THE SEC

AND

THE ACCOUNTING PROFESSION

Address of

ANDREW BARR
Chief Accountant

Securities and Exchange Commission
Washington, D. C.

Accountant in Residence Program
Department of Accountancy
School of Business and Public Administration
University of Missouri-Columbia

April 30, 1970

Nearly forty years ago I bought a book entitled "The Cultural Significance of Accounts." I cannot say now how much attention I gave to it then, but I and an accountant in my office who is somewhat of a philosopher have read it in anticipation of this meeting. We find that much of what the author, DR Scott, wrote forty years ago is pertinent to the situation we see in accounting and business today. 1/ The author's stated purpose was to present an orientation of accounts: ". . . an exposition of the place of accounts in the existing scheme of human affairs among peoples who make the largest use of accounting technique." After briefly outlining the cooperative attitude he suggested, he said:

> "One further point remains to be made in this connection in order to guard against misapprehension. While it is argued here that the time has come for rewriting economic theory, it does not follow that the old economic theory should be discarded forthwith. If the motor car you drive is three years old, it is quite out of date, but good economy does not necessarily require that it be scrapped now. A new model may be based upon new principles which are destined to revolutionize motor car service but at the same time it may still be in an experimental stage. When everything is considered the current service of the old car may actually be the better. This, however, does not mean that work upon development of the new model should be abandoned.
>
> "Those who propose the immediate and complete abandonment of the old economic theory, of various sorts, are like the spoiled daughter of the family who would dispose of last year's car because it is not up to date. But those who refuse to recognize the importance of formulating the new theory are like the grandfather who not so many years ago preferred Old Dobbin to any newfangled horseless carriage on the market." 2/

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.

2/ DR Scott, The Cultural Significance of Accounts, p. 17-18; Henry Holt and Company, Inc., New York, 1931.

The ideas expressed here seem to apply to accounting as well as to economics. It may be recalled that the 9th International Congress of Accountants held in Paris in 1967 had for its theme "The New Horizons of Accounting" and included papers and discussions on the topics (a) economic horizons, (b) international horizons, (c) scientific horizons, and (d) role and training of the accountant of the future. Two of the four subtopics under international horizons were "The Harmonization of Accounting Principles" and "The International Harmonization of Auditing Standards and Procedures." National contributions on principles were summarized by T. K. Cowan, Professor of Accountancy and Dean of the Faculty of Commerce at the University of Otago (New Zealand). The national contributions on auditing were summarized by H. W. Ross, then Chancellor of McGill University and a past president of the Canadian Institute of Chartered Accountants.

I mention the international scene merely to observe that the SEC's involvement in accounting and auditing is not limited to professional practice in the United States. There are many Canadian companies and a smaller number of other foreign companies directly subject to our securities acts, and of course our large international corporations have subsidiaries in many countries. This means that we must keep informed as well as we can about developments in accounting and auditing abroad as well as at home so that, perhaps in time, we can help to bring about a reasonable degree of international harmonization. Some concrete evidence of effort in this direction is found in the three pamphlets produced by the Accountants International Study Group, 3/ which is made up of representatives of the profession from Canada, the United Kingdom, and the United States.

Reverting to DR Scott, two more passages seem to be prophetic of the passage of the securities acts only a few years after his book was published. The following seems to suggest that something more than the basic accounting record is needed to gain an adequate understanding of the business:

> "Those who conceive economic theory to be a rigid system built up deductively on the basis of a few fundamental generalizations are not without their counterparts in the field of accounting. For example, the author of a recently published elementary text writes as follows:
>
> "'Accounting is not an end but a tool for the interpretation and the direction of business. The student who grasps this truth will perceive that the methods and applications of accounting must vary to meet diverse demands and conditions. Yet all sound accounting is based on a few fundamental principles and conventions which can be mastered and then developed to fit particular cases.'
>
> "The position to be taken in this chapter is contrary to the foregoing view. It will be argued here that the so-called statistical materials included in the records of modern business enterprises are just as intimately and necessarily a part of current accounting systems as is double entry technique itself. It will be contended that accounts are not identical with the double entry record and that any definition of them based upon the double entry record is too narrow to be applicable to the accounting for current business affairs." 4/

And the following is a good summary of the place of accounting in the work of the SEC:

3/ Accounting and Auditing Approaches to Inventories in Three Nations (1968); The Independent Auditor's Reporting Standards in Three Nations (1969); Using the Work and Report of Another Auditor (1969).

