THE UNIVERSITY OF OKLAHOMA

GRADUATE COLLEGE

THE INFLUENCE OF THE SECURITIES AND EXCHANGE COMMISSION UPON ACCOUNTING PRINCIPLES AND PRACTICES

A DISSERTATION

SUBMITTED TO THE GRADUATE FACULTY

in partial fulfillment of the requirements for the

degree of

DOCTOR OF PHILOSOPHY

BY

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Norman, Oklahoma

1970

THE INFLUENCE OF THE SECURITIES AND EXCHANGE

COMMISSION UPON ACCOUNTING

PRINCIPLES AND PRACTICES

APPROVED BY

DISSERTATION COMMITTEE

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INTRODUCTION AND PRESENTATION OF PROBLEM

The purpose of this dissertation is to determine the influence of the Securities and Exchange Commission on the development of accounting principles and practices. In examining the effects of the Commission's actions it will be necessary to determine the status of accounting principles and practices as those principles and practices existed prior to the formation of the Securities and Exchange Commission in 1934.

Until the development of the corporate form of business enterprise with its attendent widespread, absentee ownership there was very little pressure exerted on the accounting profession for the development of accounting principles. This pressure began to develop approximately seventy-five years ago and increased steadily especially through the period 1910-1930.

In order to determine what accounting principles and practices existed prior to 1934 it will be necessary to examine the literature of those earlier years. Early attempts to establish generally accepted accounting principles by the American Institute of Accountants (now the American Institute of Certified Public Accountants) were largely unsuccessful because professional accountants lacked the degree of independence necessary to enforce adherence to a selected set of accounting principles.

The first successful attempt to dictate what would be accepted as accounting principles was made, not by an accounting organization, but by the New York Stock Exchange. This limited effort culminated with the New York Stock Exchange issuing a letter to all companies listed on the Exchange outlining the Exchange's attitude toward the accounting for stock dividends.[1] This original work by the New York Stock Exchange led to discussions with the American Institute of Certified Public Accountants concerning the changing emphasis of accounting.

Chapter one examines this change in emphasis in accounting, which had centered upon management and creditor information, toward supplying information to stockholders and potential investors.

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[1] J. M. B. Hoxsey, "Accounting for Investors," The Journal of Accountancy, L (October 1930), pp. 279-281.

CHAPTER I

THE DEVELOPMENT OF ACCOUNTING PRINCIPLES, PRACTICES, AND PROCEDURES PRIOR TO 1933

The Changing Form of Business Organization

The development of accounting principles and procedures in the United States closely paralleled the economic development of the business enterprise. Until the latter part of the nineteenth century the predominant forms of business were individual proprietorships and partnerships. So long as the individual proprietorship and the partnership were the typical forms of business, there was little restriction on the owners as to the accounting procedures and practices they chose. The primary obligation of the owners was to prevent fraudulent actions against creditors. Since the individual owners were personally liable for all of the debts of the business, this was a substantial assurance that fraudulent acts would not be committed.

The accounting methods employed by these early businesses were designed to measure the value of the business at any point in time. This net worth approach to accounting was vitally important to the owners because the primary use of accounting reports was for credit purposes. Even today lending institutions are inclined to use financial statements as a measure of the value of a business instead of as a report of past financial activities of the firm.

The introduction of the business principle of limited liability made the protection of creditors vastly more important. The legal capital of a company was generally regarded as the main protection offered creditors. Strict rules were formulated to safeguard creditors against any reduction of the legal capital of the firm. Laws usually required that creditors be notified and given a chance to be heard before any reduction in legal capital could be effected.

Early limited liability companies were owned and managed by relatively small groups of stockholders and accounting practices were still substantially the same as for individual proprietorships and partnerships. It was still the practice of the stockholders to adopt such accounting methods for the determination of profits and of the amounts available for dividends as they saw fit, so long as the rights of creditors were not jeopardized.

It was not until the idea of free transferability of ownership of shares of stock of corporations became widespread that accounting practices began to receive public attention. When corporations began listing their securities with stock exchanges so that the securities could be bought and sold by persons not closely allied with the corporation, it became desirable that accounting reports be published and distributed to these absentee owners. These reports should have been designed to make them not misleading to those buying and selling the securities.

The first attempt to recognize the obligation of the corporation to report the results of its activities to its stockholders was made in 1903. In that year United States Steel Corporation issued a full financial report of its activities for the year which ended on December 31, 1902. Because of the importance of the United States Steel Corporation and the public discussion its report evoked, this event is considered a landmark in the history of the development of accounting reports.[1] From this date forward, corporations whose stock was publicly traded, began giving more information to stockholders and the public.

Professional accounting organizations were vitally interested in the development of accounting practices and procedures. In 1905, the Federation of Societies of Public Accountants in the United States of America merged with the American Association of Public Accountants to form the

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[1]George O. May, Financial Accounting, A Distillation of Experience, (New York: The MacMillan Company, 1943), p. 54.

first truly national organization of accountants. The association was reorganized in 1917 and renamed American Institute of Accountants. The name of American Institute of Accountants was changed to American Institute of Certified Public Accountants in 1957. In 1916, the American Association of University Instructors in Accounting (now the American Accounting Association) was formed and with the American Institute of Certified Public Accountants has led the way in the development of accounting principles and practices.

With the decline of the closely-held corporations and the widespread ownership of corporate securities came the need for well-defined accounting practices and procedures. Accountants, because of their client relationships, generally were not motivated to lead the drive for the development of accounting principles and reporting standards.

Throughout the period from 1900 to 1920, the United States had undergone rapid growth and increasing prices. This expansion period led to greater corporate profits and a tremendous increase in the formation of new businesses. The attendant need for vast amounts of new capital led to more widespread ownership of corporate securities. The first twenty years of this century also saw the rise of mass production techniques which required even greater concentrations of capital. This requirement provided the background reason for many of the mergers and consolidations which occurred during this period.

The Holding Companies

The holding company, where one corporation controlled the activities of several others while the holding company itself had no production function, was a product of this expansion period. The holding company was first legalized in New Jersey in 1888 when a law was passed which permitted companies incorporated in New Jersey to own stock of other corporations. Prior to the enactment of this law it had generally been illegal for one corporation to own the stock of another except by special legislative permission. This was the beginning of an era when vast fortunes could be made by promoters and the owners of the combined companies. The promoters generally were assigned a large portion of the holding company shares as payment for their services in handling the transactions and the owners of the old businesses were paid in stock of the new company. Common stock was issued in huge quantities and usually on inflated terms. Frederick L. Allen points out in his book[1] that when the Consolidated Steel and Wire Company was taken over by the American Steel and Wire Company of Illinois, the holder of one one-hundred-dollar share of Consolidated Steel was

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[1]Frederick L. Allen, The Lords of Creation (New York: Harper & Brothers, 1935), p. 11.

handed $175 worth of preferred stock and $175 worth of common stock of the new company; and when the new company in its turn was taken over by a yet larger combination, the American Steel and Wire Company of New Jersey, the stockholder received (for these same shares) $175 worth of preferred and $315 worth of common in the New Jersey concern. His $100 investment had been converted into certificates with a face value of $490. At one point 318 industrial companies controlled a total of 5,288 separate plants with an aggregate capital of more than seven and a quarter billion dollars.[1] The usual procedure in organizing a giant corporation was for the directors of a new company to purchase with its common stock the assets of the combining companies and to pay in common stock the fees of the promoters and the fees of the bankers who worked out the new financial structures. The bankers also received commissions in stock and cash for advancing whatever funds might be needed to complete the transactions and for floating bonds by which the new corporation obtained working capital. Since the new common stock was without real value and the bonds were not negotiable without markets, the major investment bankers insisted on being named to the boards of directors of these companies. The investment bankers of the

[1]Thomas C. Cochran and William Miller, The Age of Enterprise, A Social History of Industrial America, Revised Edition (New York: Harper & Row, 1961), p. 191.

House of Morgan, First National Bank of New York and the National City Bank of New York occupied 341 directorships in 112 companies with resources of $22,245,000,000 in 1912.[1]

The Emergence of the Investor

Widespread abuses of accounting and reporting standards occurred during the decade following the "inventory depression"[2] of 1920-1921. After the dramatic fall in prices in 1920, commercial borrowers were hard-pressed to meet loan repayment committments and, as a result, banks began to lose importance as a source of funds for business expansion.

The period from 1922 to 1929 saw the decline in the influence of the credit grantor on accounting and an increase in the influence of the investor and the New York Stock Exchange. With the decline in the use of short-term borrowing as a method of financing business activities, companies adopted the policy of financing through preferred stock issues.

The abuses of accounting and reporting standards referred to earlier, involved both holding companies, whose main power was concentrated in the public utility field, and commercial companies engaged in production.

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[1] Ibid., p. 194.

[2] George O. May, Memoirs and Accounting Thought of George O. May (New York: The Ronald Press Company, 1962), p. 46.

By the period 1920-30, the American public had amassed huge amounts of savings which were available for investment purposes. The steady rise in stock and bond prices during this period made the holders of this capital willing to speculate in corporate securities.

Misleading Accounting Practices Resulted

Holding companies and investment trusts issued several billions of dollars worth of new securities and "pyramiding" by holding companies became commonplace. One such company was the Insull Empire in electric utilities. The structure of this holding company was so complicated that Frederick L. Allen in The Lords of Creation quotes Owen D. Young, board chairman of General Electric as having said: "It is impossible for any man to grasp the situation of that vast structure . . . it was so set up that you could not possibly get an accounting system which would not mislead even the officers themselves"[1] Cochran and Miller describe the Insull Empire as follows:

> One of the companies at the bottom of the Insull Empire was the Georgia Power Company. This was an operating company that produced electric power and light, sold it to factories and homes, employed industrial labor and paid industrial wages. Its assets consisted of land, buildings, equipment and good-will. To control all these assets, another corporation had only to control, at most, half of the voting stock of the Georgia Power Company. This the Seaboard Public Service Corporation did. And this was all it did.
> The entire "plant" of the Seaboard consisted of an office from which its directors bought and sold

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[1]Allen, Lords of Creation, p. 280.

securities. And just as the Seaboard could control all the assets of the Georgia Power Company by controlling half of its stock, so the Seaboard Corporation, itself only an "office" company, was controlled by the National Electric Power Company. The latter, therefore, controlled the Georgia Power Company as well, with an infinitesimal investment sufficient only to purchase enough voting stock in the next lower holding company.

Still higher in the Insul hierarchy was the Middle West Utilities Company--another nonentity in terms of its own "plant," a giant corporation in terms of the assets it controlled. The Middle West Utilities Company was a great holding company which "held" stock in many other holding and operating companies, one of which was the National Electric Power Company. Thus it also controlled the Georgia Power Company.

Still the end of the maze is not in sight. Higher yet was Insull Utility Investments, Inc., which was formed in 1928 to control not only the Middle West Utilities Company but three other giants: The Public Service Company of Northern Illinois, the Commonwealth Edison Company, and the Peoples Gas, Light & Coke Company. And beyond even this company, the network of whose holdings was so intricate as to defy intelligent unraveling, was the Corporation Securities Company of Chicago, a "Super-super-super-holding company" called "Corps" for short.

This "Corps" controlled Insull Utility Investments, Inc., by owning almost 30 per cent of its stock. Yet Insull Utility also held 12.5 per cent of "Corps" stock, a controlling interest. Another 1.2 per cent of "Corps" stock was held by the Middle West Utilities Company . . . . The value of the "pyramided" holding company device to the promoter becomes clear when we ralize that a single dollar invested by Insull in the voting stock of the Insull Utility Investment, Inc., controlled $1,750 in assets of the Georgia Power Company.[1]

The practice of writing up corporation assets to some appraised value became common. With the write-up of assets to offset the increase in price levels, depreciation charges were then based upon these higher values. The

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[1]Cochran and Miller, The Age of Enterprise, p. 316.

change in the accounting values of properties was accomplished by crediting the amount of the write-up to capital surplus. At that time little restriction had been placed upon the accounting for changes in capital accounts. Not only were companies in the practice of computing depreciation on appraisal values, but also there was no uniformity or consistency in rates chosen from year to year or from company to company.[1] Another practice which existed was that of charging the allowance for depreciation for replacements and improvements and also with ordinary maintenance items.[2] This wide variation of depreciation methods made the analysis of financial statements extremely difficult.

Another widespread practice of the 1920's was to have holding and operating companies sell properties and securities to each other at prices vastly higher than cost to each original owner. In January, 1928, the Middle West Utilities sold some securities to the National Electric Power (which was controlled by Middle West) for over three million dollars more than it had paid for them; at the same time, National Electric Power sold other securities to Middle West Utilities for over three million more than their cost. Although the securities were in reality only exchanged, the accounting results showed a net profit of six million

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[1]May, Financial Accounting, p. 78.

[2]Ibid., p. 79.

dollars.[1] In Frederick L. Allen's book, The Lords of Creation, where the above transaction is described, the following note is added: "In defense of such remarkable accounting it could be argued, of course, that the rising prosperity of the electrical business was causing all values to increase, and that this was simply a way of taking due advantage of the swelling wealth of the utility system."[2] Although such transactions were reported as income to the system and added to the attractiveness of the stock of the holding company, the result was completely misleading to stockholders and investors.

The emergence of the large holding companies during this period necessitated the introduction of consolidated statements to accounting. Again, there was no consensus of opinion among accountants or the companies involved as to the proper method to be followed in preparing consolidated statements. Some companies reported consolidations for all companies in which a majority of the voting stock was held, and others colsolidated only those companies in which all of the voting stock was owned. Mr. J. M. B. Hoxsey, Executive Assistant to the Committee on Stock List, the New York Stock Exchange, wrote the following comment concerning consolidated statements:

> As a case in point a certain very large corporation formerly published consolidated statements, including

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[1]Allen, The Lords of Creation, p. 276.

[2]Ibid., p. 276.

> only its wholly owned subsidiaries. These statements apparently justified the dividends which were regularly paid. It also held from 75% to 85% of the stock of certain large unconsolidated subsidiaries. When asked to publish either fully consolidated statements or separate statements of the subsidiaries, it developed that the company's proportion of the current losses of the unconsolidated subsidiaries had for years been larger than the total profits of the rest of the system as shown by the consolidated statements. Certainly in this case, however unintentionally, the stockholders had been misled.[1]

It was in this article that Mr. Hoxsey recommended "that no accountant should certify partly consolidated statements without including in them a clear statement of the company's equity in the current undistributed earnings or losses of its unconsolidated subsidiaries and a statement of its equity in their earned surplus, since acquisition, as at the date of the report."[2] This recommendation was later accepted by accountants and is substantially the accounting principle followed today.

Arthur Lowes Dickinson also wrote of the problems encountered in preparing financial statements for holding companies in his book Accounting Practice and Procedure.[3] Mr. Dickinson recommended that consolidated financial statements be prepared on the basis of the common-sense fact that a network of companies connected with each other

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[1]Hoxsey, "Accounting for Investors," pp. 251-84.

