

ACCOUNTING AND AUDITING PROBLEMS
WITH PARTICULAR REFERENCE TO NEW REGISTRANTS
WITH THE SECURITIES AND EXCHANGE COMMISSION

Address of

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Experience of the past two years at the Securities and Exchange Commission, recent events in accounting circles and some current literature, bolstered by specific suggestions from some of your members, indicate the timeliness of a discussion of certain accounting and auditing problems with particular emphasis on new registrants with the Commission.^{1/} Some of you may have attended briefing conferences on practice before the SEC at which the programs were largely directed to the legal profession. At these sessions one period has been devoted to accounting with a brief description of the Commission's accounting requirements and some advice for new registrants and their professional advisers, who may have been contemplating their first experience with a registration statement. Discussion of some of the problems which may arise in a new registration statement may be useful here.

But, first, a few figures may be of interest. For the fiscal year ended June 30, 1950, 496 registration statements were filed under the Securities Act of 1933. During that year the average staff in the Division of Corporation Finance--the division which processes these filings--was 194. During the fiscal years 1958, 1959, and 1960 there were, respectively, 913, 1226, and 1628 registrations, and the corresponding average staff of the division was 167, 175, and 181. In ten years we see an increase in this work alone from two and one-half to nine registrations per staff member. Lest this statistic be misinterpreted, it should be observed that the same staff has been faced with

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an increasing volume in all aspects of its work, which includes proxy material, especially for corporate mergers, applications for listing on exchanges, annual and periodic reports, and in particular time-consuming investigations, stop order proceedings and assistance to United States attorneys when matters reach a criminal reference stage. This situation has resulted in an increase in the median time from date of filing to effective date from 21 days in 1950 to 24 in 1958, 28 in 1959, and 43 in 1960. In the first quarter of this fiscal year, 393 registration statements were filed, being four less than last year, but the median time from filing date to effective date in this period was 58 days this year compared with 35 days last year. This is the condition our chairman had in mind when he spoke to a workshop conference in Atlanta in August and said that "There have been serious budgetary difficulties within our own agency which have contributed materially to the situation in which we find ourselves and where we simply can no longer promise unreservedly to conform our timetables to the demands of the underwriting industry."

For the benefit of those who have not had any SEC experience I should explain that in processing a registration statement the staff examines the filing and prepares a letter of comment which is sent to the registrant. This letter contains suggestions for amendment of the filing by way of deletions, additional disclosures, correction of text or financial statements, and, in many cases, requests for supplementary information. Although the staff has developed considerable skill in this process, the response to the first letter on a new company may

raise new questions to be resolved before the statement may be permitted to become effective. Since a substantial part of the filings in the last two years was made up of new registrants with the Commission, it should be clear that the average processing time I have given was affected materially by these new registrants which required much more time than for companies with prior filings with the Commission.

Included among these new registrations are many filings for the sale of stock by the owners of close corporations, filings for a combination of such sales and raising of new capital for these corporations, and filings to raise capital for new promotional ventures. Many of these companies are served by local accountants with no previous experience with the SEC, and in many cases counsel for the registrant is also inexperienced in SEC procedure.

These cases have a number of characteristics in common. It seems to the staff that all are filed barely within the ninety-day deadline for the financial statements prescribed by the Act. This means that these statements are at the age limit when filed and of course are growing older during the examination process. Consequently, if the letter of comment is mailed at the end of thirty days and the amendment is filed in twenty days it can readily be seen that the latest financial information will be stale as the financial statements may be six months old by the requested effective date. When such a situation is anticipated the staff usually will alert the registrant to the need for later statements. The alert independent accountant will suggest to his client that preparations be made in advance for immediate response to such a

request. This is particularly important if the statements as originally filed include unaudited interim statements to a date near the close of a fiscal year. In this situation preparations for the annual audit should be under way so that the amended registration statement can include certified statements for the full year. This will eliminate the troublesome interim period comparison of income statements in the summary of earnings. It should be noted that the annual audit must be done anyway if the company will have an obligation to file annual reports under the Securities Exchange Act of 1934. If the audit is completed and year-end statements are included in the registration statement, the filing of a report on Form 10-K would be deferred until the end of the following year. If you know that your client is considering the possibility of a public offering some time in the future, it is important that current year-end audits be planned along generally accepted standards without any limitations on the scope of the independent accountant's work.

