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SOME CHALLENGES IN FINANCIAL REPORTING  
FOR REGULATORY AGENCIES

Address of

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SOME CHALLENGES IN FINANCIAL REPORTING  
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The program this morning is one in which the speakers have a mutual interest and, I believe, a common objective. The Securities and Exchange Commission from its inception has sought the advice of those who would be affected by its regulations. The Administrative Procedure Act codified in many situations the Commission's long standing practice in this regard. The Commission therefore appreciates this opportunity for me to participate in this discussion of how C.P.A.'s can meet present-day challenges of financial reporting.<sup>1/</sup>

The plan of attack seems to be for Mr. Crane, who is a financial analyst for an investment banker, and me to outline our need for fairly presented financial information and to raise some of the problems we encounter in obtaining or interpreting it. The solutions by Mr. Jennings, the nominee for president of the American Institute of Certified Public Accountants, I am sure will come with his customary penetrating analysis.

In speaking of financial reporting problems I will of course be addressing myself primarily to the problems of the S.E.C. To some extent I may comment in a general way upon the impact of these problems on other agencies.

The first and basic challenge in financial reporting is, of course, fair and adequate reporting. About thirty years ago Professor W. Z.

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<sup>1/</sup> 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.

Ripley of Harvard University wrote some articles for the Atlantic Monthly, including one on the subject of publicity of corporation accounts. This caused a prominent member of this Institute, Mr. George O. May, to write a letter to the New York Times. This in turn resulted in the letter writer's appearance on the program of the Institute in September of that year.<sup>2/</sup> Some of the points made at that time were the necessity for disclosing extraordinary or extraneous profits, departures from accepted conventions such as valuing inventories on a basis other than cost or market, and the failure to provide for depreciation or depletion. The propriety of disclosing gross sales was considered debatable at that time. Substantial progress in reporting has been made since then.

Ten years ago accountants were hearing from a partner of a public relations firm on the need for a common language for financial reporting<sup>3/</sup> or the semantics of annual reports.<sup>4/</sup> The plea was that companies should not start riding off rapidly in all directions but that there should be some standard way of making a report of a company's results of operations that would be acceptable to accountants and at the same time understandable to the public. Some progress has been made in this field. Some people would have us go faster, but the challenge to a regulatory agency in these and other accounting matters is to determine whether we are being urged to go in the right direction.

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<sup>2/</sup> George O. May, Twenty-five Years of Accounting Responsibility, American Institute Publishing Co., Inc., Vol. 1, pp. 49, 53.

<sup>3/</sup> Don Knowlton, NACA Bulletin, Vol. XXX, No. 22, July 15, 1949.

<sup>4/</sup> Don Knowlton, The Accounting Review, October 1947.

More recently a number of the important present day challenges in financial reporting have been expressed by Oswald Knauth in his much quoted article <sup>5/</sup> in last January's issue of the Journal of Accountancy. The presentation there is from the point of view of the business executive rather than that of a regulatory agency. However, the points raised warrant serious consideration and may creep into the discussion this morning.

The S.E.C. operates under several statutes <sup>6/</sup> with various degrees of regulatory functions. Its major activities, however, and those of most interest to accountants, are derived from the disclosure provisions of the statutes, particularly from the disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, which we call the Securities Acts.

The purpose and basic philosophy of the disclosure statutes as stated in the title of the Securities Act is "to provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce." The Senate committee report on the bill stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary or material in carrying out the provisions of the bill but it was deemed essential to refrain

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5/ "An Executive Looks at Accountancy," Knauth, O. W., Journal of Accountancy, January 1957.

