DUTIES AND RESPONSIBILITIES OF THE CPA

(Current Practice with the SEC)

Address of

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Six months ago, when the program for this morning was in the planning stage, I was reminded that the matter of the CPA's independence and his audit responsibilities had been receiving considerable public notice due in part to a certain conflict of interest case and to articles in a well-known business magazine under the title "The Auditors Have Arrived." I am sure the author of these articles will not mind if I cite the fact that the auditors made an important impression on Congress during the hearings on the Securities Act of 1933 when they urged that an impartial audit by independent public accountants would be of benefit to investors and the public.[1/] The definition of independence and the responsibility of the auditor for the detection of fraud are subjects which have been of vital concern to the Securities and Exchange Commission from its creation. I am pleased, therefore, to have this opportunity to participate in this discussion.

The program suggests rather clearly that I am to concentrate on SEC experiences with auditors' work in filings by new registrants. In doing so I believe I can supplement or perhaps even underscore what Mr. Higgins had to say to you about independence and what Mr. Defliese had to say to you about the responsibilities of auditors.

That the Commission has been extremely busy for the last two years is not news to certified public accountants. Some measure of this activity is indicated by the number of registration statements filed under the Securities Act of 1933. For the fiscal year ended June 30,

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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.

1951, there were 544 registrations for securities totalling 6.4 billion dollars. For that year the median time from filing date to effective date was 21 days, and 69 statements were pending at June 30, 1951. For fiscal 1960 the median time was 43 days, 1628 statements were filed for 15.8 billion dollars, and 335 filings were pending last June 30. For the first eleven months of this fiscal year the figures are 1584 filings for 18.7 billion dollars, 55 days median time from filing to effective date, and 453 filings in the work-in-process inventory May 31, 1961. In May of this year there were 195 registrations compared with 129 last May. In 1951 the average staff of the Division of Corporation Finance--the division which handles these filings--was 194. For fiscal 1960 the average staff was 181, and for the first eleven months this year was 206. But these bare figures do not give full disclosure of the problem. New companies require much more attention than repeat filings by companies whose life history is known to the staff. To further complicate matters, many of these new companies are served by accountants, attorneys, and even underwriters with little or no experience in SEC work. In 1951 only 22 percent of the filings were by companies without previous experience, while 47½ percent were of this category in 1960 and 51.6 percent for the first eleven months this year.

These figures may suggest that the staff has little time for anything but registration statements. But the work under other Acts must go on. Proxy material, especially for merger proposals and contests in which the propriety of financial reporting is challenged, requires careful and prompt attention. Investigations and assistance to United

States attorneys when matters reach a criminal reference stage have also made heavy demands. Awareness of these activities may have prompted a member of another state society to ask how much review, if any, is being made of annual reports (Form 10-K) filed pursuant to the requirements of the Securities Exchange Act of 1934. The answer is that these filings are available for public inspection and use and therefore must not be ignored. Every effort is made to identify any serious matter at the earliest possible moment and to notify the registrant that a correction is in order. This is not always done before a registrant may have a new filing under the Securities Act. In such cases correction in the new registration statement may be used to amend the 10-K filing. It is a mistake for representatives of registrants to think that no one looks at these files. Our public reference room is a busy place; also photocopies of the files may be purchased by interested persons. Hence the same degree of care should be observed in the preparation of financial statements for 10-K purposes as for proxy statements and prospectuses.

The new filings with the Commission include registration for the sale of securities by the owners of close corporations, combination of such sales with the raising of new capital for the registrants, and, of course, offerings by new promotional ventures of all kinds. These cases have a number of characteristics in common which I shall develop later.

Before I go on I should say for the benefit of those who have not had SEC experience that the staff, in processing a registration statement, examines the filing and prepares a letter of comment (sometimes

referred to as a deficiency letter) which is sent to the registrant or designated agent. This letter contains suggestions for amendment of the filing. These may include requests for deletions, additional disclosures, correction of text or financial statements, and, in many cases, requests for supplementary information to assist the staff in understanding the content of the filing. The staff has developed considerable skill in this process. Nevertheless, 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.

One common cause of difficulty for a company filing for the first time is that the latest balance sheet filed is barely within the ninety-day deadline 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 experienced 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 period 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 or intends to publish a report to stockholders containing certified financial statements. 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 to conform to generally accepted standards without any limitations on the scope of the independent accountant's work.