[2]*Ibid.*, p. 259.

[3]Arthur Lowes Dickinson, Accounting Practice and Procedure (New York: The Ronald Press Company, 1914), p. 176.

by control of stockholdings, is still, in effect, one undertaking, and that if the stockholders in the holding company were to have before them a clear statement of its position, legal technicalities must be brushed aside and the position of the holding company shown in its relation, not to the subcompanies, but to the general public.[1]

During the decade under discussion, there was a great deal of confusion concerning the proper accounting treatment for various surplus accounts. The introduction of state laws permitting the issuance of no-par stock with the proceeds from the sale being credited to the capital stock account and to a surplus account also occurred during this period. The amount so credited to surplus (sometimes a substantial part of the sales price) appeared to be available for dividend payments and was used for such purposes. Although most accountants agreed that dividends should be paid only from earned surplus, many companies failed to maintain adequate records of the various sources of capital. In addition to the capital from the issuance of no-par stock, other items credited to a general surplus account included surplus created from the recording of property appreciation, surplus arising from the creation of a goodwill item, from the consolidation of subsidiary companies or surplus of subsidiaries at the date of acquisition, and from acquisition

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[1] Ibid., p. 176.

of property at less than its book value.

The accounting procedure followed in recording the surplus of subsidiary companies was either to give a stated value to the securities issued by the acquiring company equal to the full book value of acquired assets and to add to the consolidated assets the surplus of the acquired company, or to state the consolidated assets correctly and then record the stated value of the securities issued to an amount necessary to offset the surplus to be shown. Either of the methods described was acceptable although the second method was preferred. Both accounting procedures were later abandoned in preference to the current practice of eliminating all subsidiary surplus at the date of acquisition and showing any excess purchase price over the book value of assets acquired as an adjustment in the asset carrying values or if not allocated to the asset values, "any difference which cannot be so applied should be shown among the assets in the consolidated balance sheet under one or more appropriately descriptive captions."[1] Any excess of book value of assets acquired over the purchase price should be eliminated by reducing the carrying value of specific assets. "In the unusual case where the difference cannot be allocated to specific assets it would be acceptable

[1] American Institute of Certified Public Accountants, <u>Accounting Research Bulletin No. 51</u> (New York: 1959), paragraph 7.

to show the difference in a credit account, which would be taken into income in future periods on a reasonable and systematic basis."[1]

A companion problem of the proper accounting treatment for the various surplus accounts was that concerning the accounting for stock dividends issued or received. Since there was no agreement among accountants about the accounting for surplus it is no surprise that there were diverse views on the accounting treatment for stock dividends. The term "stock dividends" as used in the 1920's covered almost any kind of transaction from a stock split in the form of a stock dividend to a true stock dividend with a proper capitalization of actual earnings.

The occasional large stock dividend, which was in reality a stock split, never created serious accounting problems. When a stockholder received two shares of stock for each share owned, he knew that the value of his holdings per share had decreased and that the additional shares received did not represent current income. The only problem confronting the accountant in this case was that of changing the number of shares of stock outstanding and the par value per share if required. The periodical stock dividend presented a real problem. The major questions were whether the dividends had been currently earned and whether

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[1] _Ibid._

they had been properly accounted for. Mr. J. M. B. Hoxsey described nine different accounting methods used to record periodic stock dividends. They were:

1. The issuance of the additional stock described as a stock dividend, without the transfer to capital of any sum whatsoever, either from capital surplus, from earnings, or from earned surplus;
2. The transfer to capital account from capital surplus of the nominal sum per share issued;
3. The transfer to capital account from capital surplus of an amount per share issued equal to the theretofore stated value or par value of the stock, per share;
4. The transfer to capital account from earnings or earned surplus of a nominal amount per share issued;
5. The transfer to capital account from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share;
6. The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the theretofore stated value or par value of the stock per share, plus the theretofore capital surplus per share;
7. Particularly with companies having large uncapitalized tangible or intangible assets, the transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued greater than the sum of the theretofore capital per share plus capital surplus per share and less than the market value per share;
8. The transfer to capital account and/or capital surplus from earnings or earned surplus of the theretofore entire book value per share, including earned surplus; (note--if earned surplus were 100% of capital, this method would exhaust earned surplus upon payment of a 50% stock dividend);
9. The transfer to capital account and/or capital surplus from earnings or earned surplus of an amount per share issued equal to the market value of the stock upon some convenient near-by date.[1]

[1]Hoxsey, "Accounting for Investors," p. 265.

The accounting treatment given to the problem of stock dividends received was almost as varied as that given to stock dividends issued. The prevailing attitude of corporate officers concerning stock dividends received was that the dividend should be recorded as income in the amount of the market value per share on the day of receipt. The attitude of accountants, then as now, was that stock dividends received do not represent income to the recipient. The practice of accountants has always been to treat stock dividends as merely a reduction in the cost per share held and not to require any accounting entry. The arguments presented by the proponents of the two differing viewpoints both seem logical. There is no doubt that an individual stockholder who receives a share of stock as a dividend feels that he has received income equal to the market value of the stock. It is also probable that the market price per share will not decline after the issuance of the stock dividend. On the other hand, accountants have always maintained as a principle of accounting the idea that no earnings should be taken up in any given year except those which have been realized during that year. In the case of stock dividends received, realization of income cannot be said to have occurred upon the receipt of the shares. Realization can only take place upon the subsequent sale of the shares received as a dividend.

After the issuance of the instructions by a Special Committee on Stock Dividends of the New York Exchange an even greater controversy was created. Corporate officials, lawyers, and brokers complained that the stock exchange, by limiting the receiving company to reporting income from stock dividends at an amount not greater than that charged to earned surplus by the paying company, severely handicapped corporate policies concerning dividends by such a conservative approach.[1] Accountants reacted just as strongly in the opposite direction. As indicated above accountants have always used realization as justification for the recognition of income. In one of the earlier textbooks on accounting written by an American author, Arthur Lowes Dickinson discusses the concept of income realization.[2]

There was such controversy surrounding the proper accounting treatment to be accorded stock dividends that the New York Stock Exchange issued detailed instructions on furnishing information required to be filed by companies whose securities were listed with the Exchange.[3]

The action taken by Special Committee on Stock Dividends of the New York Stock Exchange which permitted the company receiving stock dividends to report income up to the amount the paying company had charged earned surplus, opened the door to misleading income statements by the receiving companies. This accounting method was never accepted by the

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[1]Hoxey, "Accounting for Investors," p. 281.

[2]Dickinson, Accounting Practice and Procedure, p. 94.

[3]Hoxey, "Accounting for Investors," p. 281.

accounting profession and was abandoned as acceptable for companies listed with the New York Stock Exchange in 1933.[1]

Another major accounting problem which existed before 1933 was that of determining the valuation of inventories. Throughout the early period of corporation accounting, the lower of cost or market method of valuing inventories had been accepted as a basic accounting principle. Although there was much confusion regarding the meaning of market, most accountants agreed that the term "market" applied to the "buying market" and not to "selling market." Even with the general acceptance of the lower of cost or market rule circumstances at times caused accountants to question the results of the application of the rule. Departures from the application of lower of cost or market were accepted and even encouraged during the period 1930-32. In an editorial in the Journal of Accountancy in 1932, Mr. A. P. Richardson counseled as follows:

> In such abnormal conditions as those which now annoy us, the accountant who is called in to express an opinion upon the value and stability of a concern must give some heed to what is going on outside the immediate range of his professional duty. This is a subject which it is difficult to discuss without appearing to advocate a relaxation that would be suicidal and destructive. Strictly speaking, there can be no trafficking with proposals that would depart at all from the standards of absolute probity, but on the other hand there may be a difference of opinion as to what is continuing truth. In other words, there may be spasmodic conditions which give an unnecessarily dark picture but do not last, and if the accountant, in rendering his opinion of what is the condition of affairs at a given moment, is convinced

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[1]The Journal of Accountancy, LVII (March, 1934), p. 170.

that the moment selected is not fairly representative of any length of time, it seems that he may be pardoned for taking the long view--and indeed he may be expected to take the longer view in justice to all concerned. This should not be reflected in any certificate, which must, of course, deal with facts unembellished, but it seems that it might be permissible for the auditor of a company to refer indirectly to the peculiarly, and it is hoped temporarily, debased level of values. At the end of 1930 it was felt that the worst of the depression was over, many inventories of goods and securities were not written down as they might have been and accountants in some cases were lenient and permitted their clients to indulge in a moderate form of optimism. When 1931, however, had wrought its havoc and business at the end of the year was far worse than it had been at the beginning, it seemed necessary to make complete adjustments in the cause of truth and professional duty. What happened was unfortunate because, whereas at the end of 1930 there was a certain amount of over-estimation, it was followed at the end of 1931 by undue depreciation. People went from one extreme to the other and the range of descent between the two was really greater than the actual decline in values.

We pointed out in a recent issue of this magazine that there is an inclination to fix an arbitrary rate of depreciation of securities and to carry them on the books at a figure twenty-five per cent below par instead of at the market value of the day of closing.

No one has been harmed by this white lie, because wherever it is adopted it must be accompanied by a clear explanation that it is what it is. Now, in the case of other inventories such as commodities, merchandise and the like it seems that there may be justification for fixing a valuation which is neither cost nor market but somewhere between the two . . . It is the duty of the accountant, it seems, to determine whether each case that is brought to his attention will justify departure from precedent or not. If he feels that the inventory, when there is a demand for that inventory, will surely have a greater value than at present, he has at least logic on his side when he advocates departure from the generally estimable principle of cost-or-market-whichever-is-lower.[1]

[1]A. P. Richardson, "Inventories of 1930 and 1931," The Journal of Accountancy, LIII (March, 1932), pp. 161-163.

Another contemporary commentator discussed the gross inadequacies of financial reporting as follows:

> Not all, but at least some, of the terrific financial wreckage of the past three years could have been halted short of the bankruptcy courts by the adoption of fearless accounting methods . . . I hope these disastrous experiences may hasten the time when, at least as to those corporations whose securities are held by the general public, the accountant's work will be done primarily for the shareholders and creditors at the corporation's expense, and not for the purpose of making as favorable a report on behalf of the management as the facts can be made to justify through carefully prepared "hedge clauses" in the auditor's certificate, which while perhaps absolving him from legal liability, constitutes business immorality, if not actual dishonesty.[1]

It is little wonder that accountants came under attack for their lack of consistency and the indeterminate status of principles of accounting. The shifting emphasis in accounting from the balance sheet to the income statement also contributed to the problem of financial reporting. A major complaint was summed up as follows: "Balance sheets are prone to be inadequate or misleading in two principle respects. One is the downright ommission of important items in the property account. Another is the failure to disclose the method of the valuation, whether it be of property or of stock in trade."[2]

With conflicting views among accountants and corporate officials concerning the accounting treatment of the

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[1]Fletcher Lewis, "Some Legal and Accounting Questions Presented by the Michigan General Corporation Act," Accounting Review, VIII (1933), p. 145.

[2]William Z. Ripley, "Stop, Look and Listen," The Atlantic Monthly, CXXXVIII (September, 1926), p. 387.

items previously discussed, some protection for the investor was needed. In an attempt to provide some measure of protection for the investing public, the American Institute of Certified Public Accountants and the New York Stock Exchange undertook an exchange of views concerning the development of accounting principles. This was the first cooperative effort between national organizations made towards the establishment of generally accepted accounting principles and began in 1928 when Mr. George O. May, a partner in the accounting firm of Price Waterhouse & Company, became an accounting consultant of the New York Stock Exchange. The result of these exchanges of views was the formation of a "Committee on Cooperation with Stock Exchanges" which issued a report to the New York Stock Exchange in January, 1934, which contained the first outline of what it considered to be general broad accounting principles.[1] This statement of principles was considered to answer some of the major accounting questions existing at that time. Only five broad principles were mentioned in this original statement and included the following items:

1. Income realization
2. Capital surplus and its disposition
3. Consolidated and subsidiary retained earnings
4. Treasury stock
5. Reporting of notes and accounts receivable

This list of principles was incorporated in a statement adopted by the members of the American Institute of

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[1] The Journal of Accountancy, LVII (March, 1934), p. 168.

Certified Public Accountants in 1934[1] and with one additional item covering the exchange of capital stock for property, remained in effect until modified by the Institute in its Accounting Research Bulletins which were first issued beginning in 1938.

The accounting profession was beginning to become more aware of its role in the development of accounting principles. Fortunately, even such a modest start gave the profession a high degree of respectability when the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted. The features of these acts form the basis for the investigation in the following chapter.

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[1]The American Institute of Certified Public Accountants, Audits of Corporate Accounts (New York: 1934), pp. 1-5.

CHAPTER II

THE SECURITIES ACTS OF 1933 AND 1934

The Securities Act of 1933

Background of the Act

The single most significant event which affected the practice of accounting was the passage of the Securities Act of 1933. The stock market crash of 1929 had such a devastating effect upon the investing public that something was needed to protect investors from deceptive stock promoters. The Securities Act of 1933 was an act "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[1] The Act was designed to improve the financial reporting of all companies having securities registered upon a national securities exchange. The Securities Act of 1933 provided generally that companies proposing to sell securities had to file a

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[1]U.S., Securities and Exchange Commission, Laws Relating to Securities Commission Exchanges and Holding Companies (Washington, D.C.: Government Printing Office, 1968), p. 4.

registration statement with the Federal Trade Commission.[1] The registration statement had to include a balance sheet, profit and loss statement, and other supporting schedules certified by an independent public or certified accountant.[2]

Provisions of the 1933 Act Which Affected Accounting

The key provision of the act which affected accounting was that the registration statement had to include "a balance sheet as of a date not more than ninety days prior to the date of the filing of the registration statement showing all of the assets of the issuer, the nature and cost thereof, whenever determinable, *in such detail and in such form as the Commission shall prescribe*."[3] (Italics mine).

In order to provide assurance that the Act would be complied with, Section 8(d) of the Securities Act[4] provided that, if it appeared to the Commission at any time that a registration statement included any untrue statement of a material fact or omitted to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission could institute proceedings which could result in a stop order which would suspend the effectiveness of the registration statement. Until the registration statement was amended in accordance

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[1] *Ibid*., p. 6.

[2] *Ibid*., p. 19.

[3] *Ibid*., p. 19.

[4] *Ibid*., p. 7.

with the provisions of the stop order, no securities could be sold. Even though the Securities Act of 1933 provided that the Commission could prescribe the form and content of financial statements, accountants were generally more concerned with that section of the Act entitled "Civil Liabilities on Account of False Registration Statements."[1] Section II(a) of the Securities Act[2] provided that in case any part of the registration contained an untrue statement of a material fact or failed to state a material fact required to be stated therein or necessary to make the statements therein not misleading, civil suit could be brought against those persons who signed the registration statement. Damage suits could be brought by any person acquiring a security unless the defendant could prove that such person knew of such untruth or omission.[3] Suits were not limited to persons acquiring a security at the time of the original offering to the public but could be brought by any person who acquired the security at any time thereafter.[4] The person who acquired a security did not have to show that he was misled by an incorrect statement or omission or that he had ever read the registration statement.[5] The defendant

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[1] *Ibid.*, p. 9.

