THE INDEPENDENT ACCOUNTANT AND THE SEC

Address of

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The invitation to participate in this program this morning was most welcome and was accepted promptly, for I knew that predecessors in my office at the SEC had appeared on your programs and had enjoyed the experience.[1] These talks dealt with problems in the application of accepted accounting principles and the presentation of data in financial statements. Furthermore, three years ago J. Sinclair Armstrong, then chairman of the Commission, spoke on "Corporate Accounting Standards Under Federal Securities Laws."

And twenty-one years ago yesterday Commissioner George C. Mathews spoke at your first Institute on "Accounting in Relation to Regulation of Security Sales." This paper might well have been in response to today's theme, which I understand is "Social Responsibility of Accounting." Commissioner Mathews spoke of the participation of accountants, engineers and lawyers, the three professional groups which he recognized as most prominent in the scheme of registration and disclosure under the Securities Acts. The doctrine of independence was identified only with the accountants. This doctrine, which evolved with the increase in public ownership of securities, he said was "designed to free the growth and development of accounting of managerial influences and give assurance to the security holders of the accuracy and reliability of the accountant's report." For the development of this concept of independence he recognized the work of the New York Stock Exchange, the growth and strengthening of accounting societies, the creation of departments of accounting in our universities, and the recognition of the value of accounting by the courts and various public agencies. At the same time he cited

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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.

examples in the Commission's experience (then less than five years) indicating the need for further development of the concept of an independent opinion by the certifying accountant.

Twenty-one years have passed. It now seems appropriate, and consistent with the theme of the day, for me to reexamine the concept of independence and to review the development of its application in the work of the SEC.

But, first, what is a public accountant? Norman E. Webster, C.P.A., explored this subject and reported his findings in two articles in The New York Certified Public Accountant for November and December 1944. He found among other things that the American Association of Public Accountants published a booklet in 1888 which defined an accountant and explained what he does. It appears from this that an accountant is "one who is skilled in, or keeps accounts," a person to be respected and not feared; further that "The accountant has integrity and responsibility as his birthright when he enters the guild, and an independent audit, under similar organization, would disclose the facts, and to a large degree cut short the story of defalcation, irregularity, failure and disaster which is but far too frequently told in America, and which points its own moral, severe and lasting as it is, to those who suffer." [underscoring added][2] This discussion preceded the passage of the first CPA law in New York in 1896. It appears that the newly created New York Board of Examiners for Certified Public Accountants refused certificates to accountants who worked for a single corporation employer, and the definition of a public accountant was still a subject for discussion in journals of the time. One of these, the magazine Accountics, in 1899 reprinted an extract from The Accountant of London which is pertinent; "The position of an auditor with regard to a company should be absolutely

[2] The New York Certified Public Accountant, Nov. 1944, p. 671.

independent, and to a large extent, of course, this is impossible while there is nothing to prevent the auditor being either directly or indirectly interested in the promotion."

In January 1900, shortly after the passage of the Pennsylvania C.P.A. law, The Public Accountant of Philadelphia invited leading practicing public accountants to write a definition of a public accountant. The responses from twenty-nine accountants in eight cities are interesting reading. Most replies stressed breadth of experience and nature of the work, but one is remarkably succinct in stating what is expected of an independent public accountant today. Charles C. Reckitt, a brother, and partner for a few years, of Ernest Reckitt, one of the founders of the profession in Illinois, said:

> "A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant's certificate, though addressed to president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience and undoubted integrity."[3]

The other replies included those of leaders in the profession whose names are perpetuated in major firms today. An account of the building up of the moral obligations and independence of the public accountant would not be adequate without a reference to Robert H. Montgomery, who had expressed himself with vigor in responding to the request I have mentioned and restated it with equal vigor in the first edition of his Auditing[4] where he emphasized his point with a quotation from another leader of the profession.[5] Three years later in his second edition

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[3] The New York Certified Public Accountant, December 1944, p. 707.

[4] At p. 30 (1913).

[5] A. Lowes Dickinson, C.P.A.