Since interim period financial statements have been, and continue to be, a continuing source of trouble, I will cite some examples of the problems we encounter. The situation arises, of course, from the statutory requirement for a balance sheet within 90 days of the date of filing and the interpretation of the corresponding requirement for a profit and loss statement from the close of the last fiscal year to the latest practicable date. The problems then are of two kinds--the need for current operating results and that such results be reported on a basis of accounting consistent with the preceding full fiscal years. The latter point usually is critical only in unaudited interim periods. This was recognized after a troublesome experience several years ago by adopting an instruction to the summary of earnings to require that:

> "In connection with any unaudited summary for an interim period or periods between the end of the last fiscal year and the balance sheet date, and any comparable unaudited prior period, a statement shall be made that all adjustments necessary to a fair statement of the results for such interim period or periods have been included. In addition, there shall be furnished in such cases, as supplemental information but not as a part of the registration statement, a letter describing in detail the nature and amount of any adjustments, other than normal recurring accruals, entering into the determination of the results shown."

If there are no adjustments requiring explanation by letter, this requirement in its entirety may be met by an appropriate statement in the introduction to the summary. Failure to take this instruction seriously or making a false answer can have unpleasant consequences on discovery.

A recent filing is a good model for behavior in dealing with interim period statements.[2/] As originally filed, a currently effective prospectus included certified statements for a first quarter compared with an unaudited first quarter of the preceding year as to which the required representation as to adjustments had been made. The comparison showed a substantial drop in volume of sales and earnings in the current period, so the staff made a customary request for later information. This was furnished for two more months on an unaudited basis and also was covered by the required representations as to adjustments. What happened next is recited in one paragraph in a new prospectus:

> "On May 15, 1961 the Underwriters offered these 190,000 shares of the Company's common stock to the public, pursuant to a prospectus dated May 15, 1961, at the same price and on

2/ Burgmaster Corporation, file 2-18270.

the same terms and conditions as contained herein, including the condition that the shares are being offered when, as and if received and accepted by the Underwriters. Such shares were fully subscribed on May 15, 1961 and began trading in the 'when issued' market, subject to receipt and delivery from the Underwriters. The Closing, at which the Underwriters were to deliver the net proceeds to the Company and Selling Stockholder, and the latter were to deliver the securities to the Underwriters, was scheduled for May 24, 1961. Following the offering on May 15th, but prior to the Closing, on May 24th, an accounting inconsistency between the method of preparation of the unaudited interim figures for the two months ended March 31, 1961 as compared with the audited figures included in the prospectus was discovered. For internal monthly accounting purposes, the Company records its sales as of invoice dates, determined on the basis of substantial completion, whereas sales reflected in such audited statements are based on shipment dates. Shipments normally occur on or within a day or so after a sale is invoiced. The May 15, 1961 prospectus contained the statement, 'Based on unaudited interim figures, net sales, gross profits and net income during the two months ended March 31, 1961 amounted to $699,037, $306,356 and $66,481, respectively, . . .' These figures were based on invoices whereas the audited financial statements included in the 'Summary of Earnings' section of the prospectus were based on shipments. On a shipment basis the figures would have been $578,450, $248,817 and $41,742, respectively. On March 31, 1961, a Friday, the Company invoiced $120,587 of machines, which were not actually shipped until the following Monday, April 3, 1961. Due to this inconsistency, the Closing did not occur and the Registration Statement which contained the May 15, 1961 prospectus pursuant to which the prior offering was made was withdrawn and all initial subscriptions and subsequent transactions in the stock were cancelled."

Following this there is a statement that the president of the company, a selling stockholder, would pay all additional expenses resulting from the withdrawal of the prior statement and the re-offering.

Another filing which was the subject of a recent opinion following a stop order proceeding is pertinent here.[3/] This is another example of

3/ In the Matter of Hazel Bishop, Inc., Securities Act Release No. 4371, June 7, 1961.

interim statements being presented on a different basis than the full year certified statements. The Commission also found that a transaction involving a principal stockholder should have been treated in part as a contribution of capital rather than as a reduction in losses by an adjustment of advertising expenses in its entirety.

Another common characteristic of new filings and a frequent cause for delay is the tendency on the part of agents 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 fair value in accordance with 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.