[2] *Ibid.*, p. 9.

[3] *Ibid.*, p. 10.

[4] *Ibid.*, p. 10.

[5] *Ibid.*, p. 10.

was called upon to prove that the plaintiff had knowledge of an incorrect statement or omission in order to offer a defense to a suit. The only limitation on such liability was that a suit had to be brought within two years after the discovery of the untrue statement or the omission or in no event more than ten years after the security was offered to the public.[1]

The defense granted under provisions of the act to an expert in suits involving incorrect or misleading statement was stated as his ability to prove:

> He had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[2]

It undoubtedly would have been difficult to prove to a jury of laymen the question of "reasonable investigation" and "reasonable ground to believe." The extent of the damages to which an investor might be entitled was specified in Section 11(e) of the Act as:

> The suit authorized under subsection (a) may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or (2) for damages if the person suing no longer owns the security.[3]

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[1] *Ibid.*, p. 10.

[2] U.S., *Securities Act of 1933* (Washington, D.C.: Government Printing Office, 1933).

[3] *Ibid.*

The failure to limit the amount of "damages" in part two caused additional alarm. The liability which was imposed on the accountant might have only a slight relation to and be greatly in excess of the damage caused by the accountant's error. A possibility which was seriously proposed at the time, however extreme it appears today, indicates the attitude among accountants:

> For example, in a $1,000,000 stock issue, the accountant may have made an untrue statement of a material fact by omitting to mention liabilities of $100,000, which in the average case would presumably have affected the value of the securities when issued to the extent of ten per cent. By reason of ensuing business conditions the stock which sold for $1,000,000 and in the average case should have sold for $900,000, had the accountant been correct in his statement, may fall on the stock exchange to a total value of $100,000, the stock which was issued at 100 then selling at 10. In this situation the stockholders may tender it to the accountant and require him to pay the consideration that they have given for it with the adjustment heretofore mentioned, so that if all the original purchasers still have their stock the accountant will have to pay approximately $1,000,000 and will receive stock worth only $100,000, a net penalty to the accountant of $900,000, although his error only affected the stock to the extent of $100,000.[1]

Even though such an example appears to be absurd in light of current practice, the prospect of a stock being issued at 100 and subsequently dropping to 10 was not regarded as impossible in 1933.

Other comments made about the Securities Act of 1933 cast doubts about the future of the accounting profession.[2]

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[1]Spencer Gordon, "Accountants and the Securities Act," The Journal of Accountancy, LVI (December, 1933), p. 447.

[2]James Hall, "Problems of Accountants under the Securities Act of 1933," The Journal of Accountancy, LVI (December, 1933), p. 452.

Mr. James Hall suggested in an article that accountants who accepted engagements for examinations that involved the registration of securities under the provisions of the Securities Act might be subjected to legal blackmail and unjust claims by disgruntled investors.[1]

With such dire predictions concerning the future of the profession there is little wonder that accountants sought to have the Securities Act of 1933 amended. These amendments were contained in the Securities Exchange Act of 1934. The examples which have been pointed out are representative of the reception given the Securities Act of 1933 by accountants. While it would have appeared that the position of the independent public accountant was greatly enhanced because of the provision that financial statements had to be certified, only occasional reference to such enhancement can be found. The burden of responsibility apparently outweighed any expected benefits from the passage of the Act.

The greatest threat to the accounting profession appears to have been the possibility of "strike suits," which were lawsuits for alleged negligence, carelessness or fraud, sponsored by disreputable lawyers, following the insolvency of a firm. If the insolvent firm had issued financial statements immediately preceding its difficulties, certified by professional accountants, which failed to reveal the impending insolvency, the position of the accountant was,

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[1] Ibid., p. 453.

at best, precarious. The inference was given that the certifying accountant was left vulnerable to a lawsuit that might be little short of legal blackmail.[1] Some accounting firms withdrew from engagements they had previously had because their client's financial position was too weak to warrant their assumption of the risk involved. Other accounting firms required their clients to idemnify them against loss; still others added a charge to their regular professional fees sufficient to purchase an idemnity bond.[2]

The Securities Exchange Act of 1934

Title II of the Securities Exchange Act of 1934[3] amended the Securities Act of 1933 in regard to damages. The amendment limited damages to the difference between the amount paid for the security and either the value thereof as of the time the suit was brought, or the price at which the security was sold after the suit was filed but before judgment if such damages are less. The limitation on suits also included the provision that suits had to be instituted within one year after the discovery of an untrue statement or omission and in no event more than three years after a

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[1]Joseph J. Klein, "Accountancy, the Most Hazardous Profession," The Certified Public Accountant, XVI, No. 10 (October, 1934), p. 604.

[2]The Certified Public Accountant, XVII, No. 2 (February, 1935), p. 107.

[3]U.S., Securities and Exchange Commission, Laws, p. 54.

security was offered to the public.[1] In discussing these changes one writer[2] felt that most of the objections to the Securities Act of 1933 concerning liabilities of accountants had been removed.

The remaining major objection raised by accounting practitioners was that of complying with elaborate filing requirements.[3] One of the most common complaints was that a voluntary movement could always attain higher standards than an outside commission.[4] This position might prove true if a voluntary movement were properly motivated. However, in the case of accounting standards, little progress was made until there was intervention by the federal government. The most burdensome of the items to be included in registration statements included the following:

> The details of ledger value, cost, profits to affiliates, unrealized appreciation and other historical information required for all major classifications of property, plant and equipment from the date of organization, or if not practicable, beginning January 1, 1922.
> The amounts of depreciation taken for financial purposes with the amounts claimed for federal income taxes for every year for which federal income tax returns have been filed.

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[1] *Ibid.*

[2] Spencer Gordon, "Liability of Accountants Under Securities Exchange Act of 1934," *The Journal of Accountancy*, LVII (October, 1934), p. 254.

[3] Rodney F. Starkey and A. I. Henderson, "Practice Under the Securities Act of 1933 and the Securities Exchange Act of 1934," *The Journal of Accountancy*, LVII (December, 1934), p. 433.

[4] *Ibid.*, p. 435.

Cost and other statistical information for each investment without specific limit of the period of time to be covered.

Historical statistical information for capital stock and surplus accounts.[1]

More important than the amendments concerning the liability of accountants was that section of the Securities Exchange Act of 1934 which created the Securities and Exchange Commission. The Securities and Exchange Commission was created by Section Four of the Securities Exchange Act of 1934[2] which provided for five commissioners to be appointed by the president by and with the advice and consent of the Senate. The members of the commission were to be chosen from both major political parties and, if practicable, members of different political parties should be appointed alternately. A further provision was made that no commisioner should engage in any business, vocation or employment relating to the stock market or in any activity whose operation in any way was governed by the Commission.[3] The Securities and Exchange Commission then became responsible for administering both the Securities Act of 1933 and the Securities Exchange Act of 1934.

The first group of Commissioners appears to have been a particularly fortunate choice as far as the accounting profession was concerned. The group included men who

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[1] Ibid.

[2] U.S., Securities and Exchange Commission, Laws, p. 29.

[3] Ibid.

had assisted in drafting both the 1933 and 1934 acts as well as in the administration of the Securities Act by the Federal Trade Commission. One of the first official acts of the new Securities and Exchange Commission was a request forwarded to the two principal groups of accounting practitioners, the American Institute of Accountants and the American Society of Certified Public Accountants, to make recommendations regarding accounting matters to the Commission.[1]

With a separate agency established to coordinate the requirements of the two acts, representatives of the American Institute of Certified Public Accountants at once entered into discussions with the Commission concerning suggestions for changes and regulations to be issued under the new act. The committee of accountants offered the following suggestions to the Securities and Exchange Commission.

1. The financial information required should be limited to that which would be of substantial value to investors.
2. Uniformity of major accounting principles in a particular industry is desirable as an ultimate objective, though uniformity in their application may be undesirable. For the present, corporations should be required merely to indicate the principles which are followed.
3. No standardized forms of financial statements should be prescribed. Statements in the form and detail best adapted to the particular conditions should be accepted.
4. There should be coordination of the requirements

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[1]"Securities and Exchange Commission," The Certified Public Accountant, XV, No. 2 (February, 1935).

relative to financial statements for:
(a) Listing on a national securities exchange;
(b) Registration statements and prospectuses under the securities act of 1933;
(c) Annual reports.

This would entail substantial modification of the present regulations under the Securities Act.

5. The Commission should endeavor to advise investors as to limitations of financial statements as guides to the value of investments.
6. If the commission should decide to require quarterly reports, these reports should consist only of income statements; they should be issued promptly; and they should be in condensed and comparative form; and they may be based on estimates if necessary.
7. The commission should encourage corporations to adopt their natural business years as fiscal years.[1]

It is obvious from reading the above list that accountants sought changes which would leave the development of accounting principles entirely to the accounting profession. It must be remembered that the status of accounting principles in 1934 was that of the brief recommendations made by the American Institute of Certified Public Accountants to the New York Stock Exchange in January, 1934.

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[1]Rodney F. Starkey and A. I. Henderson, "Practice Under the Securities Act," p. 445.

CHAPTER III

EARLY SECURITIES AND EXCHANGE COMMISSION EXPERIENCE WITH ACCOUNTING PRINCIPLES

Early S.E.C. Decisions

After the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, administrative control was established which permitted the Securities and Exchange Commission to review the financial statements of those companies who planned to issue new securities before the securities could be sold as well as the financial statements of those companies whose stock was traded on a security exchange. Most of the Commission's early experience was concerned with the registration of new companies and the cases which will be cited indicate the problems which confronted the Commission.

Northern States Power Company[1]

The Northern States Power Company case was one of the first major issues settled by the Securities and

[1] Northern States Power Company, Securities Act Release No. 254 (1934).

Exchange Commission and was concerned with debt discount and expense. Prior to 1934 Northern States Power Company followed the practice of amortizing debt discount and expense by charges against income over the lives of the respective issues. In 1924 there was an appraisal made of its properties by an affiliate, based wholly on an estimate of the cost of reproducing the property new. On the basis of this appraisal the company wrote up its fixed capital and investment accounts approximately $15,000,000, crediting about $7,000,000 to a retirement reserve and about $8,000,000 to capital surplus. In 1924 and 1925 Northern States wrote off substantially all of its unamortized debt discount and expense against capital surplus. The effect of this write off was to relieve the income account of amortization charges of approximately $5,000,000. The accountant's certificate described the situation, and, after saying "subject to the foregoing comments," certified to the statement. Before the registration statement became effective the accountant's certificate was amended to read "except for the matters discussed in the foregoing comments." The auditors did not indicate either approval or disapproval of the accounting procedure. The Commissioners of the Securities and Exchange Commission were divided in their opinion about the accounting treatment with three commissioners indicating that disclosure in notes to the financial statements was sufficient and two Commissioners asking that the balance sheets and the earnings and surplus statements be restated.

Although the Commissioners accepted the registration statement as filed, with the accounting treatment described in a note to the financial statements, they said that a more detailed expression of the circumstances and of the views of the majority and minority would be made public at an early date.[1] The explanation promised by the Commission was never issued and questions concerning the accounting treatment in the Northern States Power Company continued to arise, until Accounting Series Release No. 4 was issued in 1938.

Other Early Cases. In another early case the Federal Trade Commission, the agency administering the Securities Act of 1933 until the S.E.C. was created, held that promoters' fees had to be listed separately from expenditures representing the consideration for property.[2]

In a case involving the valuation of property, the Commission noted that where stock issued in part payment for property was valued at par in determining the cost of such property to the registrant, that such valuation was false and misleading when all other sales of stock were at varying prices, all considerably below par.[3]

Where a company recorded land at its appraised value and the appraisal failed to consider the cost to the promoters which was a small fraction of the appraised value

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[1]*Ibid.*

[2]*Unity Gold Corporation*, S.E.C. Decisions and Reports, Vol. 1., p. 25.

[3]*Ibid.*

and disregarded assessed value for tax purposes, the Commission held that such appraised value was misleading.[1]

In another early case a company included as "miscellaneous other income" amounts contributed by one of its sales agents. Without the contribution the company would have operated at a loss. The Commission in this case said that such accounting treatment would:

> render the profit and loss statement false and misleading since sound accounting theory and practice require that no income be considered as having been realized from these contributions and they should have been reflected on the balance sheet as donated surplus, and a corresponding amount representing the loss resulting from the company's operation should have been shown on the balance sheet as "earned surplus--deficit."[2]

Another company attempted to avoid the reporting of a loss and a deficit by capitalizing the excess of total expenses over total income as an asset called "development," and the Commission again ruled that the registration statement could not become effective.[3]

In the early years of its existence the Securities and Exchange Commission did not refuse companies the right to record appraised values in their accounting records. The Commission was concerned mainly with false and misleading appraisals. The Commission made its position clear when it

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[1] Continental Distillers and Importers Corporation, S.E.C. Decisions and Reports, Vol. 1, p. 54.

[2] National Educators Mutual Association, S.E.C. Decisions and Reports, Vol. 1, p. 208.

[3] Virginia City Gold Mining Company, S.E.C. Decisions and Reports, Vol. 2, p. 855.

ruled in a decision:

> If an appraisal or a representation of value purportedly based thereon is not to be misleading, the appraisal must meet two tests: first, it must be based on scientific method; secondly, there must be a fair and accurate application of the methods purported to be followed.[1]

Early Decisions Under the 1934 Act

After its first experience with the Securities Act of 1933 and the registration statements of newly-formed corporations, the Securities and Exchange Commission began to examine problems arising out of filings under the Securuties Exchange Act of 1934. The next two cases to be examined will illustrate the Commission's interest in the quality of the examination conducted by certifying accountants. These two cases have probably had a greater effect upon the practice of accounting than any other decisions of the Securities and Exchange Commission.

Interstate Hosiery Mills, Inc.

Interstate Hosiery Mills, Inc., had filed false financial statements with the S.E.C. and the exchange on which the company's securities were traded. The financial statements substantially overstated the company's assets because of the falsification of records by an employee of the certifying firm of accountants. The employee of the accounting firm had acted as bookkeeper for the registrant and had

[1] Breeze Corporations, Inc., S.E.C. Decisions and Reports, Vol. 3, p. 709.

forged checks on the client firm. In an effort to cover up the fraud, the employee overstated cash, receivables and gross profits.