Montgomery noted the absence of decided cases in the United States on accountants' legal liability and observed that the British cases would serve as guides to the American courts in the event of litigation. In this connection he said: "In my opinion the quickest way to weed out the incompetent men who now hold themselves out as public accountants would be to make them understand the civil responsibility of a professional accountant. Naturally, an unreliable, incompetent man cares nothing about his moral responsibility, and so long as he knows that American courts have never laid down specific rules regulating the duties or obligations of public accountants, he probably feels safe from any legal responsibility. One sure and very desirable result of the weeding out process would be the raising of the professional standard, for a few irresponsible men can offset the good work of ten times their number."[6]

One more reference will complete this short sketch of professional development before the Securities Acts became law. The rules of professional conduct of the American Institute of Accountants declared effective May 16, 1929, include this important rule:

> "(2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation of proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable."[7]

Note the resemblance here to Sec. 11(a) of the Securities Act of 1933 which says in part: "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security

[6] Auditing Theory and Practice, 2d ed. Rev. and Enl'd, 1919, p. 4.

[7] Quoted in Montgomery, Auditing Theory and Practice, 5th ed., 1934, p. 12.

(unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue-- * * *."

This is enough to demonstrate that the concept of independence was well developed and the value of a review by independent accountants who are in no way connected with the business was established before the passage of the Securities Act--the first of the several Acts now administered by the Commission. These Acts either require or give the Commission power to require that financial statements filed with it be certified by independent accountants, and with minor exceptions the Commission's rules require that such statements be so certified.

The passage of the Securities Act, however, is an important landmark in the development of the concept of the responsibility of the independent accountant to the investor and the public. The original draft of the Securities Act did not require certification by independent accountants. A representative of the accounting profession appeared at the hearings on the bill before the Committee on Banking and Currency of the United States Senate to suggest revisions of the bill.[8] He pointed out that the bill as drafted imposed "highly technical responsibilities upon the Commission as to accounting principles, their proper application and their clear expression in financial statements," and suggested the bill be revised to require that "the accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet data and also the income statement for the period indicated."

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[8] Statement of Col. A. H. Carter, President of the New York State Society of Certified Public Accountants, before the Committee on Banking and Currency, United States Senate, 73d Congress, 1st Sess., on S. 875, p. 55.

The committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public. The committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.

In the report on the bill the Senate committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but it was deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security.[9] The proposal to require certification by independent public accountants was incorporated in the bill as passed.

With the passage of the Act it became necessary for the Federal Trade Commission to publish rules. This it did in a pamphlet of eight pages which could be obtained from the Superintendent of Documents for five cents. Article 14 of these rules related to accountants and in two paragraphs set the pattern for our present rules. The first of these corresponds to the present Rule 2-01 (a) which states who will be recognized to practice, and the second paragraph dealt with the matter of independence in these words:

> "The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or with whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function."[10]

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[9] Senate Report No. 47, 73d Congress, 1st Sess., p. 2.

[10] Rules and Regulations under the Securities Act of 1933, Federal Trade Commission, July 6, 1933.

Note that in the first rule and in its republication by the Securities and Exchange Commission[11] in 1935 the independent accountant could not have any interest, directly or indirectly, in his client. In a 1936 edition of the rules "any interest" was qualified by the word "substantial."[12] This brought the rule into accord with the October 15, 1934 resolution of the Council of the American Institute of Accountants "that no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of substantial financial interest in the enterprise or if he is committed to acquire such an interest."[13] The Commission deleted the "substantial" qualification in 1950 but the Institute's rule is essentially unchanged as it applies to public issues of securities. Further comment on the present status of the rules must wait while I explore some of the Commission's experience with accountants.

Lest you get the impression that all of our experience has been discouraging, I want to inject here that it is the violation of the independence rule, or other unprofessional conduct, which gets the publicity. I am sure the profession knows that the Commission appreciates the valuable work that has been done by committees and individual accountants in assisting in the drafting of forms and regulations in the first strenuous years and the constructive comments that have been offered in the same way throughout the life of the Commission. This certainly is acceptance of social responsibility. In our daily work the breaches of the rules are a very small proportion of the total number of cases in which the professional skill of the accountant has

[11] Compilation of Regulations Issued by the Securities and Exchange Commission and Its Predecessor, April 29, 1935.

[12] Rule 650 (b), General Rules and Regulations Under the Securities Act of 1933, January 21, 1936.

[13] American Institute of Accountants, Year Book, 1935, p. 354.

resulted in financial statements presented fairly in accordance with generally accepted accounting principles after an audit meeting generally accepted standards. I am sorry that I cannot give you the details of the cases in which the extraordinary diligence and persistence of the independent accountant have resulted in significant disclosures for the protection of investors. This is what the public expects, so it comes as a shock to laymen to find that sometimes accountants are not infallible.