6/ Securities Act of 1933; Securities Exchange Act of 1934; Public Utility Holding Company Act of 1935; Trust Indenture Act of 1939; Investment Company Act of 1940; Investment Advisers Act of 1940; Bankruptcy Act, Chapter X.

from placing upon any Federal agency the duty of passing judgment upon the soundness of any security.<sup>7/</sup>

The basic financial statements are prescribed by statute, but form, extent of detail, classification, and accounting methods to be followed are specifically left to the determination of the Commission.<sup>8/</sup> The report of Mr. Rayburn's committee to the House summarized the financial statement requirements of the Act as including a balance sheet that will give an intelligent idea of the assets and liabilities of the issuer in such form and in such detail as the Commission may prescribe and a profit and loss statement that will give an intelligent idea of the earnings and operations of the issuer<sup>9/</sup> for at least three years, year by year, in such form and in such detail as the Commission may prescribe. It seems to me that these words describe our common objective fairly well. Special powers of the Commission found in Section 19(a) of the Securities Act include authority to define accounting and trade terms used in the Act and to prescribe the forms in which the required information shall be set forth and the methods to be followed in the preparation of accounts.<sup>9/</sup>

The Commission has followed the statutes<sup>10/</sup> in prescribing the basic statements, their form, detail of content, and in some areas the accounting methods to be followed, with the proviso that "the information required with respect to any statement shall be furnished as

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<sup>7/</sup> Senate Report No. 47, 73d Congress, 1st Session, p. 2.

<sup>8/</sup> 1933 Act, Items 25 and 26 of Schedule A; 1934 Act, Sec. 13.

<sup>9/</sup> House Report No. 85, 73d Congress, 1st Session, pp. 18 and 25.

<sup>10/</sup> 1933 Act, Items 25 and 26 of Schedule A.

a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."<sup>11/</sup> Although there is sufficient authority under the statutes to define accounting principles,<sup>12/</sup> the Commission early adopted the policy of leaving, insofar as possible, the determination of accounting principles to the profession.<sup>13/</sup>

Within the limits of the provisions of the statutes and the rules adopted thereunder, we try to solve routine disclosure problems in a manner consistent with accepted accounting procedures and the disclosure philosophy of the statutes. These basically are minimum requirements, and it is expected that most companies will give more information and will have their statements prepared in a workmanlike manner. It is not unusual to find that disclosures made on a voluntary basis exceed the precise requirements of the rules.

### Historical Accounting

The limitations inherent in the historical cost basis of accounting generate problems which present a challenge to regulatory agencies and to the accounting profession. It is my purpose to indicate the nature of these challenges and some of the current problems posed by them. As previously stated, I shall leave the solution of

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<sup>11/</sup> Regulation S-X, Rule 3-06.

<sup>12/</sup> 1933 Act, Sec. 19(a) and Items 25 and 26 of Schedule A.

<sup>13/</sup> See remarks of Carman G. Blough at pp. 189-190, The American Institute of Accountants, Fiftieth Anniversary Celebration, 1937.

the problems to Mr. Jennings. The program in this respect is consistent with the Commission policy of leaving the definition and development of accounting principles to the profession, with, of course, the reservation of the right to criticize and reject proposals which appear to the Commission to be contrary to principles of full and fair disclosure.

There are, of course, accepted departures from conventional accounting, such as in bankruptcy or other liquidation proceedings where statements are prepared for the purpose of showing the values expected to be realized, rather than on the basis of accounting for a going concern. Investment trust accounting, where investments are carried at adjusted market value, is another accepted departure. Conventional insurance accounting departs in some respects from generally accepted accounting and for this reason is of great concern to us at the present time because of the increase in public offerings of insurance shares.

The basic challenge from the financial reporting of the fire and casualty insurance business comes from the lack of correlation between the volume of business done and the net earnings reported by the insurance industry and from the fact that the entire amount of the premium charged the policy holder must originally be established as a liability in an "Unearned Premium Reserve," while the expenses incurred in writing the policy are immediately charged to the current profit and loss account. In a period of increasing premium volume, therefore, this method of accounting temporarily penalizes the statutory underwriting results of the companies by increasing operating

costs. Conversely, in a period of declining volume, the statutory underwriting results are benefited since credits to the profit and loss account are based upon the higher volume of business in the past and debits to such account are based upon the reduced current volume.