In addition to his duties as bookkeeper for Interstate Hosiery Mills, Inc., the employee also performed auditing functions. The S.E.C. held that the procedure followed did not constitute an independent audit.[1] The Commission held that the failure to disclose the extent to which the registrant's bookkeeping function was surrendered to an employee of the certifying accountant rendered the accountant's certificate false as to the scope of the audit and that knowledge by the registrant of so abnormal a departure from ordinary auditing practice imposed upon it considerable of the responsibility for the misdeeds of the accountant's employee.[2]

One of the principal issues of the case was whether the certifying accountants had exercised due care in reviewing the employee's work. Expert witnesses testified that the accounting firm's review of the employee's work was as extensive as that ordinarily made by other accounting firms. In commenting upon this testimony the S.E.C. said:

> . . . if we accept the views of these expert witnesses as to the usual practice followed by independent public accountants in reviewing the work of those responsible for the actual carrying out of audit procedures, in our opinion the practice requires thorough

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[1]Interstate Hosiery Mills, Inc., S.E.C. Decisions and Reports, Vol. 4, p. 706.

[2]Ibid.

revision.[1]

Commenting further regarding the review of work of subordinates, the Commission indicated that the review should first, insure the integration of the working papers with the financial statements and second, include a searching analysis of the ultimate facts developed in the course of the audit. The Commission said:

> An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements, but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner, but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work as well as those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgement of a more experienced person who can by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules, reach an informal judgement both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves.[2]

[1] Ibid.

[2] Ibid., p. 716.

McKesson and Robbins, Inc.

Because of the extraordinary effect upon the practice of accounting that this case has had, any discussion of the influence of the S.E.C. upon accounting would be incomplete without a thorough review of the pertinent facts.

Brief History of McKesson and Robbins, Inc.

McKesson and Robbins, Inc. (Connecticut) was organized in 1926 in order to complete a merger of McKesson & Robbins, Inc. (New York), an old-line drug company, with a company owned by a man known as Frank Donald Coster.

In the following ten years, the new firm of McKesson & Robbins, Inc., organized two new companies, a subsidiary McKesson & Robbins, Limited, of Canada, formed apparently for the purpose of manufacturing and selling to British possessions and a new McKesson & Robbins (Maryland) became a holding company for 43 wholesale drug firms as well as the original Connecticut corporation.

Fraudulent operations consisting of fictitious purchases and sales apparently were originated prior to 1926 in the Coster--owned Girard & Co.[1] These operations were centered in the Canadian subsidiary where 98% of the assets and 88% of the net sales were completely false.[2] The

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[1]Report on Investigation, United States of America before the Securities and Exchange Commission in the Matter of McKesson & Robbins, Inc. (Washington, D.C.: U.S. Government Printing Office, 1940), p. 48.

[2]*Ibid.*, p. 42.

president of the company had been involved in other fraudulent activities in New York and had changed his name from Musica to Coster. Musica was aided by three brothers, one of whom served as assistant treasurer in charge of the office in the Connecticut branch. A second brother was responsible for shipping, receiving, plant purchasing and warehousing. The third brother supervised the preparation of the statements of the various firms with which the Canadian firm presumably dealt.

According to the investigation, the records showed that there were five different vendors in Canada from which foreign drugs were purchased. The purchase orders were initiated by the brother who acted as treasurer and authorized the vendor to draw a draft on the McKesson & Robbins' banking firm, Manning & Company. After issuing the purchase order, invoices were supposedly received by the second brother who was in charge of the receiving department. The receiving report stated that the goods were being held by the vendor until they were sold--at which time they were to be shipped directly to the customer by the vendor.[1]

The banking firm, Manning & Company, which acted as a clearing house for purchases and sales of crude drugs was a completely fictitious bank. The McKesson companies were charged for payments to vendors and credited for collections from customers. No checks were drawn on Manning & Company,

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[1] *Ibid.*, p. 68.

and the balance of its account was not included in the list of banks on the daily cash report of McKesson & Robbins, Inc.

The Audit

Internal Control--It is easy, thirty years after the investigation, to suggest that the system of internal control of McKesson & Robbins, Inc., was weak. The duties of the brother who acted as assistant treasurer included the control of cash receipts and disbursements and also that of buying and selling. Another brother had responsibility for warehousing and also receiving and shipping. The instructions included in the audit program called for comments on the system of internal control, but the senior in charge of the Bridgeport audit reported only that he had surveyed the system and was sure that it was satisfactory. After working on the audit for eight years, the senior could not describe the way the transactions in foreign crude drugs were handled.[1]

Cash--The measuring standard for conducting an audit during the period of the McKesson & Robbins, Inc., case was that provided for in the American Institute's bulletin "Examination of Financial Statements by Independent Public Accountants." The audit of the cash account of McKesson & Robbins, Inc., was in substantial agreement with that bulletin except for one item in the bulletin which states:

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[1] Ibid., p. 189.

"In certain instances such comparison (cash receipts) may be extended to include a check of original deposit slips or authenticated copies thereof."[1] Coster's agreement with the audit firm of Price Waterhouse & Company provided that neither the original deposit slips nor authenticated copies were to be obtained from the bank. The deposits shown on the bank statements were compared only with the details of the cash book. The Commission commented on the audit procedures followed by Price Waterhouse as follows:

> We contend that normal audit procedure did not require Price, Waterhouse & Company to secure original deposit slips from the banks as a part of their balance sheet examination. Having called the procedure to the attention of the client as a desirable step to take if the audit was expected to reveal defalcations by cashiers, they violated no professional responsibility when they acquiesced to Coster's instruction to omit the procedure. However, they did examine duplicate deposit slips in offices other than the Bridgeport (the Canadian and Connecticut companies' headquarters) and to have secured authenticated copies from the banks would have entailed little, if any, extra work. Foregoing this additional step prompts an obvious reminder that if auditors in their judgement consider an audit procedure to be necessary under a given set of circumstances in order to provide a proper basis for their certification of financial statements, the omission of such a procedure at the request of a client would constitute an abdication of their professional responsibility if they nevertheless issued an unqualified certificate.[2]

<u>Accounts Receivable</u>--The audit program for accounts receivable of the Connecticut Division and the Canadian

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[1]"Examination of Financial Statements by Independent Public Accountants" (New York: American Institute of Accountants, 1936), p. 12.

[2]<u>Report on Investigation</u>, op. cited., p. 388.

company conformed substantially with the recommendations contained in the Institute's "Examination of Financial Statements by Independent Public Accountants." Three items included in the bulletin which were not contained in the Price, Waterhouse & Company audit were that:

1. Inquiry should be made into the practice of granting cash and trade discounts as well as claims of customers for allowances and the sufficiency of reserves provided.

2. The best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt. Arrangements should be made with the client and requests should be made in envelopes bearing the accountant's return address and enclosing return envelopes addressed to the accountant.

3. The amount of accounts receivable hypothecated should be shown on the balance sheet.[1]

Only item two would have added anything to the McKesson & Robbin, Inc., audit. If the audit firm had been permitted to send confirmation requests directly to the customers, the fraud would have been discovered. The firms listed as accounts receivable were real firms, but they had not done business with McKesson & Robbins, Inc. Probably the key provision in the recommendations of the American Institute's bulletin was that verification of accounts receivable be made only with the permission of the client.

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[1]"Examination of Financial Statement," p. 42.

According to the testimony of the expert witnesses, it was not uncommon for a client to deny permission because of the expense involved or the risk of offending customers.

The audit program followed by Price, Waterhouse & Company was generally accepted at the time of the audit. The failure of the program to reveal the fictitious accounts receivable could be attributed to two things: (1) the willingness to accept the accounts at face value, and (2) the failure to obtain direct confirmation from the debtor. In its findings the Commission stated that the

> Failure of that program to yield a warning to the auditors that the accounts of the foreign crude drug department were fictitious resulted from lack of observation and appreciation of the evidence on hand and the omission of direct confirmation, an audit step which at the time was generally considered optional except when there was cause for suspicion.[1]

<u>Effect of the Investigation on Auditing Procedures for Receivables</u>--After the Securities and Exchange Commission had launched its investigation into the McKesson & Robbins, Inc., case and before it had rendered any decision, the American Institute initiated action on apparent weaknesses in generally accepted audit procedures which had been disclosed by the investigation. A special committee on auditing procedure submitted a report entitled "Extensions of Auditing Procedure" which the Council of the American Institute of Accountants adopted May 9, 1939. The report

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[1]<u>Report on Investigation</u>, p. 392.

emphasized that it was the ultimate responsibility of the independent certified public accountant to adopt those procedures as in his professional judgement he thought appropriate. It recommended, however, that certain additional procedures regarding inventories and accounts receivable should be considered as generally accepted practice. The committee recommended further that in the event these additional procedures were not undertaken by the auditor, he should disclose that fact in his certificate.

The extended procedure relative to receivables was approved at the annual meeting of the American Institute of Accountants September 19, 1939, as follows:

> In regard to the question of confirming receivables by direct communication with the debtor, the following recommendation is made:
> That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represent a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirmation of receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgement.[1]

The S.E.C.'s findings regarding the receivables phase of the McKesson & Robbins, Inc., audit commended the action

[1]"Statement on Auditing Procedure No. 1," American Institute of Accountants (New York: American Institute Publishing Co., 1941), p. 7.

taken by accountants:

> A judicious confirmation of customers' accounts, while it has not been considered mandatory in all cases, is good practice and in our opinion should be a normal audit procedure. We, therefore, commend the recent action of the American Institute of Accountants in requiring this procedure whenever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern.[1]

Audit of Inventories--Inventories of merchandise constituted the largest single asset on the balance sheet of the McKesson Companies. The audit program provided for a thorough check of computations, footings, and comparison of prices and generally complied with the recommendations contained in the Institute's "Examination of Financial statements by Independent Public Accountants."

In addition to checking footings, computations, pricings, etc., another step in checking the inventories required an investigation of the methods of inventory taking and an examination of the perpetual records. Several of the expert witnesses testified that inquiries should be made of the individuals taking the inventory to determine that the methods were proper.[2] It was brought out that while Price Waterhouse & Company generally followed this procedure, inquiries were not made of the employees who worked under the direct supervision of Robert Dietrich (one of the Coster

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[1] Report on Investigation, op. cited., p. 388.

[2] Ibid.

brothers who committed the fraud), and would have been the employee responsible for inventory taking.

No book test for reasonableness would have revealed the character of the foreign crude drug inventories. Since the rates of turnover and gross profit remained relatively constant, it is not surprising that suspicions were not aroused. Only an independent inquiry of someone familiar with the drugs involved would have disclosed that the quantities shown as being on hand at any one time were highly unlikely. The expert witnesses stated that they would expect any seniors, managers or partners in charge of an audit to be familiar with the trade practices of a client under examination. There was wide disagreement among practicing accountants at the time of the McKesson & Robbins hearings as to the extent to which accountants should take responsibility as to inventory quantity, quality and condition. At one extreme, the view was held that the accountant should take no responsibility for quantity, quality or condition--that the representations of management were accepted and that fact was reported on the balance sheet.[1]

The view of the opposite extreme held that the accountant was obliged to do such work as he considered necessary to establish to his own satisfaction that the inventories were as represented. No statement is to be found

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[1] _Ibid._, p. 407.

that the auditor, having made such physical tests, then guaranteed that the inventories were as represented. The auditor stated only that having made sufficient tests to satisfy himself that in his opinion the inventories were substantially correct.[1]

Most text book material current at the time of the McKesson & Robbins, Inc., investigation supported the view that the accountant should assume a limited amount of responsibility as to inventories. One author stated that the auditor could not be an expert in highly specialized fields--for example distinguishing different grades of steel. Yet in the majority of cases the auditor could make such an examination that would enable him to certify to the balance sheet without qualification and to accept a reasonable degree of responsibility for the inventory.[2] The extent to which the examination would involve verification of inventory quantities would depend upon the size and kind of business, the adequacy of the perpetual inventory records, the opportunity for proving quantities by independent checks and the efficiency of those responsible for the custody and inventorying of the merchandise.[3] Another textbook author recognized the limitations of auditors as appraisers but pointed out that the auditor could satisfy himself by

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[1]*Ibid.*

[2]Robert H. Montgomery, *Auditing Theory and Practice*, 5th ed. (New York: The Ronald Press Company, 1934), p. 180.

[3]*Ibid.*

supervising the counting, weighing or measuring of a large part of the inventory.[1]

Effect of the Investigation on Accounting Practices--The special committee on auditing procedure of the American Institute of Accountants referred to earlier stated that the auditor is justified in giving consideration to both the effectiveness of the internal control and the methods of taking inventories in determining the extent of his inventory tests. The committee recommended that thereafter it would be generally accepted auditing procedure that in addition to tests of the inventory accounts and records he should, wherever reasonable and practicable, be present either in person or by his representative, at the inventory taking. He should satisfy himself by observation and inquiry as to the effectiveness of the methods of inventory taking and reliance to be placed in management's representations. The committee stated that in this connection the certified public accountant may require physical tests of the inventories to be made under his observation. Where inventories are kept on a perpetual basis supported by physical inventories, he may undertake the procedures outlined above at an interim date to satisfy himself as to the credibility of the perpetual records and whether they may be relied upon to support the inventory totals shown on the

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[1]William H. Bell, Auditing (New York: Prentice-Hall Inc., 1935), p. 153.

balance sheet.[1]

The published reports of the Securities and Exchange Commission since the McKesson & Robbins investigation have included no further cases having a pronounced effect on auditing procedures. Statements on auditing procedure issued by the American Institute have indicated no noticeable influence by the Commission. The manner in which auditing procedures should be administered was made the subject of Accounting Series Release No. 21, which will be investigated in the following chapter.

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[1] "Statements on Auditing Procedure No. 1," P. 5.

CHAPTER IV

ACCOUNTING SERIES RELEASES OF THE CHIEF ACCOUNTANT OF THE SECURITIES AND EXCHANGE COMMISSION

The Commission's Experience with Stop Orders

After using the stop order process to secure compliance with the Securities and Exchange Commission rules and regulations, the Commission became progressively more dissatisfied with the results obtained. The filing of corrected and amended registration statements by companies contributed very little to the development of acceptable accounting practices and principles. Although the Commission was reluctant to exercise its powers to prescribe accounting and reporting principles, it did not hesitate to urge the accounting profession to develop a uniform body of principles. It was not unusual during the early years of the S.E.C. for an accountant to present financial statements and, in his certificate, point out facts of inclusion or exclusion without expressing any opinion at all as to whether the statements properly reflected the facts or not. In writing about such problems confronting the Commission, Mr. Carman G. Blough, a CPA and the first Chief Accountant of the Securities and Exchange Commission and from 1944 to 1961, director of research for the American Institute of Certified Public Accountants, said:

> In our opinion, the protection of investors requires that the accountant who, by a narration of facts in his certificate, attempts to protect himself, should be required to express his opinion with regard to the propriety of showing the facts in the manner in which they have been shown. If all the facts have been treated in the statement in a manner he considers to be in accordance with accepted accounting practice, he should so state.[1]

Mr. Blough left no doubt in his article that the Securities and Exchange Commission intended to use its influence in the development of accounting when he said:

> The Securities and Exchange Commission is anxious to develop accounting practice and procedures on a high level, to bring to the investor for whose protection it was created a more dependable body of information than he has ever had before.[2]

Mr. Blough also noted that:

> With such broad powers over the accounting statements of companies coming under the jurisdiction of the commission, its decisions with reference to accounting policies, principles and procedures will undoubtedly have a material effect upon general accounting practices.[3]

In 1936, Mr. James M. Landis, Chairman of the Securities and Exchange Commission made a speech in which he complained of the accounting profession as follows:

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[1]Carman G. Blough, "Relationship of Securities and Exchange Commission to Accountant," The Journal of Accountancy, LXII (January, 1937), p. 28.