I have reviewed the writing of our rules relating to independence. A few cases in which the concept was developed warrant examination. Recurring questions of surprising frequency demonstrate that we have a new generation of accountants in practice today. Many of these are not familiar with our rules and have not read the history imbedded in our reported cases and summarized or identified in more accessible form in the Accounting Series releases.

The first proceeding[14] involving independence dealt solely with independence and the failure to disclose certain matters with respect to the certifying accountants. The propriety of the financial statements was not questioned and the proceedings were dismissed when an amendment to the registration statement containing the certificate of a new and independent accountant was filed.

The Commission found in this case that a most unusual relationship existed between the registrant and the accountants who signed the certificate as independent public accountants. An employee of the accountants did the accounting and auditing work and at the same time was comptroller of the registrant and in this latter capacity signed the registration statement as the unsalaried principal financial and accounting officer of the registrant. The certifying accountants' compensation was a fixed fee plus a percentage of the gross proceeds of metal sales

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[14] In the Matter of Cornucopia Gold Mines, 1 SEC 364 (1936).

of the mine for one year. Furthermore, the employee owned shares in the registrant which he had purchased before the filing was made. In their certificate the accountants said, among other things, that their relationship with the registrant was "the usual relationship of independent accountants to their client." The Commission found that this was an untrue statement and that the certification was not made by an independent accountant.

The purpose of certification by an independent accountant is so well stated in this case that it warrants quotation:

> "*** The insistence of the Act on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements. Hence a statement which serves such a high function cannot be dismissed under the Act as a mere 'tag' attached to financial statements. It is a material fact, for it gives meaning and reliability to financial data and makes less likely misleading or untrue financial statements.***"

We hear that the real measure of independence is in the accountant's integrity and attitude of mind in dealing with the problem before him.[15] These are certainly fundamental

[15] "Essentially it is a state of mind." John L. Carey, Professional Ethics of Public Accounting, American Institute of Accountants, 1946, p. 7. The short quotation was qualified by citing the need for objective standards. Ten years later Mr. Carey said that "It is most important that the CPA not only shall refuse to subordinate his judgment to that of others but that he be independent of any self-interest which might warp his judgment even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgments." (Professional Ethics of Certified Public Accountants, American Institute of Accountants, 1956)

qualities which the Commission was quick to recognize. In an early case[16] it was said that where an accountant has consciously falsified the facts an inference of actual absence of independence would seem to be justified. An accountant must approach his "task with complete objectivity--critical of the practices and procedures of registrants, and unwilling to aid and abet in making statements which the facts do not warrant."

From time to time it has been urged upon us that an accounting firm should be permitted to certify financial statements when one or more of the partners could not be considered independent because of a financial interest in the client or other complication under the rules. In these cases it is represented that other partners will supervise the audit and the disqualified partners will not participate in any way. This argument was used in an early mine promotion in which one of the partners accepted his fee in stock of the registrant and the staff applied the rule. An amended balance sheet was filed which was certified jointly by an individual and the original firm. The individual was said to be an employee or associate of the senior partner or the firm but was paid directly in cash by the registrant. The Commission found that the independence rule would be defeated and evaded if the senior partner was disqualified but his partner or employee was not and concluded that the amended balance sheet was not certified by an independent accountant as required.[17] In a recent case it became necessary to apply the ruling in this case and

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[16] In the Matter of American Terminals and Transit Company, 1 SEC 701, 707 (1936). See also In the Matter of Metropolitan Personal Loan Company, 2 SEC 803, 813 (1937) in which the Commission found that the accountants were not independent and commented that "The requirement that the certifying accountant be 'independent' is not mere verbiage. The testimony reveals that *** and *** completely subordinated their judgment as accountants to the desires of their client in setting up items questioned in the balance sheet and profit-and-loss statements. *** testified that he wasn't sure of an accountant's function in this respect and that he generally did what his clients requested."