Another frequent cause for delay is the tendency on the part of new registrants and their accountants alike to insist that accounting, including tax accounting, which has served adequately for a successful private business is equally good when the company "goes public." This is a mistake. Hours spent on insisting that our staff must accept the statements as presented not only delay the subject filing but take reviewers' valuable time from other cases. Some of the recurring subjects for debate are that all overhead, and sometimes even direct labor, may be omitted from inventory; that cash basis accounting is

generally acceptable when inventories of goods for sale are not a factor; that dubious deferred charges must be retained in the balance sheet and amortized over excessively long periods in the future; and that since the company has never prepared consolidated statements before it need not do so now. This last point often brings out the need for recasting financial statements to a common fiscal closing date, particularly in those situations in which a family group of companies is being put together preliminary to the public offering. Another frequent subject for discussion arises when a company which has had an initial public offering under an exemption issues a stock dividend and urges that the minimum amount specified by statutory law rather than accepted accounting practice governs the amount to be recorded for the stock dividend. Many of these subjects are covered in authoritative literature, particularly statements by American Institute committees and rules and decisions of the SEC. I regret to say that frequently much of this sort of discussion is necessary only because the staff of the registrant and its accountants, except for tax law, are not up to date on this and other pertinent literature. It is clear that both parties must effect a change in thinking when the company goes to the public for financing.

This change in attitude must extend also to auditing, and to improvement of accounting and operating procedures necessary for effective internal control which will give confidence to the independent accountant in his work. It is not too surprising that many new companies with phenomenal growth have not kept pace in their accounting work, but it is disturbing to find established companies which have engaged

independent accountants for many years in no better position. Because of the unsatisfactory condition of the records, accountants in some cases have had to deny opinions and the staff of the Commission has had to advise that in these circumstances the financial statements did not meet the requirements of the Act for certified statements. These are the extreme cases.

Even for companies with adequate records first audits or first engagements requiring an unqualified certificate are common. In the latter cases the scope of prior audits has been restricted so that observation of inventory taking, and in some cases confirmation of receivables, is undertaken for the first time in the current engagement. By application of appropriate auditing procedures to the earlier years it is usually possible to render an opinion. This problem was recognized in Accounting Series Release No. 62 relating to opinions on summaries of earnings in a footnote which said:

"It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

Thus it is recognized by the SEC that if the accountant is satisfied by the results of his alternative audit procedures he may certify without a qualification. Mr. Carman G. Blough reached the same conclusion in his column "Current Accounting & Auditing Problems" in THE JOURNAL OF ACCOUNTANCY for May 1953 and in a more extended discussion

in March 1956. However, as the latter discussion shows, many accountants feel that reference should be made in their certificate to this situation. This is usually done in an intermediate paragraph referred to in the scope of audit sentence in the first paragraph and usually, but not always, again in the opinion paragraph by way of explanation but not as an exception. If the accountant is not satisfied with the results of his audit procedures he should not certify. Since the circumstances vary widely it is not possible to prescribe a standard certificate to fit all cases. However, the following form of opinion covering the entire life of a company may be a useful example which can be altered to fit:

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

We have examined the consolidated balance sheet of _____ and its wholly-owned subsidiary companies as of April 30, 19__ and the related statement of consolidated income and retained earnings and the summary of earnings for the three years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

We observed the physical inventories as of April 30, 19__ but did not observe the inventories as of April 30, 19__ or 19__ (hereinafter referred to as the "earlier inventories") inasmuch as these dates were prior to our engagement as auditors. We did, however, test-check the pricing and clerical accuracy of those inventories and also made such analytical and statistical tests of related data as we deemed appropriate. As a result of these procedures, nothing came to our attention which would indicate that any significant adjustment should be made to the earlier inventories used in the computation of cost of goods sold for the three years ended April 30, 19__.

In our opinion, the accompanying consolidated balance sheet and the related statement of consolidated income and retained earnings and the summary of earnings present fairly the consolidated financial position of the companies at April 30, 19__ and the results of their operations for the three years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Before leaving the subject of certificates, there is a problem when the financial statements do not agree with the books. Rule 2-02 of Regulation S-X recognizes this possibility. Paragraph (c) of the rule requires, among other things, that the accountant's certificate shall state clearly "(iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review." Application of this rule was made in a recent prospectus as follows:

"The Company has consistently kept its books and filed its Federal income tax returns on the basis of excluding factory overhead from the work-in-process and finished product inventories. The accompanying financial statements have been prepared on the basis of including factory overhead in these inventories (a change in which we concur) and a reserve has been provided for Federal income taxes attributable to this adjustment."

This was followed by the standard opinion paragraph. Further comments on this subject and other matters which arise in our review of financial statements may be found in a paper published in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT for October 1957.