[2]*Ibid.*, p. 39.

[3]*Ibid.*, p. 23.

> The impact of almost daily tilts with accountants, some of them called leaders in their profession, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor. Such an experience does not lead readily to acquiescence in the plea recently made by one of the leaders of the accounting profession that the form of statement can be less rigidly controlled and left more largely to professional responsibility alone. Simplicity and more adequate presentation is of course an end much to be desired, but a simplicity that misleads is not to be tolerated.[1]

It was after criticisms such as these that the accounting profession undertook a program of cooperation with the S.E.C. whereby the Securities and Exchange Commission agreed to refer accounting questions to a committee of the American Institute of Accountants.[2] Even with such close association with the Securities and Exchange Commission that accountants had after the formation of the Special Committee on Cooperation with the S.E.C., the problem of inadequate auditing and accounting standards continued to plague the accounting profession. A hint of what steps the Securities and Exchange Commission proposed to take to solve these problems of reporting, auditing and accounting standards was contained in an article written by Mr. Robert E. Healy, a commissioner of the Securities and Exchange Commission. Mr. Healy wrote:

> The staff, as the result of instructions, has for

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[1]The American Institute of Accountants Special Commitee on Cooperation with S.E.C., "Cooperation with the S.E.C.," <u>The Journal of Accountancy</u>, LXIII (June, 1937), p. 436.

[2]<u>Ibid</u>.

> some time been studying the proposal to issue some rules dealing with accounting and appraisals. We are not thinking of a mass of rules or innovations in accounting. We are trying to express a few standards as to principles which we believe are accepted by a majority of good accountants, especially of those who do not assume the role of special pleaders for their more lucrative clients. The approach must be cautious, but my experience with accountants leads me to the conviction that they regret that standards are not more exactly defined. They recognize as we do that in many aspects of accounting, inflexible rules cannot now be laid down. But it cannot be that there are no real standards in accounting. It seems to me, that one great difficulty has been that there has been no body which had the authority to fix and maintain standards.[1]

Announcement of Policy of Issuing Accounting Series Releases

It was primarily because of the Commission's unsatisfactory experience with "stop orders" and "letters of comment" (also known as "deficiency letters") and of the generally vague concepts prevailing among accountants as to what constituted sound accounting principles or good accounting practice that the Commission first undertook the issuance of its Accounting Series Releases.[2]

Accounting Series Releases Affecting Accounting Principles and Practices

The first such release was issued on April 1, 1937, and dealt with the accounting treatment of losses resulting

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[1]Robert E. Healy, "The Next Step in Accounting," The Accounting Review, XII (March, 1938), p. 5.

[2]Arnold J. Pines, "The Securities and Exchange Commission and Accounting Principles," Law and Contemporary Problems (Durham, North Carolina; Duke University Press, 1965), p. 730.

from a revaluation of assets and announced "a program for the publications, from time to time of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."[1]

The accounting question involved the propriety of charging capital surplus with a reduction from net cost values of plant and equipment to a valuation established by the board of directors of a company instead of charging retained earnings with the write down. The opinion of the Chief Accountant, Mr. Carman G. Blough, that the charge should have been made against retained earnings served to reinforce one of the first principles recognized by the American Institute of Certified Public Accountants.[2] Because the question of making charges against capital surplus instead of retained earnings continued to be a problem, the American Institute felt that it was necessary to continue making its position clear. In an effort to solve the problem, the American Institute issued "Accounting Research Bulletin No. 3" which outlined the accounting procedures to be followed in a corporate readjustment or

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[1]U.S., Securities and Exchange Commission, Accounting Series Releases 1 to 77 Inclusive (Washington, D.C.: U.S. Government Printing Office, 1956), p. 1.

[2]"Audits of Corporate Accounts," American Institute of Accountants (New York: American Institute Publishing Co., 1934), p. 5.

quasi-reorganization.[1]

Accounting Series Release No. 2 was issued on May 6, 1937, and was the first of several releases dealing with the independence of accountants certifying to financial statements filed with the Commission. The text of the release stated:

> The Securities and Exchange Commission from time to time has been called upon to determine whether, in a particular case, the relationship existing between a registrant and an accountant was of such a nature as to prevent him from being considered independent for the purpose of certifying financial statements to be filed in connection with the registration of securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.
>
> In response to such requests, the Commission has taken the position that an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.
>
> In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than one percent of the partner's personal fortune.[2]

Independence of accountants had been discussed by members of the American Institute at its annual meeting in 1931, but no formal action was approved incorporating the

[1]"Accounting Research Bulletin No. 3," American Institute of Accountants (New York: American Institute Publishing Co., 1939), p. 6.

[2]Accounting Series Release No. 2, p. 1.

term "independence" until three years later.[1] The fact that the Securities Acts provided for certification of financial statements by an independent public or certified accountant explicitly introduced into law for the first time the concept of independence.[2] The Federal Trade Commission's first regulations under the 1933 Act provided that an accountant would not be considered independent with respect to a registrant when he had _any_ interest, directly or indirectly, or with whom he was connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director or person performing a similar function.[3]

After the Securities and Exchange Commission was formed the rule on independence was changed to _any substantial_ interest, direct or indirect. This rule served as a model for the American Institute rule passed in 1934 which held "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 a substantial financial interest in the enterprise or if he is committed to acquire such an interest."[4]

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[1] John L. Carey, _The Rise of the Accounting Profession From Technician to Professional 1896-1936_ (New York: American Institute of Certified Public Accountants, 1969), p. 240.

[2] _Ibid._, p. 197.

[3] _Ibid._, p. 198.

[4] _Ibid._, p. 243.

Even after the Securities and Exchange Commission issued its statement on independence contained in accounting Series Release No. 2, there was no general agreement on the interpretation of what constituted a "substantial" interest. The Commission continued to examine individual cases and issued Accounting Releases No. 12, 19, 22, 28, 37, 44, 47, 48, 51, 59, and 70, all covering various problems concerning the independence of accountants.[1]

The question of independence continued to be such a problem that the Securities and Exchange Commission amended its rule concerning independence. Accounting Series Release No. 79, issued on April 8, 1958 amended Rule 2-01 of Regulation S-X to read:

> 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.[2]

The American Institute of Certified Public Accountants began to attempt to amend its Code of Professional Ethics to conform to the new rule on independence. At the Institute's 1960 annual meeting the new rule on independence

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[1]Accounting Series Release No. 1-77.

[2]Accounting Series Release No. 79.

was discussed but no action was taken.[1] The amended rule was finally adopted by the membership of the American Institute in 1961, and has remained unchanged since January 1, 1964.[2]

The distinction between the Securities and Exchange Commission's view and the accounting profession's view of independence has been stated as follows:

> The S.E.C. emphasizes the specific relationships between an accountant and his client which gives rise to a presumption of lack of independence--the S.E.C. will not recognize an accountant as independent if any of the proscribed relationships exist.
> The Institute emphasizes the face of independence--the state of mind which the word denotes.[3]

There can be little question of the influence of the Securities and Exchange Commission upon the development of independence of accountants. This influence has been summed up as follows: "In fact it was the S.E.C. which first set up objective criteria by which a C.P.A. could be considered to lack independence without the necessity of proving a 'state of mind.'"[4]

The third accounting series release was issued on

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[1]Thomas G. Higgins, Thomas G. Higgins, CPA, An Autobiography (New York: privately published, 1965), p. 279.

[2]Ibid., p. 283.

[3]Louis H. Rappapert, SEC Accounting Practice and Procedure (New York: The Ronald Press Company, 1966), p. 22.6.

[4]John L. Carey and William O. Doherty, Ethical Standards of the Accounting Profession (New York: American Institute of Certified Public Accountants, 1966), p. 32.

September 13, 1937 and covered the Commission's views concerning the purpose of consolidated statements. The release stated that such purpose was to reflect the financial condition of a parent company and its subsidiaries as if they were a single organization and that the parent's actual equities in the subsidiaries' net assets be substituted for its investments in the consolidated statements.[1] While most textbooks agreed with Mr. Blough's opinion,[2] it had been the Commission's experience that many companies eliminated only the par or stated value of the stocks of subsidiaries with the result that the retained earnings of the subsidiaries were improperly included as retained earnings in the consolidated statements.[3] The release continued that after the parent company's investment account had been offset by an amount equal to the par or stated value of the subsidiaries' stock owned by the parent and its proportionate share of the subsidiaries retained earnings at acquisition, any remaining investment (representing the excess cost over the equity acquired) could be shown among consolidated assets.[4]

The opinion concluded with the following statement

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[1]Accounting Series Release No. 3.

[2]See particularly Arthur Lowes Dickinson, Accounting Practices and Procedures, p. 176.

[3]Accounting Series Release No. 3.

[4]Ibid.

which confirmed the Commission's purpose in issuing accounting releases:

> The opinion is the third of a series of interpretations on accounting principles which the Commission is publishing from time to time for the purpose of contributing to the development of uniform standards and practice in major accounting questions.[1]

Because the American Institute of Accountants had expressed concern that opinions of the Chief Accountant might be interpreted as having wider application than the Securities and Exchange Commission intended, Accounting Series Release No. 4 was issued on April 25, 1938, to clarify the Commission's administrative policy with respect to financial statements. The Commission's policy was announced as follows:

> In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.[2]

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[1] Ibid.

[2] Accounting Series Release No. 4.

This release was issued, at least in part, in response to an editorial in the Journal of Accountancy which had appeared in 1938 relating to the Accounting Series Releases and stated:

> It would be a grave mistake for the accounting profession, or for business in general, to accept these rulings as more authoritative than their authors intended them to be. The chief accountant of the Security Exchange Commission has publicly stated within the past three months that accounting releases of the Commission should "serve as a basis for discussion of accounting rules and standards and thus submit the commission's views to effective criticism."[1]

Mr. William W. Werntz replied to the editorial as follows:

> I do not feel that this language is at all appropriate when used in respect of the formal accounting opinions which have been rendered from time to time. While future advances in accounting theory and practice might result in modification of such releases, nevertheless, until then such accounting opinions set forth principles which must be observed in statements filed with the Commission.[2]

It should be noted that Accounting Series Release No. 4 provided that disclosure was not to be accepted in lieu of a correction of the financial statements if a different view as to the practice involved had been taken in a published opinion of the Chief Accountant. Under this statement the Commission could have compelled a registrant to make changes in its accounting procedures even though

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[1]"Effective Criticism," Editorial, The Journal of Accountancy, LXVI (December, 1938), p. 354.

[2]"Effective Criticism," Correspondence, The Journal of Accountancy, LXVII (January, 1939), p. 41.

substantial authoritative support could have been found for the practices adopted. In writing about research conducted by the S.E.C., Mr. Andrew Barr, now the Chief Accountant of the Securities and Exchange Commission, commented on Accounting Series Release No. 4 as follows:

> Reduced to its essentials this release says that the accounting principles followed must have authoritative support but that if a difference of opinion develops between the Commission and the registrant, then despite a marshaling of authorities behind the registrant's opinion, a previously published rule, regulation or other official release of the Commission, including the published opinions of its Chief Accountant would be controlling.[1]

Accounting Series Release No. 6 was issued on May 10, 1938 on the subject of "treatment of excess of proceeds from sale of treasury stock over cost thereof."[2] The Opinion of the Chief Accountant was as follows:

> Question has been raised with respect to the proper treatment of an item of $488,211.83 representing "excess of proceeds from sale of 12,200 reacquired shares of the company's capital stock over the cost thereof." These shares represent part of 41,400 shares of the capital stock of the registrant, a manufacturing company, reacquired by it prior to the year 1934 "for the purpose of resale when market conditions improve."
>
> Under the laws of most states there are certain legal restraints upon the issuance of new shares that do not apply to the sale of treasury shares. However, from an accounting standpoint, there appears to be no significant difference in the final effect upon the company between (1) the reacquisition and resale of a company's own common stock and (2) the reacquisition and retirement of such stock together with the subsequent

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[1]Andrew Barr, "Accounting Research in the Securities and Exchange Commission," The Accounting Review, XV (March, 1940), p. 91.

[2]Accounting Series Release No. 6.

> issuance of stock of the same class.
>
> It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.
>
> In my opinion the $488,211.83 excess of proceeds from the sale of 12,200 reacquired shares of this registrant's capital stock over the cost thereof should be treated as capital stock or capital surplus as the circumstances require.[1]

The language used in this release is almost identical to that used in Accounting Research Bulletin No. 1, issued September, 1939, by the American Institute of Accountants.[2]

On May 16, 1938, the Securities and Exchange Commission released Accounting Series Release No. 7 which contained the text of a letter by Mr. Carman G. Blough, Chief Accountant of the Commission, addressed to accountants practicing before the Securities and Exchange Commission and entitled "Commonly Cited Deficiencies in Financial Statements Filed under the Securities Act of 1933 and the Securities Exchange Act of 1934." This accounting series release probably had a greater effect upon accounting reports than any other outside influence.

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[1] Ibid.

[2] Committee on Accounting Procedure, Accounting Research Bulletin No. 1 (New York: The American Institute of Accountants, 1939).

This release stated deficiencies which existed in the accountants' certificates as follows:

1. Accountant's opinion in respect of (1) the financial statements of, and (2) the accounting principles and procedures followed by the registrant, not clearly stated.

2. Use of equivocal phrases such as "subject to the foregoing," "subject to the above comments," "subject to comments and explanations in exhibits," "subject to the accompanying comments," etc.

3. A reasonably comprehensive statement as to scope of the audit made not included in the certificate.

4. Adequate audit not made by certifying accountant. In this connection attention is directed to the regulation that accountants shall not omit "any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

5. Failure to certify all financial statements required to be submitted, e.g., failure to certify profit and loss statement as well as balance sheet, and failure to certify statements of registrant as well as statements of registrant and subsidiaries consolidated.

6. Financial statements and supporting schedules covered by the certificate not clearly identified.

7. Certifying that the accounting principles followed by the registrant are in accordance with the system of accounts prescribed by a State regulatory body, or in a particular industry, but without indicating whether the practice of the registrant is in accordance with generally accepted accounting principles and procedures.

8. Effect upon the financial statements of substantial changes in accounting policies of the registrant not commented upon and explained by the certifying accountants.

9. Effect upon the financial statements of the registrant's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.

10. Disclaimer of responsibility on the part of the certifying accountants with respect to matters clearly within their province.

11. Reservations on the part of the certifying accountants with respect to matters not within their province which might indicate that apparently the accountants were not satisfied that such matters as legal titles, outstanding liabilities, etc., were properly reflected in the financial statements.