This problem in conventional insurance accounting is not new. Alfred M. Best was quoted in the Journal of Commerce, July<sup>21</sup>/1921, as saying, "One great company added in the year 1920 \$8,000,000 to its unearned premium liability, and reported in consequence an underwriting loss of about \$1,800,000. It had no choice under the law, but was obliged to make up its accounts on that basis, for which reason it would be absurd even to suggest that its officers were guilty of manipulation of its figures in order to conceal profits. Yet, the underwriting operations of that company, considered from the standpoint of the stockholders, were highly profitable during the year in question, because, as a practical business fact, the company under normal conditions, and, barring the possibility of a great conflagration, will never require anything like \$8,000,000 to meet the losses under the policies, the writing of which resulted in the \$8,000,000 increase of its unearned premium account."<sup>14/</sup>

In connection with the financial statements of fire and casualty companies filed under the Securities Act, the certifying accountants are required to comment upon these differences in accounting practices. Usually in the prospectus there is also presented a tabulation showing

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<sup>14/</sup> Guthman, The Analysis of Financial Statements, 3d ed., 1946, p. 463, fn. 16.



the adjustment of statutory net earnings to give effect to the increase or decrease in unearned premium reserve during the years reported, and a tabulation showing an adjustment of net equity to give effect to the equity in the unearned premium reserve.

This is not an entirely satisfactory solution to the challenge of obtaining full and fair disclosure for investors in insurance companies. I understand that an Institute committee is considering this problem and may be working toward an adequate solution of reconciling regulation for the protection of policy holders and fair disclosure of financial position and operating results to stockholders.

One of the recurring, and in the last ten years continuing, challenges to accountants is the pressure from various quarters, including prominent public accountants, to depart from historical cost as the basis for accounting and reporting in other industries than these specialized examples. In the 1920's upward appraisal of assets was a common practice. This was followed in the early 1930's by reversals and in some cases drastic reductions from costs. Now no one can deny that we have experienced a long period of rising prices which has forced serious study and reexamination of the effect of changing price levels on our accounting principles. How, if at all, should this condition be dealt with in the accounts and financial reports of the business entities affected?

The Report of Study Group on Business Income published under the title "Changing Concepts of Business Income"<sup>15/</sup> brought together the

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<sup>15/</sup> The MacMillan Company, New York, 1952.

varying ideas of many persons seriously concerned with this problem. It is impossible to summarize this report adequately in one sentence. The report recognizes that there are problems to be solved but suggests that as a long-range program methods should be developed whereby the effects of the change in value of the monetary unit would be reflected separately but integrated with present methods of reporting. However, the report concludes:<sup>16/</sup> "For the present, it may well be that the primary statements of income should continue to be made on bases now commonly accepted. But corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate the determination of income measured in units of approximately equal purchasing power, and to provide such information wherever it is practicable to do so as part of the material upon which the independent accountant expresses his opinion." Some of the accountant members of the study group expressed grave doubt about including the supplemental statements within the scope of their opinions.

In the face of such doubt the question arises as to whether a regulatory agency should permit the inclusion of such material in the certified financial statements. If such material is permitted to be included in the certified statements, the question then arises as to whether the practice should be made a requirement.

