

PROFESSIONAL ETHICS AS VIEWED BY THE  
SECURITIES AND EXCHANGE COMMISSION

Address

of

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## PROFESSIONAL ETHICS AS VIEWED BY THE SECURITIES AND EXCHANGE COMMISSION

An examination of Securities and Exchange Commission publications indicates that considerable publicity has been given to the viewpoint of the Commission with respect to the ethics of the accounting profession; consequently, my comments, to some extent, will be repetitious.

That the Commission should have a direct interest in, and therefore hold considered views upon, the ethics of accountants stems from statutory requirements of the Acts administered by the Commission. The Securities Act of 1933<sup>1</sup> provides that financial statements required to be filed with the Commission “shall be certified by an independent public or certified accountant”, and the Securities Exchange Act of 1934,<sup>2</sup> the Public Utility Holding Company Act of 1935,<sup>3</sup> and the Investment Company Act of 1940<sup>4</sup> permit the Commission to require certification by “independent public accountants.” The Commission’s rules require, with minor exceptions, that financial statements filed pursuant to each of these Acts be so certified.

The word ethics connotes an ethical system. Ethical is defined by Webster as “that which is professionally right or befitting; conforming to professional standards of conduct.”

The American Institute of Accountants long ago promulgated Rules of Professional Conduct applicable to its members, and the fact that these rules are familiar to, and honored by, most Institute members is indicated by the relatively few instances of record in which they have not been lived up to.

Your own John Carey’s book, Professional Ethics of Public Accountants, familiar, I am sure, to all of you, states very clearly what is expected of a practicing accountant.

Your rules and Mr. Carey’s book, together with numerous articles appearing in the Journal of Accountancy and other professional publications from time to time, should leave no doubts in the minds of the readers thereof as to what constitutes ethical (and unethical) professional conduct.

The Commission has promulgated no code of professional conduct, as such, pertaining to accountants certifying statements filed with it. Its rules in this respect are confined principally to those dealing with the professional status of accountants and the relationships between them and their clients. Thus Rule 2-01 of Regulation S-X states:

“(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing

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1 Schedule A, paragraphs 25 and 26.

2 Section 13(a)(2).

3 Section 14.

4 Section 30(e)

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.”

Paragraph (c) of the foregoing rule was adopted<sup>5</sup> subsequent to the original promulgation of Rule 2-01. Its adoption was announced in Accounting Series Release No. 37 wherein it was stated that:

“The amendment makes it clear that, in determining whether certifying accountants are in fact independent as to a particular company, there should be taken into account the circumstances surrounding not only the work done in certifying statements filed with the Commission, but also other work done for the particular company by such accountants, including the certification of any financial statements which have been published or otherwise made generally available to security holders, creditors, or the public.”

It will be noted that independence of accountants with respect to their clients is the main theme of Rule 2-01 – a subject upon which the Commission’s views have been expressed sufficiently, I think, not only by the rule itself but also in the numerous published releases and opinions of the Commission,<sup>6</sup> particularly an address of Chairman Cook of the Commission at the annual meeting of the Institute in Boston in October 1950.

I shall therefore direct my remarks to other considerations which, although perhaps they do not involve ethics at all, are highly important to the Commission in determining whether

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<sup>5</sup> Paragraph (c) has since been amended for clarity. See Accounting Series Releases Nos. 44 and 70; the latter announced, on December 20, 1950, a general revision of Regulation S-X.

<sup>6</sup> See, for example, Accounting Series Releases Nos. 2, 22, 47, 48, 59, 67 and 68.

certifying accountants are fulfilling their part in the presentation to the investing public of financial statements which contain full and fair disclosure of all material facts necessary for the making of financial decisions.

High on the list of such considerations is the failure of some accountants to make themselves familiar with the Commission's rules and regulations pertaining to financial statement presentation and the accounting principles upon which such statements are based. There can be no acceptable reason or excuse for an accountant who is practicing as such, and particularly one who has certified or proposes to certify financial statements filed with the S.E.C., to be uninformed in this respect.