12. Certificate undated, or not manually signed.

Other deficiencies cited by the Chief Accountant, Mr. Carman G. Blough, included the following problems with consolidated financial statements:

1. Failure to include footnotes indicating the method followed in dealing with the difference between the investment in subsidiaries, as shown in the parent's books, and the parent's equity in net assets of the subsidiaries, as shown in the books on the latter and to state the amount of such difference.

2. Amount of the minority interest in the capital and in the surplus of the subsidiaries consolidated not stated separately in the consolidated balance sheet.

3. Failure to state, as required, the principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated balance sheet.

4. Improper treatment, in consolidation, of surpluses of subsidiary companies existing at date of acquisition by parent company.

5. Preparation of consolidated profit and loss statement on a different basis than the consolidated balance sheet, e.g., inclusion in the consolidated profit and loss statement income and expenses of subsidiaries whose assets and liabilities are not reflected in the consolidated balance sheet but for which separate balance sheets are submitted.

6. Failure to eliminate intercompany items, or to explain satisfactorily the reasons for not eliminating such items.

In a continuation of the criticism of financial statements, <u>Accounting Series Release No. 7</u> outlined these further deficiencies:

1. Failure to state total of current assets and to designate the total.

2. Inclusion among current assets of assets not realizable within one year, excepting where recognized trade practices, which are stated, permit otherwise.

3. Classification, in the parent company's balance sheet, of receivables from subsidiaries as current assets, in cases where the subsidiaries classify their obligations to the parent company as noncurrent.

4. Failure to indicate, where required, assets hypothecated or pledged.

5. Failure to disclose, with adequate explanation, assets held conditionally.

6. Classification as marketable securities, securities not having a ready market.

7. Failure to state, where required, the basis of determining the balance sheet amounts of investment or marketable securities. In this connection the term "book value" is unacceptable.

8. Failure to state parenthetically the aggregate quoted value of investment and marketable securities when not shown on basis of current market.

9. Failure to reduce the carrying value of investments in subsidiaries to the extent of any dividends received thereon out of surplus of such subsidiaries existing at date of acquisition.

10. Inclusion in trade accounts receivable of accounts not properly within such category.

11. Failure to state separately in the balance sheet, or in a schedule therein referred to, major classes of inventory such as (a) raw materials; (b) work in process; (c) finished goods; and (d) supplies, or to use any other classification reasonably informative.

12. Basis of determining the amounts of the inventories

as shown in the balance sheet not stated.

13. Reserve for depreciation on appreciated value of fixed assets not provided.

14. Inclusion in carrying values of fixed assets, expenditures not properly includible therein, such as discount or commissions on capital stock and promotion expenses.

15. Method used in amortizing debt discount and expense not stated.

16. Failure to explain what provisions have been made for writing off discounts and commissions on capital stock.

17. Where treasury stock is carried as an asset, failure to state reasons for such practice.

18. Failure to state separately the amount of re-acquired long-term debt of the registrant.

19. Absence of a reserve for doubtful accounts not explained.

Liabilities

1. Failure to state total of current liabilities and to designate the total.

2. Inclusion, with general reserves, of accruals for taxes which are actual liabilities.

3. Failure to state separately by years, where required, the total amounts of the respective maturities of long-term debt.

4. Accounts and notes payable, and accruals, not segregated as required.

5. Deferred income not set out separately.

6. Failure to disclose, with full particulars, all contingent liabilities.

Capital Stock

1. Aggregate capital stock liability of each class of stock not stated separately.

2. Failure to show the number of shares authorized, in treasury, and outstanding.

3. Assigned or stated value of no par value stock not indicated.

Surplus

1. Failure to show in balance sheet the division of surplus into various classes, in cases where registrant has differentiated in its accounting for surplus.

2. Use of capital surplus to absorb write-down in plant and equipment which should have been charged to earned surplus.

3. Failure to date earned surplus account after deficit has been eliminated (with stockholders' approval) by a charge to capital surplus.

4. Failure to state amount of surplus restricted (a) because of acquisition of company's own stock and (b) to the extent of the difference between par, assigned or stated value of preferred stock and the liquidation value of such stock.

5. Deficit not clearly designated in the balance sheet.

6. Treatment of surplus of subsidiary at date of acquisition as earned surplus.

Profit and Loss Statement

1. Charges made to surplus rather than profit and loss for expenses or losses properly attributable to current operations.

2. Crediting profit and loss rather than surplus for sale of assets previously written off by a charge to surplus.

3. When opening and closing inventories are used in determining cost of goods sold, failure to state basis

of determining the amount of such inventories.

4. Where no depletion or depreciation has been provided, failure to indicate that fact and the effect upon current operations in the profit and loss statement.

5. Failure to state basis of conversion of all items in foreign currencies, and the amount and disposition of resulting unrealized profit and loss when significant.

6. Gross sales net of discounts, returns, and allowances not shown in profit and loss statement.

7. Failure to state separately, as required by instructions, gross sales and operating revenues when the lesser amount is more than 10 percent of the sum of the two items.

8. Selling, general, and administrative expenses not segregated in profit and loss statement.

9. Failure to explain in footnote to profit and loss statement, effect of change in significant accounting principle or practice.

10. Failure to show separately from other taxes surtax on undistributed profits or failure to state expressly that no liability existed for such tax.

11. Principle followed in determining the cost of securities sold not stated, e.g., "average cost," "first-in, first-out," "specific certificate or bond."

12. Failure to state basis of taking profits into income when sales are made on an installment or other deferred basis.

13. Failure to refer in profit and loss statement to supporting schedule when analysis of certain expenses is presented in such schedule.

Schedule of Property, Plant, and Equipment

1. Failure to show property by major classifications such as land, buildings, equipment, leaseholds, etc., where required.

2. Nature of changes in property, plant, and equipment

during the year not explained clearly, and accounts affected not indicated.

3. Failure to explain fully policy of amortization and/or depreciation of property, plant, and equipment credited directly to asset accounts.

Schedule of Reserves for Depreciation, Depletion, Amortization of Fixed Assets

1. Failure to follow instructions: "State the company's policy with respect to the provisions for depreciation, depletion, and amortization or reserves created in lieu thereof during the fiscal year."

2. Failure to comply with the instructions: "Where practicable, reserves shall be shown to correspond with the classifications of property in (property schedule) separating especially depreciation, depletion, and amortization."

3. Charges to reserves other than retirements, renewals, and replacements, not adequately described as required by instructions.

Schedule of Intangible Assets

1. Intangible assets not listed by major classes as required by instructions.

2. Failure to state policy with respect to provisions for depreciation and amortization of intangible assets in cases where a separate schedule for such reserves is not provided.

3. Failure to comply with instructions: "State the company's policy with respect to the provisions for depreciation and amortization of intangible assets, or reserves created in lieu thereof."

Schedule of Funded Debt

Each issue of funded debt not designated fully as required by instructions.

Schedule of Reserves

Failure to reflect all changes in reserves during the year and to properly describe major charges thereto.

Schedule of Capital Stock

1. Failure to list each issue of capital stock of all corporations in a consolidated group, whether eliminated in consolidation or not.

2. Treatment of unissued stock as treasury stock.

Schedule of Surplus

1. Failure to show division of surplus into classes when required by instructions.

2. Analysis of surplus account not included either in balance sheet or as a continuation of the profit and loss statement, or in a schedule referred to in the balance sheet.

3. Failure to describe in detail miscellaneous additions to and deductions from surplus.

Schedule of Analysis of Certain Expenses in Profit and Loss Statement

1. Amounts charged to cost and those charged to other profit and loss items not segregated.

2. Failure to report in this schedule all expenses pertaining to maintenance and repairs.

3. Items in this schedule at variance with other statements or schedules.

Schedule of Income from Dividends

1. Failure to show as required in column C of this schedule the "amount of equity in net profit and loss for the fiscal year" of affiliates, notwithstanding the fact that no dividends were received during the year from affiliates.

2. Failure to show separately for each affiliate the "amount of dividends" and the "amount of equity in net profit and loss for the fiscal year" when registrant does not meet requirements that these items may be reported in total only when substantially all the stock and funded debt of the subsidiaries are held within the affiliated group.

The criticisms cited in Accounting Series Release No. 7 apparently were valid for the majority of corporations. In commenting on common defects in financial statements one author noted that in spite of the progress made in the 1930's a considerable portion of contemporary statements were defective.[1] One of the major weaknesses in financial statements was the lack of detail in the income statement. One author suggested that a complete breakdown of items concerning sales, cost of goods sold and expenses should be shown on the income statement.[2] Another common defect was that of showing treasury stock as an asset. The preferable treatment recommended by almost all contemporary authors was to treat treasury stock as a deduction in the net worth section of the balance sheet.[3]

The subject which probably caused more confusion than any other at the time was that of reserves. Accountants themselves were responsible for the confusion because they used the word reserve to mean several different things. A valuation reserve was used to record depreciation and depletion of fixed assets and the estimated amount of uncollectible accounts receivable. Another type of reserve

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[1]John N. Meyer, Financial Statement Analysis (New York: Prentice-Hall, Inc., 1939), p. 37.

[2]Howard S. Noble, Accounting Principles, 4th ed. (Cincinnati, Ohio: South-Western Publishing Company, 1945), p. 41.

[3]Meyer, Financial Statement Analysis, op. cited., p. 42.

was used to record accrued liabilities of uncertain amounts such as "Reserve for Federal Income Tax." Still a third type of reserve was used to appropriate retained earnings for specific purposes so that they were no longer available for dividends.[1] Only the last type of reserve is currently shown in accounting records.

By insisting upon financial statements in which the most flagrant deficiencies had been corrected, the Securities and Exchange Commission gave support and strength to those authors, including almost all authors of textbooks who advocated the things that the S.E.C. was in a position to insist upon.

Accounting Series Release No. 8 dated May 20, 1938 established the Commission's concurrence with the cost principle as used in accounting. The release required the amendment of its balance sheet by a registering company to eliminate from its balance sheet surplus created by appraisal. An item reported as "surplus arising from revaluation of property" was accompanied by an independent appraisal which indicated that valuation represented "sound value." The term "sound value" was qualified by the appraiser as being "the value for use by a going concern having prospects for the profitable use, at normal plant capacity, of the properties appraised.[2]

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[1] Ibid.

[2] Accounting Series Release No. 8.

The Commission's action concerning the recording of appraisals in the records of companies was seemingly in conflict with the prevailing accounting theory. The American Institute of Accountants recognized the problem of accounting for appraisals in its Accounting Research Bulletin Number Five issued April, 1940.[1] This bulletin stated that historically, fixed assets have been accounted for on the basis of cost. This bulletin noted however, that fixed assets had occasionally been written up to appraised values because of rapid rises in price levels, and to adjust costs in the case of bargain purchases. The bulletin further stated that when appreciation had been entered on the books, income should be charged with depreciation expense computed on the written-up amounts.[2]

The result of the Securities and Exchange Commission's refusal to permit registration statements to be filed when such statements contained assets stated at appraised values was to eliminate such appraisals from generally being recorded in accounting records.

At the American Institute of Accountants' Council meeting in September, 1938, the Committee on Accounting Procedure was increased in size from seven to twenty-one members and a research division was established with paid

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[1] American Institute of Accountants, Accounting Research Bulletin No. 5 (New York: 1940), p. 37.

[2] Ibid.

assistants.[1] The announced plan was to eventually formulate pronouncements on specific procedures and practices.[2] This marked the beginning of the accounting profession's second major effort to establish what it considered to be generally accepted accounting principles. The feeling of the accounting profession was summed up by John L. Carey, Managing Editor of the Journal of Accountancy, in March, 1939 when he wrote:

> The necessity for frequent and prompt decisions on accounting questions in cases arising under the acts administered by the Securities and Exchange Commission, has emphasized the need for an early enunciation of accounting principles, rules or procedures (whichever may be the proper descriptive word) by the accounting profession itself. There is every reason to believe that the Commission will cordially welcome news of the establishment of machinery through which the accounting profession itself may regularly issue authoritative opinions on controversial questions. Pronouncements by the American Institute of Accountants' committee on accounting procedure based on the work of the new research department, and supported, as the plan provided, by a full statement of the reasoning underlying each conclusion, will carry authority.[3]

The action taken by the American Institute was partly in response to the Accounting Series Releases of the S.E.C. and partly because the Institute's Committee on Cooperation with the S.E.C. had experienced difficulty in convincing the S.E.C. that the Institute was the proper body to direct the

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[1]Higgins, An Autobiography, p. 166.

[2]Ibid.

[3]John L. Carey, ed., The Journal of Accountancy, LXVII (March, 1939), p. 130.

search for accounting principles.[1] In commenting on this failure to develop accounting principles, Mr. William W. Werntz, a CPA and the second Chief Accountant of the S.E.C. said:

> In part this original policy failed and the Commission found it necessary to take measures to implement directly the provisions of the statute dealing with the form and content of financial statements and with the accounting principles reflected therein.[2]

It was during this period of development by the American Institute that Mr. William W. Werntz became the Chief Accountant for the Securities and Exchange Commission. Mr. Werntz remained as Chief Accountant until 1947 and during his tenure Accounting Series Releases No. 9-60 were issued.

Accounting Series Release No. 9 was issued on December 23, 1938 and dealt with the balance sheet presentation of preferred or other senior classes of capital stock having preference on involuntary liquidation in excess of par or stated value.[3] Accounting Series Release No. 9 apparently caused little discussion among accountants and was considered an unimportant release. Because the Commission continued to receive financial statements which failed to disclose special liquidating preferences of preferred and other senior capital stock the Commission adopted stronger measures. In

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[1]Carey, The Rise of the Accounting Profession, p. 201.

[2]William W. Werntz, William W. Werntz: His Accounting Thought, ed. by Robert M. Trueblood and George H. Sorter (New York: American Institute of Certified Public Accountants, 1968), p. 490.

[3]Accounting Series Release No. 9.

adopting Regulation S-X in Accounting Series Release No. 12, in 1940, the Commission required that the involuntary liquidating value of preferred stock be stated per share and in total. If the excess of liquidating value was significant, the difference between the total preference on liquidation and the total par or stated value had to be stated.[1] The regulation settled the question of reporting preference requirements of preferred stock on involuntary liquidations and has been substantially adopted by the accounting profession for reporting purposes.

Accounting Series Release No. 10 was issued on December 23, 1938, and covered the accounting treatment of unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from the sale of capital stock.[2] The release stated:

> Question has frequently been raised as to the proper treatment to be accorded unamortized debt discount and expense applicable to bonds which, prior to maturity, have been retired by the use of funds derived from the sale of capital stock. As generally presented, the inquiry relates to the propriety of carrying such unamortized debt discount and expense as a deferred charge and amortizing it over the remaining portion of the original life of the retired bonds.
>
> While it may be permissable to retain on the books and amortize any balance of discount and expense applicable to bonds refunded by other evidence of indebtedness, similar treatment is not ordinarily acceptable, in my opinion, when funds used to retire the existing bonds are derived from the sale of capital stock. In such cases it is my opinion that, as a general rule, sound and generally accepted accounting

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[1] Ibid.