The foregoing remarks provide a background for a discussion of the competitive problem of the small firm or local practitioner versus the large national firm. Mr. J. S. Seidman, the immediate past president of the American Institute of Certified Public Accountants, used a page in the July-August 1960 CPA to talk to his fellow members on the topic "Minimizing Displacement on Engagements." Four papers presented at the

Institute meeting in Philadelphia were devoted to aspects of this problem, presumably at Mr. Seidman's suggestion. Three of these papers are closely related: "Correspondent Engagements--an Untapped Source of Opportunity for CPAs," by E. C. Leonard, Jr.; "Ethics of Correspondent Engagements and Referrals," by John R. Ring; and "The Audit of a Nationwide Company Now Performed by Local Firms"--this is a case study on how to do it presented by A. H. Puder. The fourth paper, by Leslie A. Heath, is entitled "An Ounce of Prevention--Means Dollars to You or Your Estate." This is a warning to single practitioners and very small partnerships. I mention it because we recently had a case in which the financial statements were certified by a single practitioner who died suddenly and left no one to carry on for him. This is a situation which should not arise in any case and particularly in a public company and probably could have been avoided by proper planning.

Displacement of the small local accountant by the large national firm does happen. This may be for at least four reasons, possibly more. Four reasons are: first, the client may realize that the small firm has not been rendering auditing services of the standard required for a certificate and feels that the local accountant is not qualified because of limited staff or other reasons to do so; second, the local practitioner may not wish to assume the liabilities of a certification in connection with a public offering of securities; third, the underwriters may prefer a national firm, especially when the securities are to be sold outside the area where the local practitioner is known; and

fourth, although willing and able to do the work, the local accountant may not be independent under the rules of the Commission.

In the first instance the client would be right if his local accountant tended to limit his practice to bookkeeping and tax service and failed to develop his own capabilities as his client grew. I recall one situation of this kind in which the company entered a period of rapid expansion by opening at new locations. The accountant here conceded that his firm did not have the capacity to render adequate service and felt that he had no means of expanding to cope with the situation. A national firm of accountants took over.

Another example fits my second case. An accountant who confined his practice to bookkeeping service and tax work in his local community had a client which registered with the Commission. A competent job was done on the financial statements, a satisfactory amendment having been filed after a telephone discussion of items in the letter of comment. But in this case I learned that the accountant did not want another registration--life would be easier without expanding his practice in this field. In contrast to this attitude we have observed that some local practitioners do not realize the seriousness of the obligation they are assuming when they undertake to certify financial statements for a registration statement.

The problem of the underwriter is the one of particular concern to Mr. Seidman and which comes to our attention from time to time. In many of these cases the underwriter has no alternative. The filing may

be for a newly organized company to take over a group of affiliated companies which have never had an audit on which an opinion could be based. The underwriter's investigation convinces him that only a large firm with adequate staff immediately available can do the work in time and in good form to avoid unnecessary delay. Even in this case the local accountant may perform services in organizing material, developing schedules, and doing other accounting work which will reduce audit time. I know of cases of this kind in which the national firm has certified the statements for registration purposes but the small firm has been retained to continue on cost and tax work and later resumed the audit for annual reporting purposes.

I suppose the most distressing problem for the small firm is to meet the challenge of the underwriter that he is not competent to do the audit required for a certificate for the client he has served for many years while it grew up from a small family enterprise to a leading business in the community. Here the small practitioner with no SEC experience can get advice in many cases from the large firms which render consulting service. The accountant can also get help from the staff of the Commission, and he should not feel that this avenue is closed to him. I have seen instances where I felt that the accountant was reluctant to admit to his client that he was not an expert in SEC work and stayed away from a conference with us for this reason. Telling your client that you know where to get help when you need it and that you can do the job may avoid a displacement. I have seen it done.

Experienced firms with large clients do not hesitate to arrange conferences before filing when new or unusual problems are believed to be present. Clarification in a conference before filing of the accounting principles involved or the manner of compliance with the requirements as to financial statements in a complex or borderline case will save time in meeting a schedule when time is the most important.

The fourth cause of displacement, lack of independence, can be avoided only by looking ahead. Local practitioners as a group seem to feel that the SEC is out of their lives and always will be. In the flood of registration statements of the last two and a half years we have seen many names of accountants we never heard of before and we had never heard of their clients before either. I do not have any more recent statistics than those I used at the Institute meeting in 1957 when I reported that in a list of 3,072 filings on Form 10-K for 1955 and 1956 there were 558 different accounting firms of which 384 each certified to only one statement, 77 firms each certified to two statements, and only the top ten firms each certified to more than 25 statements, as had been the case ten years earlier. While it is undoubtedly true that the big get bigger, there is plenty of evidence that with the growth of small companies into public companies small accounting firms in substantial numbers do follow their clients into the new area of practice. So my suggestion here is to get acquainted with the rules that may affect you before they deprive you of the client you have raised from infancy.