4/ Op. cit., pp. 208-9, footnote omitted.

> "The resort to accounts as a source of the administrative law of government regulation; the recognition of accounting principles in the application of more general rules of law by courts of law, and the increasing importance of accounts to private business management are all parts of a single pattern. Whether business is public, semi-public or private, it has come to hinge upon accounts. The most significant thing in current institutional development relative to the adjustment of economic interests is not a shifting of responsibility from economic to governmental machinery. It is rather a shifting of responsibility to accounting processes of adjustment and an organization of economic control about accounts. So pervasive is this tendency that it promises a leading role for accounts in the process of institutional reconstruction. Indeed, circumstantial evidence points to the conclusion that just as market machinery and the principles involved in market control were absorbed into the government and law of an individualistic period, so accounting technique and accounting theory are destined to be absorbed into the government and law of a succeeding period." 5/

The draftsmen of the Securities Act of 1933 set a pattern in granting authority over accounting to the Commission empowered to enforce the law. This was the Federal Trade Commission until the Securities Exchange Act of 1934 created the SEC and administration of the 1933 Act was transferred. A point often overlooked by the investing public should be noted before we continue. In a public information pamphlet the Commission emphasizes that

> "It should be understood that the securities laws were designed to facilitate informed investment analyses and prudent and discriminating investment decisions <u>by the investing public</u>. It is the investor, <u>not</u> the Commission, who must make the ultimate judgment of the worth of securities offered for sale. The Commission is powerless to pass upon the merits of securities; and assuming proper disclosure of the financial and other information essential to informed investment analysis, the Commission cannot bar the sale of securities which such analysis may show to be of questionable value." 6/

5/ *Ibid.*, pp. 236-7, footnote omitted.

6/ "The Work of the Securities and Exchange Commission," October 1969, p. vii.

The part of section 19(a) of the 1933 Act pertinent to this discussion cannot be summarized in less space than a quotation which will be more accurate:

> "The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this title. Among other things, the Commission shall have authority, for the purposes 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 earning 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; . . ."

This grant of authority and a similar provision in the 1934 Act were implemented initially by prescribing the form and content of the financial statements to be included in the forms used for registration and reporting under the Acts. These portions of the forms were later gathered together in Regulation S-X under the title "Form and Content of Financial Statements."

Regulation S-X is primarily a disclosure regulation as there is very little in the way of accounting principles or specific auditing standards in it. For these the Commission has elected to cooperate with the accounting profession in the program of the American Institute of Certified Public Accountants designed to provide professional standards and to narrow the areas of difference in financial reporting.

This relationship with the profession and the problem of alternative accounting practices were the subjects of testimony before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, February 19, 1964. This testimony was given on the last afternoon of the last day of the hearings on proposed amendments to the securities acts.[7/]

William L. Cary, then Chairman of the Commission, was asked by Representative Staggers whether he considered the financial statements filed with the Commission were on a sufficiently sound and uniform basis to protect investors and who has the primary responsibility for the determination of appropriate accounting principles to be followed in the preparation of financial statements. Mr. Cary responded that the Commission had cooperated with the profession "as a joint responsibility" while recognizing that it had the ultimate responsibility to determine whether the accounting profession has taken appropriate action to determine adequate accounting principles.

Mr. Staggers asked "Is it true that the Commission now accepts financial statements from various companies following alternative accounting practices with materially different results for similar transactions and the certifying statement that all of these practices are in accordance with generally accepted accounting principles?" The short answer, of course, was "It is, sir." This required further explanation including the citing of Accounting Series Release No. 4, published April 25, 1938, which stated the Commission's administrative policy with respect to financial statements to be:

7/ See "Statements in Quotes," The Journal of Accountancy, June 1964, p. 56.

"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."

The Commission was then asked to file a memorandum with the committee setting forth areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles and its conclusions as to the significance of each such area and whether investors are adequately protected by acceptance of alternative practices.