A recent case is a rather dramatic example of what I have in mind here. Profit and loss statements used as a summary of earnings opened with gross sales from which cost of sales reported in two items was deducted to arrive at gross margin on sales. Parenthetical disclosure revealed that the second item labelled "Other Direct Cost" included selling expenses and referred to a footnote twelve pages in the rear. This note disclosed that "Other Direct Costs" was composed of "Sales Department Expense" and "Sales Discounts," the latter amounting to twenty percent of gross sales in one of the years. The summary combined interest expense with other operating expense (a glance at the capitalization table on the opposite page suggested that interest was a material amount requiring separate disclosure); provision for income tax was less than ten percent of income in all years except the last when it rose to 12-1/2. A note to "Net Income" disclosed that this figure was "before charges for amortization of research and development and stock

issue expense." These items were reported as deductions in the statement of earned surplus. A note disclosed that research and development was first capitalized and then amortized over a 17-year period the same as patents but for tax purposes the expenditures were charged to operating expense as incurred. Minor items of debits and credits to surplus were of a character usually handled through profit and loss. Having turned to surplus, we also found a separate analysis supporting a balance sheet item described as "Surplus from unrealized appreciation on equipment." This in the surplus account was labelled "Revaluation of equipment at salvage value acquired under lease-purchase agreement." A note explained that credit had been given, when the equipment was purchased, for a portion of past lease payments which had been expensed so that when this credit was recognized as salvage value it was not being depreciated.

The balance sheet and related notes revealed a substantial item for patents and a lesser amount for goodwill both set up when the principal stockholder's sole proprietorship was incorporated. These and other matters were dealt with in a series of four amendments with the result that income for all years was affected--the last three being substantial reductions--the latest about forty percent from the original figure and the stockholders' equity was reduced by about the same percentage. Familiarity with current accounting practice would have saved much time and expense in this case.

Another aspect of this problem of presenting the financial statements is the evident failure in many cases of the accountant to apply

the instructions in the forms and in Regulation S-X. Care in this matter can reduce the length of the letter of comment and avoid extensive and repeated amendments of the kind I have described. Mr. Carman G. Blough, the Commission's first chief accountant, surveyed this situation as it existed in 1937-38 and published a list of the more common deficiencies.[4/] These related to accountants' certificates, consolidated financial statements, balance sheets, profit and loss statements and schedules. Mr. Blough's successors have covered similar ground and have made their findings available.[5/]

A survey of 367 letters of comment issued from April through September 1960 revealed 23, or 6%, with no comment on the financial statements. In ten, or 3%, the comments were so extensive that no effort was made to list them. The remaining 91% of the registrants were sent letters ranging from a single request to disclose the cause of fluctuations in earnings to listing of up to 15 financial statement items requiring the attention of either the registrant or the certifying accountant. Tnis survey showed that a more careful compliance with the instructions would have avoided the majority of these comments.

As in prior surveys of this kind, the accountants' certificate required considerable attention--this time in 109 of the 367 cases with

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4/ Accounting Series Release No. 7, May 16, 1938.

5/ Werntz, Current Deficiencies in Financial Statements, The Accounting Review, Vol. XVI, No. 4, December 1941; The Journal of Accountancy, January 1942, pp. 25-34.

King, What the S.E.C. Requires in Financial Statements Filed With the Commission, The Journal of Accountancy, November 1947, pp. 377-384.

Barr, Comments on Financial Statements Filed With the Securities and Exchange Commission, The New York CPA, October 1957.

comment including mechanical matters such as signing, dating and addressing, requests for clarification of language, and supporting explanations as to auditing procedures and accounting principles for our files.

Many of the comments are required because of evidence that the registrants' officers or the certifying accountants are not familiar with Institute bulletins on such subjects as business combinations, earnings per share, depreciation and taxes, stock dividends, and income and surplus. The summary of earnings requires considerable attention and of course the footnotes--the latter for failure to comply with the rules in Regulation S-X or for lack of clarity. Also it is frequently necessary to request supplemental information reconciling disclosures in various sections of the prospectus and in justification of the accounting treatment. This latter point should be emphasized. For example, it is particularly helpful to find a clear explanation as to the method of accounting followed by finance companies (determination of income) and real estate development companies (basis for costing sales and properties in inventory). Notes as to inventory valuation and depreciation and tax accounting are often inadequate.

It should be clear from the small number of no-comment letters that there are few perfectionists in this work, or perhaps I should say that it is not possible for all practitioners, no matter how omniscient, to reconcile their judgment as to materiality with that of the staff. At this point a brief observation about the local accountant versus the national firm may be in order. A tabulation of

substantially all of the Securities Act registrations for the calendar year 1960 shows that 363 firms participated in the work as principal accountant (no effort was made to count all of the secondary certificates). These names were taken from 1357 filings, of which the top eight firms named in FORTUNE certified financial statements in 851 (each over 40); seven firms served in from 6 to 20 filings; 15 for 3, 4 or 5 filings; 51 for two each; and 282 for a single filing.