[2] Accounting Series Release No. 10.

> principles and practice require that the unamortized balance of the debt discount and expense applicable to the retired bonds should be written off by a charge to earnings or earned surplus, as appropriate, in the accounting period within which the bonds were retired.[1]

Objection to the Chief Accountant's opinion was raised by William D. Cranstoun, Editor of "The Commentator" in the Journal of Accountancy. His objection was:

> It is hardly to be expected that the ruling of the Commission will receive the immediate approval of accountants. That approval may not be forthcoming at all, because the soundness of the opinion is not self-evident and because no reasons are given to support a distinction between bonds where apparently no distinction should be drawn.
>
> The contrast drawn in the opinion is between situations in which bonds are refunded by other evidence of indebtedness and those in which bonds are retired out of funds derived from the sale of capital stock. The word "refunded" in the first case is ambiguous but presumably is meant to include situations in which a new issue of bonds is sold and an old issue is paid off out of the proceeds. If this interpretation is correct, then the distinction in the treatment of unamortized discounts is presumed to rest solely on the means by which new funds are raised. Is that a sound principle? Is it generally accepted practice?[2]

The announcement concerning the accounting treatment of unamortized debt discount and expense applicable to retired bonds was instrumental in shaping Accounting Research Bulletin No. 2 issued in September, 1939, and reaffirmed in Bulletin No. 18 issued in December, 1942. The accounting treatment recommended by the Chief Accountant of the Commission is now found on Chapter 15 of Accounting Research

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[1] Ibid.

[2] William D. Cranstoun, ed., "The Commentator," The Journal of Accountancy, LXVII (March, 1939), p. 179.

and Terminology Bulletins and is worded as follows:

> If the debt is discharged--otherwise then by refunding--before the original maturity date of the issue, any balance of discount and other issue cost then remaining on the books, and any redemption premium, should be written off at the date of such retirement by a charge against income.[1]

Accounting Series Release No. 19 was issued on December 5, 1940, and contained the summary of findings and conclusions of the Commission's report on the McKesson & Robbins, Inc., hearings held in 1939. The McKesson & Robbins, Inc., hearings were held because of evidence that the information contained in the registration statement and annual reports of McKesson & Robbins, Inc., was materially false and misleading. The purpose of the hearing was to determine:

> (1) the character, detail and scope of the audit procedure followed by Price Waterhouse & Co. in the preparation of the financial statements included in the registration statement and reports:
>
> (2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by Price Waterhouse & Co. in the preparation of the financial statements; and,
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> (3) the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.[2]

The Securities and Exchange Commission listed the following "Summary of Conclusions as to Individual Auditing

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[1]American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins, Final Edition, (New York: American Institute of Certified Public Accountants, 1961), p. 132.

[2]Accounting Series Release No. 19.

Procedures:"

1. Appointment and Responsibility of Auditors; Determination of the Scope of the Engagement.

   All appointments of Price Waterhouse & Co. as auditors for McKesson & Robbins, Inc., were made by letter from the president or the controller. While the Commission conceded that the appointment and the method of determining the scope of the engagement was according to generally accepted practice it recommended that the auditors be elected by a vote of the stockholders at the annual meeting. The Commission also suggested that if the auditors did not complete the engagement, they should render a report on the amount of work done and the reasons for not completing the engagement.

2. Organization and Training of Staff

   In commenting upon the practice of hiring large numbers of temporary employees during the busy season, the Commission urged corporations to adopt the natural business year for accounting purposes.

3. Investigation of New Clients

   The Commission suggested that when a new client was obtained the auditor should make an independent investigation of the company and of its principal officers before undertaking the work.

4. Review of the Client's System of Internal Check and Control

   In commenting upon this audit procedure the Commission said, "We are convinced by the record that the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certifying financial statements has been treated in entirely too casual a manner by many accountants. Since in examinations of financial statements of corporations whose securities are publicly owned the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized."

5. Cash

The comments concerning the audit procedures of the cash of McKesson & Robbins were as follows:

> The record is clear that the cash work performed on this engagement by Price, Waterhouse & Co. conformed in scope to the then generally accepted standards of the profession. It is equally clear to us that prior to this case many independent public accountants depended entirely too much upon the verification of cash as the basis for the whole auditing program and hence as underlying proof of the authenticity of all transactions. Where, as here, during the final three years of audit, physical contact with the operation of a major portion of the business was limited to examination of supposed documentary evidence of transactions carried on completely offstage through agents unknown to the auditors save in connection with the one engagement, it appears to us that the reliability of these agents must be established by completely independent methods. Confirmation of the bank balance under these circumstances was proven in this case to be an inadequate basis for concluding that all the transactions were authentic.

6. Accounts Receivable

The view taken by the Securities and Exchange Commission of the audit program for accounts receivable was that it conformed to the then generally accepted procedures for an examination of financial statements even though the program did not provide for the confirmation of the accounts. At the time of the McKesson & Robbins engagement, the circularization of accounts receivable was an optional auditing procedure.

7. Intercompany Accounts

In commenting upon the audit of the intercompany accounts the Commission stated:

> The record indicates that it is not enough for auditors to reconcile intercompany balances and that valuable insight into the company's manner

of doing business may be gained by a review of the transactions passed through such accounts during the year. Best practice we believe requires the latter procedure. In this case the recommended procedure, although employed to some extent, was not applied in a thoroughgoing and penetrating manner.

8. Inventories

In the McKesson & Robbins case, a total of $10,000,000 of inventories shown on the financial statements were found to be fictitious. Although the conclusion reached by the Commission was that the audit program used for the verification of inventories was essentially that which was prescribed by generally accepted auditing practice for the period, the Commission commented further:

> However, we find that a substantial difference of opinion existed among accountants during this time as to the extent of the auditors' duties and responsibilities in connection with physical verification of quantities, quality, and condition. Price, Waterhouse & Co., in common with a substantial portion of the profession, took the position that the verification of quantities, quality, and condition of inventories should be confined to the records. There was, however, a substantial body of equally authoritative opinion which supported the view, which we endorse, that auditors should gain physical contact with the inventory either by test counts, by observation of the inventory taking, or by a combination of these methods. Meticulous verification of the inventory was not needed in this case to discover the fraud. We are not satisfied, therefore, that even under Price, Waterhouse & Co.'s view other accountants would condone their failure to make inquiries of the employees who actually took the inventory and to determine by inspection whether there was an inventory as represented by the client.

9. Other Balance Sheet Accounts

The release continues with comments on the auditing procedures applied to other accounts:

> a. The testimony in respect to the auditing of plant accounts suggests that some accountants,

including Price, Waterhouse & Co., could, with advantage, devote more attention to physical inspection than has been general practice with them in the past.

b. The work in respect to liabilities was in accord with generally accepted practice but suggests the desirability of independent inquiry when large purchases are made from a very few otherwise unknown suppliers.

c. The record demonstrates the necessity of a thorough understanding of the client's tax situation which apparently was not obtained by Price, Waterhouse & Co. in regard to the application of the Canadian law.

10. Profit and Loss Accounts

The last item which drew unfavorable comment from the Securities and Exchange Commission was the manner in which profit and loss accounts were reviewed.

> We are of the opinion that such analyses of profit and loss accounts as were made were applied to improper combinations of departments with the result that significant relationships were concealed. It is our conclusion that the independent accountant is derelict in his duty if he does not insist upon having proper analyses available for his review. It is our opinion that best practice supports this view.[1]

The McKesson & Robbins, Incorporated, case and the resultant action taken by the Securities and Exchange Commission probably had greater effect upon the development of auditing procedures than any other single event. After the fraud was discovered in 1938, the accounting profession, through the American Institute of Certified Public Accountants, undertook a program of self-appraisal which led to the appointment of a separate committee to study auditing problems. The Committee on Auditing Procedure was appointed

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[1] Ibid.

on January 30, 1939, by the executive committee of the Institute "to examine into auditing procedure and other related questions in the light of recent public discussion."[1]

The Committee on Auditing Procedure issued its first statement on auditing procedure in October, 1939 as a result of the McKesson & Robbins case. Opinion number one, "Extensions of Auditing Procedure," dealt with extensions of auditing procedures with respect to inventories and receivables.

The extended auditing procedures as to inventories were as follows:

> That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.[2]

The extended procedures to be used in the audit of receivables were:

> In regard to the question of confirming receivables

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[1]The American Institute of Certified Public Accountants, Codifications of Statements on Auditing Procedure (New York, 1961), p. 7.

[2]American Institute of Accountants, Statements on Auditing Procedure No. 1 (New York: American Institute of Accountants, 1939), p. 6.

by direct communication with the debtor, the following recommendation is made:

> That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivable in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgement.[1]

Accounting Series Release No. 19 also was responsible for the development of auditing standards and audit reports. In commenting upon the form of certificate to be used in reporting upon the results of an audit the Chief Accountant said:

> We are of the opinion that the form of the accountant's certificate should be amended to include in addition to the description of the scope of the audit a clear certification that the audit performed was, or was not, adequate for the purpose of expressing an independent opinion in respect to the financial statements. If any generally accepted procedures are omitted these should be named together with the reasons for their omission. Exceptions to the scope of the audit or to the accounts must be clearly designated "exceptions."[2]

The importance of the McKesson & Robbins, Inc., report is pointed out by John L. Carey in his article as follows:

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[1] Ibid., p. 7.

[2] Accounting Series Release No. 19.

> This report must be distinguished from other reports of the Commission dealing with individual cases under de-listing or stop-order proceedings, no matter how important the individual cases may be. The announced purposes of the hearings on which this present report is based included the following extraordinary provision: to determine "the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements."[1]

In a continuation of the announced policy to be followed upon the conclusion of the McKesson & Robbins, Inc., investigation, the form of accountants' certificates served as the basis for another accounting series release.

Accounting Series Release No. 21, dated February 5, 1941, was issued to set forth the Securities and Exchange Commission's views respecting the form and content of accountants' certificates. The new rules under Regulation S-X were:

> Rule 2-02. Accountant's Certificates
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> (a) Technical Requirements.
> The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.
>
> (b) Representations as to the audit.
> The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii)

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[1]John L. Carey, ed., The Journal of Accountancy LXXI (January, 1941), p. 1.

shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinion required by paragraph (c) of this rule.

(c) Opinions to be expressed.
The accountant's certificate shall state clearly:

(i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

(ii) The opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and

(iii) the nature of, and the opinion of the accountant as to, any significant 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.

(d) Exceptions.
Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

<u>Rule 3-07. Changes in Accounting Principles and Practices.</u>

> If any significant change in accounting principle or practice, or any significant retroactive adjustment of the account of prior years, has been made at the beginning of or during any period covered by the profit and loss statement filed, a statement thereof shall be given in a note to the appropriate statement, and if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.[1]

This accounting series release was another which has had a substantial influence upon the development of accounting principles and practices. As a result of the discussions and correspondence initiated by the Securities and Exchange Commission with accounting organizations a new report form was adopted by practicing accountants.

<u>Accounting Series Release No. 21</u> contained the first reference to "generally accepted auditing standards."[2] This release was dated February 5, 1941, and became effective on March 1, 1941.[3] In the interim the Committee on Auditing Procedure of the American Institute of Accountants asked the Securities and Exchange Commission for its approval of the statement "In our opinion our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it included all procedures which we considered necessary."[4] The Committee indicated that in

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[1]Accounting Series Release No. 21.

[2]<u>Ibid</u>.

[3]<u>Ibid</u>.

[4]Statements on Auditing Procedure No. 5, p. 39.

discussions with the S.E.C. it had maintained that there was no criterion or group of criteria by which conformity of audit procedures in given circumstances to a generally accepted standard or standards could be factually determined and that any statement which the auditor made could be no more than an expression of belief.[1]

In reply to the Committee on Auditing Procedure, the Securities and Exchange Commission, through its Chief Accountant, William W. Werntz, noted that it had given careful consideration to the views of the Committee and other interested parties. As a result of the Commission's study, it was deemed necessary and appropriate to make a clear cut distinction between matters as to which the accountant was asked to express an opinion and the positive representation he is considered to make when he holds himself out as a professional and expert accountant or auditor. For that reason the Securities and Exchange Commission held that there was an inconsistency in the use of the words "In our opinion" to qualify a representation as to the application of generally accepted auditing standards.[2]

The American Institute of Accountants Committee on Auditing Procedure issued another statement one month later attempting to give further explanation of the term "generally accepted auditing standards."

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[1] Ibid., p. 38.

[2] Ibid., p. 40.

> A distinction was drawn by the Commission in its discussions with the committee between auditing standards and auditing procedures. Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures. In regard to inventory pricing, for example, auditing standards would require the auditor to satisfy himself by reasonable evidence and approval methods that the prices had been determined on a basis that was recognized as generally accepted in the circumstances. Procedures would embrace the details of his work, whether he satisfied himself by reference to cost records, purchase invoice, published quotations, subsequent selling prices, gross-profit test, retail method or any or all of these and other methods. The committee believes this distinction between standards and procedures has not been drawn with sufficient clarity in accounting literature and should be emphasized more than it is.
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> Subsection (b) (i.e.) is thus evidently intended to require the auditor to assure the reader that the examination would stand up in comparison with what competent auditors would have felt necessary in the particular case. The term "generally accepted auditing standards applicable in the circumstances" does not imply a representation that in the particular case all procedures were followed which would be followed in the majority of all cases. It rather implies evidence which accountants generally would consider adequate in the particular circumstances.[1]

The Commission's attempt to make a distinction between standards and procedures although not completely successful, laid the groundwork for the accounting profession. In November, 1941, Mr. Samuel J. Broad, Chairman of the American Institute of Accountants Committee on Auditing Procedure published an article which represented the first attempt to establish a limit on the standards which previously had been held to be not only "undefined" but also

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[1]Statements of Auditing Procedure No. 6, p. 46.

"indefinable."[1] Mr. Broad pointed out that the elements of due care, reasonable evidence, materiality and relative risk which underly all examinations must be considered in an attempt to establish standards.[2] The general standards which were proposed consisted of the following:

1. Consideration should be given throughout the course of the examination to the accounting practices applied with a view to reaching a conclusion as to whether they are in accordance with generally accepted accounting principles; and whether such principles were applied on a basis consistent with that of the preceding period.

2. The scope of the auditor's tests should be sufficient to satisfy him that the transactions actually occurred and that their results are properly stated.

3. Examination of documents requiring approval by the stockholders, directors or other authority.

4. The reasonable adequacy and effectiveness of the system of internal control.

5. Consideration of internal auditing program with an attempt to coordinate the two efforts.[3]

This article is of unusual importance because it marks the first published attempt to establish standards

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[1]Statements on Auditing Procedure No. 5, p. 38.

[2]Samuel J. Broad, "Auditing Standards," The Journal of Accountancy, LXXII (November, 1941), p. 390.