The memorandum submitted by the Commission expressed the belief that much improvement in financial reporting practices had occurred since the enactment of the first Federal securities law in 1933 and that "its policy of working with and supporting the accounting profession in the development of accounting principles has directly influenced this progress and is the best means of assuring continuing improvement of accounting practices."

Eight items were discussed in some detail and others were mentioned in the memorandum. At that time the Accounting Principles Board, set up in 1959, had issued three opinions and the Director of Research had authorized publication of six research studies. The opinions dealt with

(1) new depreciation guidelines and rules (adopted unanimously but with five qualified assents); (2) accounting for the "investment credit" (reversed one month after the hearings because of lack of support by major accounting firms, industry, and the SEC); and (3) the statement of source and application of funds. I think it is fair to say that the last mentioned opinion has had complete support, including our recent proposals to amend SEC registration and reporting forms to require the statement and to provide a new article in Regulation S-X to govern its form and content.

About the time of these hearings in 1964 the Board was being criticized from all sides as being ineffective, with some writers warning that the SEC would be forced to take over and exercise its powers in a direct way rather than continuing its policy of supporting the efforts of the profession to improve financial reporting. With this background it may be useful to identify the specific items cited in the memorandum to Congress and to indicate what has been done about them.

The first point was valuation of inventories--citing the lifo-fifo methods as the best known alternatives with substantial impact on the balance sheet, especially working capital. Some accountants have urged use of fifo for the balance sheet with continued use of lifo for the income statement. A study of inventories is on the Board's agenda.

Depreciation and depletion is a subject which needs no elaboration as to its importance and potential for materially different results. This is also under study.

Income tax allocation after much debate has been reexamined in APB Opinion No. 11 and a much needed extensive interpretation has been provided. 8/

Pensions--a solution acknowledged to be a compromise in some respects and requiring further study is found in APB Opinion No. 8. This opinion is supported by a compilation of articles. 9/

Research and development costs is a subject on which we need guidance. A study has been under way for the Board for some time. The Gilberts in their Thirtieth Annual Report of Stockholder Activities at Corporation Meetings during 1969 criticize deferral of these costs and praise the alleged conservative approach of immediate expensing. Sydney Davidson does not seem to agree with this, 10/ and neither do I--circumstances may be widely different. Even the well known financial analyst, Thornton L. O'glove, who objects strenuously to the deferral approach, in a comment on Davidson's article in the Journal admits there may be exceptions. His observation points up the problem here quite sharply:

> "Empirical evidence indicates that permissive deferral of R&D expenditures and related items is an area that is being much abused. If the Accounting Principles Board should place its seal of approval on the capitalization of accounting for intangible services, a Pandora's box would be opened. I realize that there are cases (mostly in the high technology fields) where deferred R&D is in order. However, it is my contention that the sanctioning of deferred expense in the area of training costs and advertising expenditures can be misused by corporations wishing to enhance temporarily their share earnings." 11/

8/ Donald J. Bevis and Raymond E. Perry, Accounting for Income Taxes, AICPA, New York, 1969.

9/ Accounting for the Cost of Pension Plans, AICPA, New York, 1968.

10/ Accounting and Financial Reporting in the Seventies, The Journal of Accountancy, December 1969, p. 29; Forbes, April 1, 1970, p. 40.

11/ "Letters to the Journal," The Journal of Accountancy, April 1970, p. 28.

The sixth item in our list was goodwill. The issue here was raised by Wyatt (ARS No. 5) and covered more fully by Catlett and Olson (ARS No. 10), and we now have before us an exposure draft of a proposed APB opinion: "Business Combinations and Intangible Assets." The first half of this title was mentioned in our memorandum but was not discussed. I will have more to say on this subject.

The seventh, but in some respects an unlucky number, was listed as "When is income realized?" This is widely recognized as one of the most important and difficult problems in financial reporting. It is being considered by the APB in its effort to prepare a statement on basic concepts and accounting principles. The problem is most often presented in the premature reflection of income when a continuing upward trend is desired--as it usually is when securities are offered to the public. The Commission dealt with some problems of this kind in the real estate business when it issued Accounting Series Release No. 95. More recently, the Securities Commission of Ontario used this release as a pattern for a policy statement which included a percentage test for the cash down-payment on the sales contract.