It is, or should be, well known that the Commission's rules governing the form and content of financial statements filed pursuant to the 1933, 1934, 1935 and 1940 Acts are contained in a single regulation titled Regulation S-X which was originally adopted in February 1940 and was revised in December 1950. Both the original promulgation and the subsequent revision were submitted to the accounting profession for suggestions and comments before being issued. The October 1949 Journal of Accountancy contained an article commenting upon the proposed revision and urging that suggestions and views of Institute members thereon be submitted to the Commission. Many members of the profession submitted comments, criticisms, and suggestions, some of which now are reflected in the revised regulation.

Issuance of the revised regulation was announced in Accounting Series Release No. 70, copy of which was sent to the several thousand accountants on our mailing list, and many others requested and obtained the release and a copy of the regulation. In addition two articles appeared in the February 1951 Journal of Accountancy discussing the regulation and particularly the changes therein and their significance.

Implementing Regulation S-X are the Accounting Series Releases, of which there are now seventy-two, which were started in 1937 for the announced purpose "of contributing to the development of uniform standards and practice in major accounting questions." This series of releases serves as one means of acquainting the profession and industry with the Commission's views – its policies, actually – with respect to accounting principles and practices upon which either the opinions of the accounting profession have not become settled or there is disagreement as to the acceptability thereof.

Each year since the Commission was established there has been transmitted to the Congress, pursuant to statutory requirements, a report outlining the activities of the Commission under the various statutes administered by it. Each of the seventeen such reports issued to and including the one for the fiscal year ended June 30, 1951, has included comment upon matters of interest to accountants, particularly those practicing before the Commission. Beginning with the fifth of these reports (for the fiscal year ended June 30, 1939) a separate section has been devoted to accounting and auditing activities. Many problems, some new, some old but rejuvenated, but most of them controversial, have been dealt with therein and the Commission's views thereon expressed.

These have included: the “all-inclusive” versus the “current operating performance” type of income statement<sup>7</sup>; the “statement of financial position” and “single step” income statement versus the orthodox balance sheet and income statement<sup>8</sup>; reporting of so-called “tax savings” or “charges in lieu of taxes”<sup>9</sup>; relations between and inconsistencies in financial and tax accounting practices<sup>10</sup>; accounting for “emergency facilities” and the tax effect of “certificates of necessity” issued in connection therewith<sup>11</sup>; employees’ pensions<sup>12</sup>; inventory and other reserves against future losses<sup>13</sup>; depreciation provisions based upon estimated replacement cost of fixed assets as compared with the generally accepted accounting concept that such provisions should amortize the cost of such assets over their anticipated useful lives<sup>14</sup>; development of new terminology for reserves and surplus<sup>15</sup>; “buy-sell-lease” financing<sup>16</sup>; accounting for “stock dividends” and “split-ups”<sup>17</sup>; and devaluation of foreign currencies.<sup>18</sup>

Notwithstanding the publicity thus given our rules and regulations and the Commission’s views on accounting and financial statement presentation, it is almost a daily occurrence that some accountant inquires where our accounting rules are to be found; or admits that he is not familiar with Regulation S-X – we have had instances where the accountant has never heard of this regulation; or whether we will accept a “single-step” income statement in lieu of the orthodox one; or whether goodwill or other intangibles may be written off against capital surplus; or whether the loss on sale of a fixed asset may be charged to earned surplus.

Then there are those who ignore our requirements, sometimes with the explanation, when we find a statement deficient, that they have found precedent therefor in statements of other companies filed with the Commission or in reports to stockholders. Usually it develops that the statements upon which they relied either had not yet been examined by the staff, or had been examined and deficiencies cited but not yet complied with; or the statements filed with the Commission were different from those contained in reports to stockholders. Others ignore, or appear to ignore, our requirements because they have misconstrued them; more often than not because of legal interpretations made without regard to accounting proprieties.

Occasionally an accountant disagrees in principle with some specific requirement and, without making his point of view known to us, certifies statements which ultimately may be required to be amended.

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7 11<sup>th</sup> Annual Report, p. 88; 12<sup>th</sup>, pp. 117-118; 14<sup>th</sup>, pp. 111-112; 16<sup>th</sup>, p. 159; 17<sup>th</sup>, pp. 164-165.

8 13<sup>th</sup> Annual Report, pp. 127-128.

