisted companies not subject to our jurisdiction. The need for these figures by financial analysts was tested in the courts on appeal from a decision by the Commission denying confidential treatment.^{14/} All registrants today furnish this information.

In a recent filing fixed assets acquired from a director and a controlling stockholder in exchange for capital stock were booked at values determined by the Board of Directors although such values were in excess of the cost of the property to the transferors. We requested here that the assets be reported at the cost to the transferors and that the value assigned to the shares of capital stock so issued be reduced accordingly. In such cases if the books are not adjusted to conform to the financial statements the accountant's certificate should comment on this fact. Such a comment would appear to be consistent with your practice and our rules.^{15/}

^{14/} American Sumatra Tobacco Corp. v. SEC, 110 F. 2d 117.

^{15/} Regulation S-X, Rule 2-02 (c)(iii).

The problem of accounting for assets received in exchange for stock in promotional companies was of frequent occurrence in the early years of the Commission and led to the adoption of a form of reporting in which no values are extended for assets so acquired.^{16/} The problem of the donation back of shares issued in these circumstances was considered in an early decision^{17/} in which the Commission discussed statutory law and court decisions and then said: "With the question of whether or not stock reacquired under these circumstances is true treasury stock and hence is to be regarded as fully paid and nonassessable, this Commission in this case has no concern; but, under the standards of truthfulness demanded by the Securities Act, such an entry cannot be regarded as otherwise than untrue and misleading."

In another early case the Commission questioned the value of services rendered in exchange for stock and said: "Statutory provisions in the state of incorporation making values fixed by directors conclusive for certain purposes in the absence of fraud, cannot foreclose this Commission's inquiry as to the truthfulness of a statement that a corporation has received services of a certain value, reasonably determined, nor prevent such a statement from being tested for truth under the standards set by the Securities Act."^{18/}

Authority in some of your Companies Acts for the issuance of par value common shares at substantial discounts and not subject to call

^{16/} See Article 5A of Regulation S-X.

^{17/} In the Matter of Unity Gold Corporation, 1 SEC 25 (1934).

^{18/} In the Matter of Brandy-Wine Brewing Company, 1 SEC 123 (1935).

makes it possible to avoid in large part the problems presented in these early cases under our state laws. When, in these circumstances, assets are reported in a balance sheet as "at cost," disclosure should be made that this is in stock, for otherwise "cost" may be interpreted as being measured by a cash payment or an obligation to pay cash.

Perhaps the greatest difficulty we have is with depletion and amortization of development expenses. We prefer that such charges be included among operating expenses rather than shown separately at the foot of the income statement. The rate at which such expenditures are written off is frequently subject to question. In one recent case the depletion rate had been adjusted retroactively for five years based on new oil discoveries in the year of report. A substantial credit was made to income in the most recent year reported reflecting the excess of the reductions of the provisions for depletion accumulated in prior years over the current year's provision at the new rate. At our request the retroactive adjustment was not made and the new oil discoveries were used only as the basis for current and future write-offs.

In another case development expenditures were being written off at the rate of \$1.00 per ton milled and a footnote to the financial statements stated that the rate would be reviewed after determination of the ore reserves. After review the amortization rate was increased to \$4.00 per ton and the explanatory footnote was expanded to indicate that the adequacy of the per ton rate depended on discovery of a substantial addition to the ore reserves, as to which there was no assurance.

We have noted in the last few years a recurrence of the type of filing experienced in the early days of the Commission. Today's

accountants both here and at home should be on the alert for the situation described in 1935 in the Commission's conclusion in a stop order opinion relating to a registration statement filed by Plymouth Consolidated Gold Mines, Ltd.:^{19/} "It is obvious that the enterprise projected by this registration statement is primarily to extract gold and silver from investors in this country for the benefit of the promoters and only incidentally to extract gold and silver from mines in distant Mexico. The entire corporate structure of this registrant demonstrates that even though the mines should prove in some degree to realize the predictions of their romantic engineers, the return to the investors would still be negligible. So much is siphoned away by the promoters from the money contributed by investors, that an almost negligible equity is the return for the cash contributed by the public. When that situation occurs and is concealed by the way in which promoters, selling property to themselves through the fiction of a corporation, acquire huge blocks of salable stock for property for which they paid little or nothing, the type of full disclosure demanded by the Securities Act calls for an adequate and succinct disclosure of the effects of these strange and curious proceedings to the investor. To insist upon less than this, would be to fail to fulfill the mandate of that Act and to allow it to be perverted to the uses of fraud rather than to its prevention."

A discussion of the S.E.C.'s accounting requirements would not be adequate without some reference to brokers and dealers in securities. At June 30, 1958, there were 4752 effective registrations with the Commission of brokers and dealers in securities of which 37 were in

Canada. Every registered broker-dealer is required to file with the Commission a report of financial condition as of a date within each calendar year except under certain conditions specified in Rule 17a-5(a). All but a limited number of these reports must be certified by independent accountants. The tests of independence here are the same as I have described under other provisions of the securities acts.

The style for these reports is a financial questionnaire and supplementary information prescribed in Form X-17A-5. The form differs in some respects from that of The Broker-Dealers' Association of Ontario which I have seen. The form specifies certain minimum audit requirements which should not be interpreted as a complete audit program. Rule 17a-5 (f) and (g) describe, respectively, the qualifications of accountants and the accountant's certificate. The latter is the usual short form in use in the United States but with a specific requirement that it include a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers. One significant difference in audit procedure in Canada and the United States appears to be that you rely on a negative confirmation of "clients' balances" whereas we use the positive method.^{20/}

One of our principal problems in this field in the United States is the failure of many small brokers and dealers to keep their bookkeeping up to date. If your clients follow the advice of Mr. W. Grant Ross in his article on "Brokers' Records"^{21/} you should have no trouble on this account.

^{20/} Cf. I. Beverley Howson, "The Audit of Stockbrokers' Accounts," The Canadian Chartered Accountant, March 1958, pp. 207-213, and Audits of Brokers or Dealers in Securities by Independent Certified Public Accountants (American Institute of Accountants, 1956).

^{21/} The Canadian Chartered Accountant, April 1958, pp. 316-324.

It has been suggested that it might be helpful to some if I discussed our net capital-aggregate indebtedness ratio rule applicable to brokers and dealers. Since one of our experts on this subject took thirteen double-spaced pages for an elementary discussion, I can only call Rule 15c3-1 to the attention of those concerned with it.

You must have discovered by this time that much of what I have had to say this morning has been covered in what appears to me to have been a well-planned series of articles in your own Institute's journal. My office and other accountants on the Commission's staff have had the pleasure of keeping informed on the practices of the accounting profession in Canada through The Canadian Chartered Accountant and the statements issued by the Committee on Accounting and Auditing Research. This practice began in 1946 when some of us got acquainted with Mr. Clem L. King, then your Secretary and later your first Director of Research, at a meeting of the American Institute of Accountants in Atlantic City. I had the pleasure several years ago of visiting with him in his office in Toronto. We want to continue to keep abreast of your thinking on accounting and auditing and in turn to assist you in any way we can in your practice before the Securities and Exchange Commission.

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