Currently, here at home, we have had some difficulty with financial reports of franchising companies. In this situation we sought advice from the AICPA's Committee on Relations with the SEC and Stock Exchanges. It is our practice to meet with this committee from time to time to review problems of mutual concern. A meeting agenda may include auditing questions and professional ethics as well as accounting principles and financial reporting. The discussion of accounting for initial franchise fees led to the article prepared by Archibald E. MacKay and published in the "Accounting and Auditing Problems" section of the January 1970 issue of the Journal.

The eighth point was the classical controversial issue of the "all-inclusive" versus "current operating performance" profit and loss or income statement. The Commission had supported the "all-inclusive" style for many years, while many accountants favored the other. APB Opinion No. 9 finally officially ended the debate for most companies by prescribing the "all-inclusive" approach. When APB Opinion 9 was adopted banks were exempted from its application. This exemption was reversed by APB Opinion 13 and, by agreement among interested parties, a provision for loan losses was included in the operating expenses, and realized gains and losses on securities were included before arriving at net income. A difference of opinion over the meaning of a single word in paragraph 33 of Opinion No. 9 in prescribing rules for calculating earnings per share led to a long discussion which resulted in a "clarifying" opinion, No. 15. The conflict arose over the meaning of a <u>major</u> portion of value. In the course of the discussion the effect of fluctuations in market values of securities was reviewed, new tests were adopted, and "residual securities" became "common stock equivalents." The increasing use of unusual types of securities made this necessary. While many deplore the emphasis on a single figure, this is a fact of life which must be met by agreement on the rules.

Another topic cited in the memorandum was intercorporate investments, on which a subcommittee of the APB has held a seminar with cooperating groups in attendance. Another was intangible costs in the oil and gas industry which is discussed in Robert E. Field's Accounting Research Study No. 11 on Financial Reporting in the Extractive Industries.

We are involved in a joint effort with the Accounting Principles Board to adopt more restrictive guidelines to govern pooling of interests accounting. The staff, and the Commission as well, has been kept informed of the preliminary study and development work which led to the Proposed APB Opinion: "Business Combinations and Intangible Assets," which was published for comment in February 1970. Prior to its release the Commission had indicated to the APB that it supported the proposed opinion. Chairman Budge on February 18, 1970, in testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, described some of the important criteria which were to be included and filed a copy of the exposure draft, when it became available, as an exhibit for the record. The criteria that he noted were

(a) Common stock only to be exchanged on a proportionate basis.

(b) The relative size of the combining companies should be at least on a three-to-one ratio.

(c) There must be no intention of liquidating a major portion of the assets of the combining companies, or of retiring or reacquiring all or a part of the common stock issued in the transaction.

(d) There could be no provisions for the contingent issuance of additional securities or other consideration or for any other financial arrangement for the benefit of the former stockholders of a combining company after the consummation.

(e) Pooling accounting could not be retroactively applied to a given fiscal year or the prior years for a transaction which was consummated after the end of that fiscal year.

We are aware of wide differences of opinion on this proposal. The principal ones have been forcefully presented to the business world in releases of the Financial Executives Institute. This organization at first supported a 9 to 1 size test instead of the 3 to 1 test in the proposal but later reconsidered and it now takes the position that no size test should be imposed. The FEI also opposes mandatory amortization of intangibles. These views and those of other interested parties must be considered. All concerned, I am sure, believe this to be one of the most important accounting problems today demanding a prompt solution. That final solution will not come easily may be indicated by Herbert C. Knortz' summary of the situation:

> "Today, as the profession enters the significant years of the 1970s, accountants are faced with the greatest controversy that has ever threatened the harmony of their professional world. The debate centers around accounting for business combinations: should they be handled as 'poolings of interests' or as 'purchases,' and how should any 'goodwill' identified in the course of accounting for the transactions be handled. The controversy is particularly significant because mandatory rules, rather than optional guidelines, are being suggested; because the amounts involved are large enough to turn certain profitable major corporations into losing situations; and because each of the protagonists in the controversy argues that realism is being violated.
>
> "At the present time, there is no unanimity of opinion on the proper recording of business combinations. The Financial Analysts Federation is divided on the subject. The National Association of Accountants and the Financial Executives Institute have differing views. The SEC is taking one position and the Internal Revenue Service another. The American Management Association opposes the APB drafts. The Investment Bankers Association argues for poolings. Even within the Accounting Principles Board there is drastic cleavage, and the AICPA has avoided implementing conclusions of its own researchers on the subject. In the absence of more definitive investigation, it would appear unwise for the AICPA to attempt to mandate compliance with such a highly controversial 'opinion' as has appeared in the drafts." 12/