9 11<sup>th</sup> Annual Report, p. 88; 12<sup>th</sup>, pp. 116-117.

10 12<sup>th</sup> Annual Report, p. 116.

11 13<sup>th</sup> Annual Report, p. 126.

12 13<sup>th</sup> Annual Report, pp. 128-129; 16<sup>th</sup>, pp. 157-158; 17<sup>th</sup>, p. 164.

13 11<sup>th</sup> Annual Report, p. 87; 12<sup>th</sup>, pp. 114-115; 14<sup>th</sup>, pp. 110-111; 15<sup>th</sup>, pp. 178-179.

14 14<sup>th</sup> Annual Report, pp. 110-111; 15<sup>th</sup>, pp. 178-179.

15 15<sup>th</sup> Annual Report, p. 9.

16 15<sup>th</sup> Annual Report, pp. 181-182.

17 12<sup>th</sup> Annual Report, p. 116.

18 16<sup>th</sup> Annual Report, pp. 158-159.

Unfortunately, most instances of non-compliance do not come to our attention until statements are filed, and amendments therefore are necessary. As a result, in the case of statements under the 1933 Act, it often delays, and sometimes even stops, the offering of securities. The extent to which amendments are necessary to financial statements filed with the Commission before they may become effective is indicated by the fact that during the first six months of the current year deficiencies were cited with respect to 160 statements out of a total of 385 filed pursuant to the 1933 Act. Most of these deficiencies resulted from failure to comply with our requirements and never should have been necessary.

Regardless of the reasons why certifying accountants many times fail to comply, or obtain compliance, with our requirements, it is of extreme importance to all concerned that they be complied with and any accountant who certifies or intends to certify statements filed with the Commission should make certain that he is completely familiar with the applicable rules and regulations; if he disagrees with or has any questions concerning them he should contact the Commission's staff well in advance of filing and make certain that the statements are properly prepared. Failure to do so, in my opinion, results in disservice to his client.

An example of the type of situation I have just referred to involved the reflection in an investment company balance sheet of a provision for Federal income taxes in respect of unrealized appreciation on investments – a specific requirement contained in Rule 6-02-9 of Regulation S-X. In this instance no such provision was made although to have done so would have reduced the net asset value of the company's shares (a significant item to investors in such companies) more than 15%. Amendment of the statement was required.

In another case a registrant included in its balance sheet contained in a 1933 Act proposed filing a substantial write-up reflecting the estimated value of oil reserves. After discussion with the staff the balance sheet, minus the write-up, was filed almost immediately. It was clear that the accountant had some doubt that the statement as proposed would meet our requirements and he had therefore prepared two balance sheets, one with and one without the write-up, either of which it is assumed he would have certified without qualification.

The examination of another recent registration statement by the staff indicated possible relationships between the certifying accountant and the registrant which cast considerable doubt upon the accountant's independence. These relationships proved to be such as to place the accountant in violation of Rule 2-01 of Regulation S-X notwithstanding his admission that he was familiar with the rules but nevertheless considered himself "completely independent". It was necessary for the registrant to obtain another, and independent, accountant and a new audit, with the result that the offering of securities was delayed several weeks.

Commission requirements are not the only presumed-to-be well known pronouncements with which too many accountants are unfamiliar, or choose on occasion to ignore or disagree with. The accounting and auditing procedure bulletins issued by the Institute, the articles and editorials appearing in the Journal of Accountancy, and even the Institute's rules of ethics, fall into the same category.

For example, while preparing this paper I received a phone call from an accountant inquiring whether, in making an audit for the purpose of preparing financial statements to be included in a registration statement, it was necessary to confirm accounts receivable and verify inventories. (Incidentally, the accountant had been auditing the company's accounts for several years but had never performed either of these procedures.)

Recently an accountant certified a statement which in a material respect was not in accord with an Institute accounting research bulletin. He sought to justify his action by reliance upon the dissent of a member of the Committee expressed in the bulletin. Another accountant stated that he does not pay too much attention to Institute bulletins because they are merely recommendations or suggestions of a group of individuals and carry no enforcement authority. Still others appear to "pick and choose" the bulletins or parts thereof when they will best serve to support a particular procedure which they or their clients favor.