A 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 which said in a footnote:

> "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 the 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 staff can give some assistance in solving this problem if we are given a complete and clear explanation of the circumstances.

A belated discovery that the registrant's public accountants are not independent under the Commission's rules presents a problem for

many registrants. A first step in preparing for registration should be to get acquainted with the rules that apply to the process. Of special interest to accountants is that the instructions as to financial statements to be included in a filing are spelled out in the prescribed forms with an introductory statement similar to this from Form S-1:

> "These instructions specify the balance sheets and profit and loss statements required to be filed as a part of a registration statement on this form. Regulation S-X governs the certification, form and content of such balance sheets and profit and loss statements, including the basis of consolidation, and prescribes the statements of surplus and the schedules to be filed in support thereof. Item 21(a) above specified the statements which are to be included in the prospectus. Attention is directed to Rule 411(b) regarding incorporation by reference of financial statements."

A reading of Rule 2-01 of Regulation S-X will disclose that the Commission relies upon the laws of the place of residence or principal office of the accountant to establish qualification to practice before it. We do not maintain a register of qualified accountants.

Current accounting literature is replete with reference to the wide difference in the view on independence between the Commission and the accounting profession, particularly the American Institute of Certified Public Accountants. An article[6/] in the May 1961 issue of Accountancy, The Journal of The Institute of Chartered Accountants in England and Wales, again raised this theme, stating that:

> "Great emphasis is placed on the independence of the independent public accountants. But there is some difference between the views of the accounting profession and of the S.E.C. on the definition of independence, the S.E.C. being

6/ J. F. Shearer, The Securities and Exchange Commission - II.

> more restrictive than the profession. Broadly, the profession takes the view that independence is a state of mind, while the S.E.C. proscribes certain specific relationships between the accountants and their client on the grounds that they give rise to a presumption of lack of independence."

This difference of view, if it exists, arises largely from the point of interest. The profession is interested in cultivating a professional and independent state of mind in its members, and therefore emphasizes that independence and professional responsibility are a state of mind founded upon character and integrity; whereas the Commission accepts the profession as it exists and imputes an independent state of mind and ethical and professional responsibility to all accountants entitled to practice in their own state; however, we specify certain overt relationships which we consider either disqualify or tend to disqualify an accountant with respect to a particular client.

The Commission's basic guide on independence consists of paragraphs (b) and (c) of Rule 2-01 of Regulation S-X to which reference is made in the forms. To emphasize the similarity of the Institute's proposed rule 13 to the SEC rule which was amended to its present form in 1958, I shall read our rule to you:

> "(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

> "(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the

Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

From time to time the Commission has published summaries of interpretations of these rules. The most recent of these is identified as Accounting Series Release No. 81, published December 11, 1958.

Reverting now to the importance of early discovery of complications arising from the lack of independence of the accountants, I think a recital of questions raised during the last four months will demonstrate the hazards which lie in any proposal that we place our confidence in each accountant's own judgment as to his independent state of mind upon which we are to rely for his objective opinion as to the financial statements he examines:

1. Will my independence be impaired if I buy stock of my client on the open market after I sign my certificate and consent but before the registration statement becomes effective?

2. Is my independence impaired if a member of my staff, or a partner, has been holding the office and serving as an officer or director of my client? [This question has been presented at least seven times in the last four months.]

3. Is the independence of my firm affected if my partner who is a practicing attorney as well as a CPA serves as counsel to my client?

4. Is my independence affected because I took an option on a substantial block of stock as a finder's fee and also purchased a substantial amount of stock on the open market?

5. Can my firm be accepted as independent of a company in which my son is a promoter, officer and substantial stockholder?

6. Does the fact that a principal partner is an officer of a lending company which lends money to the registrant through its president as intermediary affect my firm's independence?

7. Can I certify to the statements of a company which is owned and controlled by my wife's family?

8. Can I evade the prohibition against owning stock in my clients by belonging to an investment club?

9. Is an accountant considered independent with respect to a corporation managed by his father?

10. Can an accountant be considered independent with respect to a company if his family (wife, father, brothers, sisters, uncles, etc.) has control of at least 51% of the voting stock?

11. Can I be considered independent if the father of my wife, who is an only child, owns the company?

To resolve any possible shadow of doubt, the answer we gave after considering all of the facts presented to us in these examples was that the accountant could not be considered as being independent with respect to his client under these circumstances. Most of you, I am sure, if familiar with all of the details would have reached the same conclusion.

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