In 1948 the question as to whether depreciation on replacement cost could be reflected in financial statements filed with the Commission was raised by several companies. After an informal discussion

of the matter, during which a registrant vigorously advocated this procedure, the Commission denied the request.<sup>17/</sup>

With respect to the question of a mandatory requirement, the Commission in 1954 was petitioned by a formal application to adopt a rule that economic depreciation (based on replacement at current prices) be reflected either in the accounts or by other appropriate disclosure. This petition was denied also.<sup>18/</sup>

This subject should not be left without referring to the completion by Professor Ralph C. Jones of Yale University and publication by the American Accounting Association of a thoroughgoing study of this problem financed by grants from the Merrill Foundation for Advancement of Financial Knowledge, Inc. After years of study and advocacy of recognizing the effect of the changing value of the dollar on financial statements, Jones has this to say with respect to formal reports to stockholders:

"The failure to recognize in formal fashion the effects of inflation upon financial statements is due in part to conservatism and in part to a genuine belief that the presentation of purchasing power information would lead to confusion rather than understanding. It is also due in part to the diversity of remedies proposed. Even if a majority of business men and of accountants should favor

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<sup>17/</sup> Securities and Exchange Commission, 14th Annual Report, p. 111.

<sup>18/</sup> Securities and Exchange Commission, 20th Annual Report, p. 107.

in principle the adjustment of financial statements for the effects of general price level changes, such a change in methods of reporting could hardly be achieved in practice until a general agreement on basic methods for making the adjustments had been reached. Since a revolutionary change in official certified statements is hardly possible and probably not desirable, progress toward more realistic reporting must be made gradually."<sup>19/</sup>

### Disclosure

There also is a challenge which comes from the innate conservatism of accounting. This conservatism results naturally from the exercise of judgment in the many phases necessary in the determination and preparation of the accounts. Since there is no precisely correct answer in a decision involving judgment, the safe course is to lean toward the conservative side. The simple rule therefore has been conservatism rather than the theoretical or mathematical accuracy so often attributed by laymen to accounting reports.

Conservatism, however, is limited to the range in which there is room for a legitimate difference of opinion. Beyond these limits an understatement of assets or income is misstatement of the accounts in the current period in which the understatement is permitted and in benefited future periods. It is often argued with conservatism in mind that an understatement is not as misleading as an overstatement.

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<sup>19/</sup> Ralph C. Jones, "Effects of Price Level Changes on Business Income, Capital and Taxes," American Accounting Association, 1956.

There is some evidence that this form of conservatism is deemed appropriate for healthy established companies with a desire to get bad news behind them but it is not deemed appropriate for new developing companies with a need for additional capital. There is some evidence, too, that conservatism is being abandoned with doubtful propriety in the face of rising operating costs. This finds expression in the claiming of immediate tax benefits arising from deductions for liberalized depreciation and research and development costs as incurred coupled with lower rates of depreciation and amortization for reporting purposes. The heavy impact of income taxation cannot be safely ignored. Failure to keep accounting for taxes and reporting purposes on the same basis when the operating facts support uniform treatment may result in seriously misleading financial statements. Practice seems to vary by industries and has been influenced in the regulated industries by the position taken by the federal or state commissions having primary jurisdiction.

For example, a number of cases have come to our attention in which sum-of-the-years-digits or declining balance depreciation has been claimed for tax purposes but straight line depreciation has been continued on the books without any adjustment for deferred taxes or supplementary amortization charge. The improvement in earnings resulting from this practice has been so large in some of these cases that amendment of the statements to include an additional charge equal to the tax benefit has been required on the grounds that failure to do so would make the statements seriously misleading. An argument

advanced in support of no tax or other adjustment is that after a few years the resulting discrepancy between book and tax return determination of income will disappear and that the tax will never be paid on the accumulated difference. In the earlier years, and these may run to ten or more before the leveling-out effect appears, securities could be sold on an appearance of rapidly improving earnings which it is conceded will not be sustained. While I think it is well established that it is not the work of the accountant to make estimates for the future, neither he nor the registrant has any ethical right to endorse a statement of past earnings if they know "it is calculated to mislead the investor as to the reasonable prospects for the future."<sup>20/</sup>

Other major differences between tax accounting and accounting for corporate reporting purposes may be significant in the treatment of intangible drilling costs, statutory depletion, installment sales, bad debts and warranties. In fact there are so many such items of material importance that it may now be deemed of material significance to know whether there are such differentials. It may well be that a complete reconciliation between taxable income and reported income and between the tax charged to income and the tax liability shown in the balance sheet is now indicated in order to meet the standards of full and fair disclosure.