12/ Economic realism and business combinations, Financial Executive, April 1970, p. 49.

All of this adds up to an extensive effort on the part of the Accounting Principles Board--all work in the successful completion of which the Commission has a keen interest. By action of Council, members of the AICPA may depart from opinions of the Board only if they call attention to the departure in their certificate and are prepared to buttress their position with other authoritative support. This may be hard to do. Two professors at the University of Kentucky have reported on a survey they made in their state. The responses reflect a healthy respect for Accounting Research Bulletins and APB Opinions, Codes of Ethics and SEC Regulations as lending "substantial authoritative support" to the accountant in rendering an opinion on a client's statements. Principles or practices endorsed by these sources are entitled to be classified as being "generally accepted." With respect to these points and others related to control over the profession the authors conclude that:

> "These results, although not surprising, nevertheless indicate that those sampled are much more inclined to respect control which originates within the profession. Conversely, pressures which are brought to bear on members by 'external' agencies are clearly rejected. One may readily infer, therefore, that future improvements in the structure of authority in the accounting profession will most likely produce better results if such improvements derive from internally generated efforts." 13/

This discussion would not be complete without a reference to a significant gathering that took place at the Seaview Country Club in New Jersey on November 7-8, 1968, and reported by the AICPA in 1969. 14/

13/ W. W. Ecton and Donald L. Madden, CPAs Consider the Question of "Authority" in the Accounting Profession, The Ohio CPA, Winter, 1970, p. 25, 30.

14/ Corporate Financial Reporting: Conflicts and Challenges, John C. Burton, editor.

The sponsors were the American Institute of Certified Public Accountants, the Financial Analysts Federation, the Financial Executives Institute, and the Robert Morris Associates. Four college professors played leading roles and the president of the American Stock Exchange made the opening remarks. Representatives of government agencies were conspicuously absent, thus avoiding inhibiting the participants.

It is hard to judge the importance of this single effort to bring such a group together. All have a continuing interest in promoting a common understanding of accounting principles and their application to financial reporting. All, as well as other groups, have sent delegations to the simposia conducted by the Accounting Principles Board in its effort to develop opinions for the guidance of all.

Perhaps it is significant that with only one exception, I believe, the speakers had something to say about the SEC's influence on accounting and financial reporting--some deplored, others praised or warned that if the professional and business world did not move, the SEC was "standing in the wings"[15/] waiting for the APB to act.[16/] The difference of opinion as to the SEC's role is clearly expressed by two professors. After predicting that the APB would not succeed by its present procedures, Robert Sprouse said:

> "My prediction, therefore, is that the Securities and Exchange Commission will play an increased role. We already have evidence of an increasing activity on the part of the SEC, and I certainly foresee a continuation of this trend.

15/ *Ibid.*, p. 108.

16/ *Ibid.*, p. 149, 196.

This trend will be accelerated if the Accounting Principles Board continues on its current path of doing what could be done more easily and more quickly and more economically by a group of one or two or three people in the office of the SEC. I guess I must confess that it is not at all clear to me that the results would not be at least as satisfactory, or perhaps more satisfactory." 17/

To this Robert Mautz responded:

"I am not at all despondent about the possibilities for improvement in financial reporting. In fact, I think financial reporting is going to continue to improve, as it has, but at a faster rate, and the improvement will come from the most logical source. I am just naive enough to believe in a great profession, and I think that public accountants as a group are just about ready to reclaim the responsibility that they have abdicated to the SEC. I think they are just about ready to see the futility of substituting rule-making for judgment." 18/

I will let you be the judge.

--oOo--

17/ Ibid., p. 80.

18/ Ibid., p. 82.