[17] In the Matter of Rickard Ramore Gold Mines, Ltd., 2 SEC 377, 389 (1937).

a similar ruling of the American Institute of Certified Public Accountants Committee on Professional Ethics.[18]

In an unusual case twenty years ago it was found that unknown to the certifying accountants their supervisor in charge of the audit had kept certain books of a client. This situation came to light when it was discovered that the client's financial statements for several years were false and that the accountants' employee was responsible for the false entries. The Commission in its opinion agreed with the partner of the accounting firm who testified that "an audit should be a check by an outsider of original work done by the client's employees; 'if an accountant is permitted to do original work the whole purpose of the audit is lost.'"[19]

These few cases from the first five years of the Commission's experience have been the guides in deciding cases in the last twenty years. There have been variations in circumstances, but we have in these cases examples of conflicts of interest due to financial interest, direct employment by the client, and apparent submission to the will of the client without other complicating factors. These matters are covered in our rules[20] and in part in the codes of professional ethics of the Institute and of the state societies of certified public accountants. The frequency with which my office must answer questions on matters of this kind suggests the possibility that greater emphasis could be put on the subject of professional ethics in the colleges and by the accounting societies.[21]

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[18] C.P.A. Handbook, Chapter 5, Appendix A, Rule 13, p. 7.

[19] In the Matter of Interstate Hosiery Mills, Inc., 4 SEC 706, 717 (1939).

[20] Rule 2-01, Regulation S-X.

[21] See Accounting Series Release No. 81, December 11, 1958, for a Compilation of Representative Administrative Rulings and references to published cases on independence.

I am, of course, aware that much effort is directed along these lines, but it cannot be relaxed. The codes of ethics, in my opinion, could be reexamined in one major area at least. Most of the codes have a double standard on the subject of financial interest--permitting no substantial interest in a client with a public distribution of securities, but only requiring disclosure of such an interest to private lenders. Many cases coming to our attention are those of accountants who have served closely-held corporations and are entering the public financing area for the first time. I was encouraged by Thomas G. Higgins' remarks at Detroit last October when he discussed this dual standard and said that "It is really difficult to see why the rule should be different for statements used for public financing and those used as a basis of credit."[22] He also remarked that "There is a growing feeling that the Institute's rule on investments in clients should be more comprehensive than it is and that it probably should parallel the Illinois rule, which is essentially the rule of the SEC." Most accountants seem to recognize that they should not be an officer or director of the client whose statements they certify, but perhaps the codes could be strengthened by covering this point too. Such strengthening might relieve accountants from pressures by well-meaning clients.

I have not dealt with the general problem of the improvement in auditing procedures and the definition of generally accepted auditing standards which have received a great deal of attention in the profession and by the SEC particularly since the McKesson & Robbins investigation. This case may be cited as an example of the profession coming forward both individually and in national and state organizations to examine a serious problem among themselves, by assisting the SEC as expert witnesses, and thereafter in promoting the use of the

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[22] Thomas G. Higgins, "Professional Ethics and Public Opinion," Journal of Accountancy, November 1958.

extended auditing procedures which were found necessary as a result of the investigation. The fraud had been exposed on or about December 5, 1938. On January 6, 1939, committees of the American Institute of Accountants and the New York Society of Certified Public Accountants made a joint statement at a meeting with the Attorney General of the State of New York in which they said: "professional accountants, in sponsoring C.P.A. legislation, adopting codes of ethics, and establishing standards of procedure, have assumed heavy responsibilities, and by statute and court decision additional responsibilities have been imposed upon them. All reputable accountants assume a responsibility to persons other than those who employ them. The greatest asset of a public accountant being his reputation for competence, care and integrity, it is essential that he guard that reputation with all diligence. The legal penalties imposed on accountants for fraud, deceit, or gross negligence are so severe that no practitioner would deliberately risk incurring them."

Strengthening the understanding of the meaning of independence by all members of the profession is a vital factor here. In this connection I want to highlight one finding in the McKesson report that an audit which relies heavily on a proper appraisal of the client's system of internal check and control "should not *** exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted."[23]

By this brief review of the concept of independence I believe I have demonstrated that the Securities Act embraced what had become good business practice. Any course of conduct by the profession which may have the effect of undermining public confidence in the independence of the accountant who certifies financial statements upon which third parties are asked to rely would destroy the usefulness of the accountant's work in the securities field. It is for this reason

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[23] Accounting Series Release No. 19, p. 35 (1956 ed.).

that the SEC has vigilantly guarded the concept of independence--so firmly in some cases as to bring criticism from the properly constituted guardians of the profession's code of ethics. These reactions have been disturbing but at the same time I know that our intent has been to promote the highest standards in one of the most important qualities of the accountant in public practice.

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