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<sup>20/</sup> George O. May, "The Accountant and the Investor," lecture at Northwestern University, 1932, in Twenty-five Years of Accounting Responsibility, Vol. 1, p. 10.

On the other hand the continual emphasis on presenting information in a manner to be not misleading is itself a challenge. It leads at times to too lengthy explanations and a tendency to arrange factual information in a manner to invite a particular conclusion. The extreme is either a mass of confusing explanations or a reversion to the practice of giving only briefly summarized statements.

Much essential information frequently found only in elaborate footnotes may be included in captions in the financial statements. But it would be a rare case today that could meet fair disclosure standards

without the use of footnotes. In addition to the tax and depreciation matters previously mentioned, adequate disclosure of methods applied in valuing inventories, accounting for pensions, deferred compensation plans and stock options is essential today. Isn't it time to reconsider whether something more than footnote disclosure is necessary? In this connection, the recent Libby, McNeill & Libby proxy litigation in which the Commission obtained an injunction enjoining the solicitation of proxies by means of false and misleading statements, many of an accounting nature, should be of interest to all accountants who prepare reports to stockholders.<sup>21/</sup>

#### Validity and Integrity of Financial Statements

Col. A. H. Carter, then president of the New York State Society of Certified Public Accountants, in testifying before the Senate

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<sup>21/</sup> SEC v. May, 134 F. Supp. 247 (S.D.N.Y.) aff'd 229 (2d) 123 (CA 2d 1956).

Committee on Banking and Currency on the proposed Securities Act,<sup>22/</sup> suggested that the required financial statements be examined and certified by an independent public accountant. Note that the emphasis in the recommendation was that the Federal Trade Commission could not properly discharge its duty by merely accepting a statement that had not been independently examined and certified to by an accountant. This suggestion was probed for some time by the committee, but the main concern seemed to be whether the benefit to the public of certified financial statements would be worth the cost of the audit. Some of the committee seemed to think that this would be unnecessary duplication as the government agency would have to do its own audit. Fortunately Colonel Carter protested that such a procedure would require an unobtainably large force and an important question of time was involved. It would seem reasonable to assume that today we are all in agreement on the desirability of certification of financial statements whether for use in a report to stockholders, in a registration statement for the sale of securities or in annual reports to the Commission.

There appears to be a rather general belief that only large accounting firms with many offices do any substantial practice with the S.E.C. A survey of financial statements included in 2,265 annual reports filed with the Commission for 1946 showed that 416 accounting firms were represented of which 279 each certified one statement and

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<sup>22/</sup> Hearings before the Committee on Banking and Currency, 73d Cong., 1st Sess., on S. 875, March 31 to April 8, 1933, pp. 55-67.



58 each certified to only two statements, while six firms each certified to 100 or more and four other firms each certified 25 or more but less than 100. A recent list compiled from 3,072 filings on Form 10-K for 1955 and 1956 included 558 different accounting firms of which 384 each certified to one statement, 77 firms each certified to two and only the top ten firms each certified to more than 25 as in 1946. One firm in the top ten in 1946 had merged with another in that bracket by 1955 and one firm qualified to take its place. In addition, in 1955-56 162 accountants not included above certified reports for broker-dealers in securities. I do not know how many individual accountants are represented by these firms, but I think it fair to assume a number in the thousands even if we limit it to partners who would be subject to our independence rules in all cases.