One of the Institute's Rules of Professional Conduct which apparently has not received as much attention as it should is Rule 5(d) which reads as follows:

"In expressing an opinion on representations in financial statements which he has examined, a member or associate shall be held guilty of an act discreditable to the profession if \* \* \* he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion."

It is not an uncommon occurrence for an accountant's certificate to include exceptions which completely negative his certification. For example, one recently filed contained the statement:

"These amounts [referring to certain receivables] have been estimated by the company on the basis of developments and information available to date, but we are not in a position to verify or confirm the tentative accrual of \* \* \* [these amounts] and the accounts correspondingly affected thereby.

\* \* \*

"Subject to the qualifications stated in the preceding paragraphs, in our opinion [etc.]."

The amounts referred to represented more than 25% of the registrant's total assets and more than 50% of its net assets.

Obviously this certificate was unacceptable for registration purposes and, in my opinion, was violative of the Institute's Rule 5(d).

Reference was made previously to an investment company balance sheet in which the required provision for income taxes applicable to unrealized appreciation on investments was not reflected. Notwithstanding the fact that this balance sheet failed to meet our specific

requirements, and was amended, the company's report to stockholders, which pursuant to the 1940 Act<sup>19</sup> is required to be submitted to stockholders and to contain financial statements which are not materially different from those filed with the Commission, did not reflect the necessary provision for income taxes. Thus there was a material difference between the two financial statements; nevertheless, the accountant's certificate was the same in each case.

This situation raises a serious question as to the propriety of the action of an accountant in furnishing the same unqualified certificate with respect to materially different financial statements each of which purports to present the financial position of a company "in accordance with generally accepted accounting principles." We have had to deal with several such cases, particularly where reserves for depreciation of fixed assets are deducted from the applicable assets in statements filed with the Commission, but in reports to stockholders are shown on the liability side of the balance sheet.<sup>20</sup> In my opinion such practice is subject to criticism, if for no other reason than that the growing inclination of investors to place dependence upon certificates of certifying accountants can only be retarded thereby.

One more matter which has given accountants, the Commission's staff, and the public, headaches, especially within recent months, concerns the financial statements filed by broker-dealers. There are more than 3,000 of these statements filed each year on a form (X-17A-5) prescribed, pursuant to the 1934 Act, in Commission's Rule X-17A-5. The purpose of these reports is to furnish a basis for determining whether certain capital requirements of securities brokers and dealers, prescribed by statute, are met and to protect their customers with respect to funds or securities held for their account.

During the past year at least half a dozen cases have come to our attention where officers, partners or employees of these broker-dealers have violated their trust and have misappropriated amounts of as much as several hundred thousand dollars. In each instance the financial statements were certified by presumably qualified accountants. Whether or not any of these "shortages" could have been avoided, or disclosed sooner, had the certifying accountants done any more, or proceeded differently, in their examination of the accounts involved, can, of course, only depend upon the facts in each case. I mention them only for the purpose of emphasizing the extreme importance to accountants engaging upon examinations of this type of making themselves entirely familiar with brokerage practices; with our minimum audit requirements which are prescribed in detail in the instructions applicable to Form X-17A-5; and with the standard audit practices of the profession.

While the several Federal statutes designed for the protection of investors, as well as the expressed viewpoints of the Commission, point up the extensive dependence placed upon the accounting profession in carrying out the purposes of the statutes, the responsibilities of the profession to investors have long been recognized. Much has been said and written on the subject. One statement which I think is particularly apropos is the following made in a lecture

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<sup>19</sup> Section 30(d).

<sup>20</sup> See, for example, E. I. du Pont de Nemours & Company.

entitled "The Accountant and the Investor" delivered at Northwestern University School of Commerce in 1932 by Mr. George O. May:

"I would not have you think that because the investor is not his immediate client the accountant owes nothing to the investor except legal duties and ethical obligations. This is not, of course, the fact. It is to the investor that he owes his entire practice in the field of financial auditing, and it is only because the investor exists, and attaches weight to an accountant's report, that the banker employs the accountant's services in this field. And the continued success of the accountant is dependent on his retaining the confidence of the investing public. An enlightened self-interest, therefore, as well as self-respect calls for the maintenance of a proper ethical standard by the practitioner."

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