Despite discussion of this topic of independence at every opportunity I have, the frequency of inquiries to my office indicates that repetition will do no harm and may serve to alert some accountants to unsuspected dangers from conflicts of interest. The Commission's rule relating to qualifications of accountants is Rule 2-01 of Regulation S-X. This is the regulation which prescribes the form and content of financial statements for most purposes under the Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. The forms prescribed under these Acts contain instructions as to what financial statements to file, i.e., what dates and periods, whether parent company, consolidated, group or other combination of statements.

Since we have been receiving a number of inquiries as to who can certify statements for filing with the Commission, I quote paragraph (a) of the rule:

"(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 his residence or principal office."

To aid us in administering this part of the rule my office attempts to keep a current file of accountants authorized to practice in the several states. Some states publish such lists for all licensed or registered accountants, both certified and not certified. State societies of CPA's cooperate by furnishing copies of directories as

they are published. And of course the American Institute's directory is available. If the certifying accountant new to us cannot be identified in this way, we ask for evidence of his qualification to practice. In a few cases state boards have challenged the accountant's right to certify. Where after review of the facts the accountants were found not to be properly qualified, the registrants were requested to furnish financial statements certified by qualified accountants.

In a recent stop order opinion the Commission noted that one of the accountants involved, who was practicing alone, had used the words "and Company" although this is prohibited under New York law (Cornucopia Gold Mines, Securities Act Release No. 6339, August 11, 1960). There is a similar prohibition in the American Institute's Rules of Professional Conduct and in the rules of some of the states, including Ohio. To imply that an individual practitioner has partners is misleading--more so today than a generation ago when it was not quite so hard for a professional man to keep abreast of what is going on in his profession.

Paragraph (b) of Rule 2-01 is:

"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."

This is a point the experienced underwriters will check early in the negotiations for the issue of securities. The inexperienced accountant

may hear of our rules for the first time from this source. It would, of course, have been better if he had read our regulations and, if he found a possible conflict, consulted with us as to whether anything could be done to cure the situation and avoid embarrassment. In Accounting Series Release No. 81 we listed some cases of possible conflict of interest but upon examination found that the accountants could be deemed independent, sometimes conditioned on certain actions being taken. I suppose it is not necessary to recite in detail the efforts of the American Institute to amend its Rule 13 to bring it more nearly into agreement with the SEC rule. A discussion of the SEC rule may be found in THE JOURNAL OF ACCOUNTANCY for October 1959, so I need not go into further detail here.

Paragraph (c) of Rule 2-01 says:

"(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."

It is under this paragraph that all types of conflicts of interest other than those specifically stated in (b) may be considered in determining whether an accountant is not independent. The most common of these perhaps is the bookkeeping situation which does present problems for the small firm. As Release 81 indicates, we have made exceptions here for emergency services, but our experience shows that continuous bookkeeping service may cause the accountant to become too closely identified, even in his own thinking, with the management. This is a

danger that must be guarded against in the popular demand for expansion of managerial services.

I do not want to leave the impression that it is only the small firm that has problems under our independence rule. Many small firms, in their own practices, have observed rules similar to those of the SEC. Large firms have problems when they obtain new clients or their old clients expand by the merger route or the accounting firms expand by merger. Elimination of conflicting interests must be made.

It should be clear that a familiarity with the Commission's regulations is necessary for all practitioners. We have observed that the small firm is inclined to furnish excessive detail in financial statements and that there is a tendency on the part of larger firms to be over-zealous in the simplification of statements and to be generous in the application of the materiality test. And we encounter from time to time a lack of clarity in notes which skeptics might suspect was intended. The use of prose when tables would make the disclosure crystal clear is a common example.

Exempt offerings of not in excess of \$300,000 under Regulation A should not be overlooked in a discussion of this kind. It should be sufficient, however, at this time to say that we do not have two standards of independence, of auditing or of accounting principles. Although the financial statements for this purpose are not required to be certified, if they are certified the accountant must be independent and the audit must be made in accordance with generally accepted standards. In short, the accountant should use the same care as he

would for what is usually referred to as a full registration. Generally accepted accounting principles govern in all cases--certified or not certified. Regulation A may be only the first venture into public financing. A good start here will make a full registration easier when it comes.

May I conclude with a few suggestions as to procedure, particularly in complicated cases. First study the requirements of the form on which the registration is to be made. Fit your facts to the instructions as to financial statements. If the result seems to you to be an excessive and confusing collection of statements, try to develop a solution which will produce a better and more useful presentation. Now note that there is an instruction which permits either the registrant or the Commission to propose a substitute for the literal application of the specific instructions. At this point you should apply this rule by working out a solution and then consulting with the staff either by telephone, letter or conference before filing. If the facts change as you approach the filing date, a recheck before printing the financial statements for the registration may be advisable. The result should be a saving in expense for your client and in the long run a saving in time for you and the staff of the Commission.

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