Our experience shows that the practicing public accountant may become subject to the S.E.C. rules most unexpectedly. This may happen when a closely-held corporation or its stockholders find it necessary or desirable to sell securities in interstate commerce, thus becoming subject to the registration requirements of the Securities Act of 1933; or a company whose securities have been traded in the over-the-counter market may desire to list on a national securities exchange, thus becoming subject to the financial reporting requirements of the Securities Exchange Act of 1934. New legislation may create a similar situation. Other companies may come under the jurisdiction of the Commission by making public offerings of their securities under Regulation A, which prescribes the simplified filing procedures for

issues not in excess of \$300,000. In the event that an accountant's certificate is used in any of these circumstances, the Commission's tests of independence are applicable, and compliance with generally accepted accounting and auditing standards is subject to our scrutiny.

By one of the tests under the Commission's rules,<sup>23/</sup> the accountant is prohibited from having any financial interest in the registrant or its affiliates. On the other hand, the rules of the American Institute of Certified Public Accountants merely require disclosure of <sup>a</sup>/substantial interest of the accountant if he renders an opinion on financial statements which are used as a basis of credit and prohibit ownership of a substantial interest in an enterprise financed in whole or in part by public distribution of securities. These two conflicting standards of independence often cause confusion. It has been urged by some accountants that independence is a state of mind -- the accountant's

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23/ Rule 2-01 of Regulation S-X:

"(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 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.

"(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."

conscience -- and that standards of professional work should not be affected by his financial interest in the registrant. However, the objective tests of independence to which certifying accountants are held by the rules of the Commission have been adopted for the purpose of avoiding both the opportunity for, and the appearance of, bias and prejudice, or the possibility of undue influence on the part of the client.

Public accountants whose practice involves the rendering of certificates based upon audits should be mindful that their clients may come under the jurisdiction of the Commission. This may require certification of income statements for at least three years, and in some cases the client may desire certified summaries of earnings for five or more years. Serious personal embarrassment to the accountant and added expense for the client can be avoided if the accountant is sufficiently foresighted to disengage himself from any entangling relationships with his clients. With present day interest in developing services to management, care should be taken to maintain a clear distinction between the giving of advice to management and the making of decisions for management.

In addition, the fact of coming under the Commission's jurisdiction for the first time may require an extension of the audit program. Extensions of auditing procedures to require confirmation of receivables and observation of inventory taking were adopted by the profession as a result of the McKesson affair. Our experience indicates that these procedures have frequently been omitted by

companies attempting to register for the first time. Acquiescence in the client's desire to reduce auditing costs while the company is closely held and not seeking public financing may be a disservice in the long run.

There is another activity of the Commission in which the professional services of independent public accountants are required by our rules. The Congress in the Exchange Act <sup>24/</sup> left to the Commission the determination of the records to be kept and reports to be made by brokers or dealers in securities deemed necessary and appropriate in the public interest and for the protection of investors. Here we are concerned primarily with safeguarding the securities and funds of the customers of the brokers or dealers, rather than the protection of the owners of the business.

At June 30, 1957, there were 4,770 effective registrations of brokers and dealers, of which 1,318 were in New York City. Of the total, 1,627 were corporations, 1,297 were partnerships and 1,846 were sole proprietorships. Every registered broker-dealer is required to file with the Commission during each calendar year a report of financial condition. Under a revision of our rules <sup>25/</sup> effective November 15, 1957, all but a limited number of these reports must be certified by independent accountants. The extension of the certification requirement was postponed until publication by the American Institute of Certified Public Accountants of the booklet "Audits of Brokers or Dealers in

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24/ The Securities Exchange Act of 1934, Sec. 17(a).

25/ Securities Exchange Act of 1934, Release No. 5560.

Securities" which was issued by the Committee on Auditing Procedure after several years of study. The Commission's release announcing the amendment of the rules called attention to this booklet and said that it should fill the need for an authoritative guide to accountants in this specialized field of auditing. Copies of the booklet have been issued to our broker-dealer inspectors in our field offices. The cooperation of all who participated in the preparation of this work is greatly appreciated by the Commission and staff.

I am happy to have had this opportunity to participate in a program looking toward the improvement of financial reporting.

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