[3]Ibid., p. 393.

which could be used as a guide by the profession. After this start, very little was added to the development of auditing standards until 1947. In 1947 the American Institute of Accountants issued a report Tentative Statement of Auditing Standards--Their Generally Accepted Significance and Scope which explained auditing standards.[1] Generally accepted auditing standards included general standards, which related to the training, competence, and independence of the auditor, standards of field work which dealt with audit planning and minimum audit procedures and standards of reporting covering the items to be included in the audit report.[2]

Accounting Series Release Number Thirty-Two. This accounting series release which was dated March 10, 1942, discussed the requirements as to disclosure, by independent public accountants, of the principle followed in including or excluding subsidiaries in the consolidated statements and the requirements when a subsidiary previously included in financial statements is currently excluded. The text of the release is as follows:

> Inquiry has been made whether, under the rules of the commission, it is necessary for an independent public accountant to indicate in his certificate that generally accepted accounting principles and practices have not been applied on a basis consistent with that of the preceding year where a wholly owned subsidiary consolidated in the preceding year is not to be

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[1]American Institute of Accountants, Tentative Statement of Auditing Standards (New York: American Institute of Accountants, 1947), pp. 1-17.

[2]Ibid.

> consolidated in the year under review. The inquiry assumed that the registrant's policy in the past had been to consolidate all wholly owned subsidiaries and that the current exclusion of the subsidiary from consolidation was due to changed conditions and was made with a view to more fairly presenting the financial conditions and results of operations of the registrant and its subsidiaries.[1]

The conclusion reached by the Commission was that the accountant would have to indicate that generally accepted principles of accounting had not been followed on a basis consistent with that of the preceding year. Accounting Research Bulletin Number Fifty-One maintains the position that consistent consolidated statements should be filed from year to year in order for financial statements to be not misleading.[2]

Accounting Series Release Number Thirty-Five. Release number thirty-five, dated September 3, 1942, dealt with the disclosure to be given to certain types of provisions and conditions that limit the availability of retained earnings for dividend purposes.

Some of the more common situations described by the Commission were as follows:

1. Where treasury stock has been acquired.
2. When dividends are in arrears on cumulative preferred stock.
3. When the preference of preferred shares upon involuntary liquidation exceeds the par or stated value of such shares.

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[1]Accounting Series Release No. 32.

[2]American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletin, Final Edition (New York, 1961), ARB 51.

4. Where the provisions of a trust indenture or loan agreement prohibit the payment of dividends when such dividend payment would reduce the working capital of the firm below a stated level.

5. When a contractual arrangement permits the payment of dividends only from earnings from a specified date or if retained earnings exceeds a certain amount.

In commenting upon the requirements of the Commission, the Chief Accountant of the Commission, Mr. William W. Werntz, said:

> In my opinion, generally accepted and sound accounting practice requires the disclosure of restriction on surplus. . . . Minimum disclosure, in my opinion, would consist of a description of the restriction, indicating briefly its source, its pertinent provisions, and, where appropriate and determinable, the amount of the surplus so restricted. Such disclosure would be made either in a note to the balance sheet or in an appropriate place in the surplus section of the balance sheet.[1]

This position taken by the Securities and Exchange Commission reinforced the position of the accounting profession. In Accounting Terminology Bulletin Number One, the American Institute's Committee on Terminology discussed the use of the term retained earnings and stated:

> In connection with use of the term "retained earnings," there should, so far as practicable, be an indication of the extent to which the amounts have been appropriated or are restricted as to withdrawal.[2]

The Securities and Exchange Commission had taken a similar

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[1]Accounting Series Release No. 35.

[2]American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins, Final Edition (New York, 1961), p. 88.

position in its Accounting Series Release Number Nine.[1]

Accounting Series Release Number Thirty-Seven, issued by the Chief Accountant, Mr. William W. Werntz on November 7, 1942, was an amendment of Rule 2-01 of Regulation S-X and dealt with the question of independence of accountants. Rule 2-01 of Regulation S-X was amended by adding the following section:

> In determining whether an accountant is in fact independent with respect to a particular company, appropriate consideration shall be given to the propriety of the relationships and practices involved in all services performed for the company by such accountant, including the furnishing of a certificate or report as to any financial statements of such company which have been published or otherwise made generally available to security holders, creditors or the public.[2]

In determining whether certifying accountants were truly independent the Securities and Exchange Commission ruled that all of the circumstances surrounding the work of the accountant should be examined, not just the work done in certifying statements filed with the Commission. One of the Commission's main concerns was with a company which had substantial amounts due from officers and directors shown separately in balance sheets filed with the Commission but, in balance sheets contained in annual reports to stockholders included, without disclosure, under trade accounts and notes receivable. The Commission recommended that where an indebtedness resulted from a transaction between the company

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[1]Accounting Series Release No. 9.

[2]Accounting Series Release No. 37.

and one or more of the management, the certifying accountant should employ every means at his disposal to insist upon full disclosure by the company and, if he failed to persuade the company, should qualify his certificate or disclose in his report the information not set forth in the statements.[1]

The accounting profession has always been concerned with the problem of the independence of accountants certifying to financial statements. It was not until Accounting Research Bulletin Number Thirty was issued in August, 1947, however, that the problem of reporting receivables from officers, and employees was discussed. This Accounting Research Bulletin provides:

> This concept of the nature of current assets contemplates the exclusion from that classification of such resources as . . .(c) receivables arising from unusual transactions (such as the sale of capital assets, or loans or advances to affiliates, officers, or employees which are not expected to be collected within twelve months.[2]

Accounting Series Release No. 45, issued on June 21, 1943, was the Commission's first statement concerning its position on the treatment of premiums paid on the redemption of stock. The accounting for the capital of a corporation has traditionally been designed to meet statutory and corporate charter requirements and to show significant financial

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[1] Ibid.

[2] American Institute of Accountants, Accounting Research Bulletin No. 30 (New York: American Institute of Accountants, 1947), p. 249.

relationships. The corporate charter provides proper names of the various classes of stock, any preferences as to dividends and to assets in liquidation, whether par or no-par value stock, number of shares authorized and voting rights. In accounting for capital invested, the emphasis is placed on the source and nature of the owners' contributions, but separate accounts are provided for the par or stated values and for capital contributed in excess of the par or stated values for the shares that have been issued. In order to insure the proper accounting treatment of the capital accounts of the companies filing with the Securities and Exchange Commission, the Commission issued release number forty-five which stated:

> Inquiry has frequently been made as to whether a premium paid on the redemption of preferred stock in excess of the amounts paid in thereon may properly be charged against capital contributed by another class of shareholders or whether, when earned surplus is present, the excess premium should be charged thereagainst. The following case is typical.
>
> The A Corporation has outstanding, 10,000 shares of $100 par value 6 percent cumulative preferred stock which was sold at 105 and is redeemable at the option of the company on any dividend date at 110. There are also outstanding, 40,000 shares of $50 par value common stock which were sold at $60 per share. At the time the corporation proposes to call the preferred shares for redemption, the balance sheet reflects earned surplus of $300,000 and capital surplus of $450,000. The capital surplus consists of $50,000 paid in by preferred shareholders and $400,000 paid in by common shareholders.
>
> The case presented involves a fundamental principle of accounting maintenance of the distinction between capital and income. In recognition of this principle, it has long been agreed that paid-in capital may not be used to absorb expenses or charges that should be deducted from gross income or revenue to determine net income. While the charge involved in the instant case

is not relevant to a determination of the amount of net income, it does raise the cognate question of whether payment of redemption premiums in excess of the amount paid in on the shares being retired should first be considered to be distributions of available earned surplus, rather than of amounts paid in on shares still outstanding.

In order to maintain a proper distinction between capital and income, it is my opinion that it is necessary to consider the entire amount contributed by shareholders as capital regardless of whether reflected in the accounts as capital stock or as capital or paid-in surplus. When a corporation by appropriate legal action classified its share capital, with resulting distinctions in dividend rights, assets priorities, voting powers, and other matters, adherence to the principles mentioned, in my opinion, requires appropriate accounting recognition of the classification of shares not only in respect of the legal or stated capital but also in respect of the related contributions in excess of legal or stated capital. In my opinion, reflection of a redemption premium paid to one class of shareholders as a diminution of utilization of amounts contributed by another class, or by shares of the same class still outstanding, would ordinarily be inconsistent with recognition of these principles in that the capital contribution shown for outstanding shares would thenceforth be less than the amount actually paid in on such shares although (1) no amounts were in fact repaid in respect of the outstanding shares; (2) at the time of the disbursement there existed accumulated earned surplus; and (3) such earned surplus would therefore be available for distribution as apparently earned dividends, although in fact, capital contributed in respect of the outstanding shares had not been maintained intact.

It is, therefore, my opinion that in the case cited the amount paid preferred shareholders in excess of the amounts contributed by them should be charged to earned surplus. Also, if at the time of redemption any amounts are paid on account of accumulated unpaid dividends, such amounts should likewise be charged to earned surplus.

In the above example an entire issue of preferred shares was assumed to have been redeemed. If less than an entire issue were redeemed it would not, in my opinion, ordinarily be proper, in the light of the above discussion, to charge against capital surplus contributed by the preferred stock an amount per share in excess of the pro-rata portion of such capital surplus applicable to each share of preferred stock outstanding prior to the redemption in question.

In the case cited all of the capital surplus represented amounts paid in on shares still outstanding. In some cases a part of capital surplus may have resulted from the prior reacquisition and retirement of preferred or common shares at less than the amounts paid in thereon. Such capital surplus does not therefore represent any amounts paid in on shares still outstanding. Where this condition exists, I would ordinarily see no objection to utilizing such capital surplus for the purpose of absorbing the excess of the redemption price over the amounts paid in on the shares being retired.

There remain to be considered cases in which outstanding preferred stock is retired and replaced by new preferred stock, usually bearing a lower dividend rate. In such case, of course, a saving to junior security holders is accomplished which will be reflected in increased earnings applicable to junior securities, and unless distributed, in increased balances of earned surplus. In a number of such cases arising under the Public Utility Holding Company Act of 1935, where earned surplus was absent or inadequate, the Commission has as a matter of administrative policy raised no objection to a procedure designed to offset the redemption premiums against subsequent earnings. However, in such cases it has ordinarily been required that the annual offset be not less than the saving effected by the lower dividend rate on the new stock and that in any case the premiums be fully offset within a reasonably short period.[1]

Although the American Institute of Certified Public Accountants has never dealt specifically with the problem of premiums paid upon the redemption of preferred stock, it has always supported the position taken by the Securities and Exchange Commission. The Institute supported a similar principle in accounting for the retirement of treasury stock. As a general rule, the applicable par or stated value is deducted from the appropriate capital stock account. Any excess of cost over the par or stated value is first charged to any related invested capital in excess of par

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[1]Accounting Series Release No. 45.

value from shares no longer outstanding, and any remainder to retained earnings.[1] The procedure outlined above is followed when preferred stock is redeemed. If a premium over the par or stated value was received at the time of the issue and was credited to invested capital, premium on retirement should be debited to invested capital to the extent of the pro rata premium received when the stock was issued; any remaining premium should be debited first to any invested capital applicable to preferred issues previously redeemed in their entirety, and second, to retained earnings.

Accounting Series Release No. 50, dated January 20, 1945, was issued at approximately the same time that the American Institute of Accountants published Accounting Research Bulletin Twenty-Four, "Accounting for Intangible Assets."[2]

This opinion of the Chief Accountant of the Commission was worded as follows:

> Inquiry has been made as to whether in a financial statement required to be filed with the Commission goodwill may be written down or written off by means of charges to capital surplus. The goodwill in question resulted from the acquisition during the year of the assets and business of a going concern at a price of $2,000,000; payable in cash or its equivalent. It was determined that $1,750,000 was paid for the physical assets acquired and $250,000 for goodwill. It is now proposed to write off this goodwill by a charge to capital surplus.
>
> In my opinion the proposed charge to capital surplus

[1] Accounting Series Release No. 1, p. 7.

[2] Accounting Research Bulletin No. 24 (New York: American Institute of Accountants, 1944).

is contrary to sound accounting principles. It is clear that if the goodwill here involved is, or were to become, worthless, it would be necessary to write it off. Preferably such write-off should have been accomplished through timely charges to income, but in no event would it be permissible, under sound accounting principles, to charge the loss to capital surplus. The procedure being proposed would, however, evade such charges to income or earned surplus and would consequently result in an overstatement of income and earned surplus and an understatement of capital.

This position was expressly taken in the following paragraph of the Commission's opinion in "In the Matter of Associated Gas and Electric Company, 11 S.E.C. 1025:"

> the position taken with respect to intangibles not subject to amortization assumes that as long as the write-off is made because of conservatism before actual realization of the loss, the write-off may be made to capital surplus. This practice would permit a corporation to circumvent charges which should be made against income or earned surplus by recognizing them in advance as a charge against capital surplus and, in our opinion, it is not consistent with the fundamental principle that a distinction should be maintained between capital and income.[1]

The position outlined above was substantially the same as outlined in Accounting Research Bulletin No. 24 of the American Institute of Accountants. In this bulletin intangible assets are classified as type "a," those having a term of existence limited by law, regulation, or agreement, and type "b," those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life.

The cost of type (a) intangibles is amortized by systematic charges in the income statement over the period

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[1]Accounting Series Release No. 50.

benefited. When it becomes reasonably evident that the term of existence of type (b) intangible has become limited and that they have become type (a) intangibles, the cost should be amortized.

Accounting Research Bulletin No. 24, now chapter five of the Accounting Research Bulletin No. 43, states:

> When a corporation decides that a type (b) intangible may not continue to have value during the entire life of the enterprise it may amortize the cost of such intangible by systematic charges against income despite the fact that there are no present indications of limited existence or loss of value which would indicate that it has become type (a), and despite the fact that expenditures are being made to maintain its value. Such amortization is within the discretion of the company and is not to be regarded as obligatory. The plan of amortization should be reasonable; it should be based on all the surrounding circumstances, including the basic nature of the intangible and the expenditures currently being made for development, experimentation, and sales promotion. Where the intangible is an important income-producing factor and is currently being maintained by advertising or otherwise, the period of amortization should be reasonably long.
>
> The cost of type (b) intangibles should be written off when it becomes reasonably evident that they have become worthless. Under such circumstances the amount at which they are carried on the books should be charged off in the income statement.
>
> Lump-sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.[1]

Because the Securities and Exchange Commission had indicated in the Associated Gas and Electric Company case in 1940 that it would insist on amortization of intangible

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[1]Accounting Research Bulletin No. 43, op. cited.

assets by systematic charges to income, the American Institute of Accountants had no alternative except to adopt this principle of accounting.

Accounting Series Release No. 53, was issued on November 16, 1945, in order to outline the Security and Exchange Commission's views on the subject of accounting for income taxes.

In 1944 the Commission had circulated a proposed accounting series release for the purpose of obtaining comment from interested parties. The proposed release contained the Commission's conclusions concerning the matter of accounting for income taxes. Several individuals and firms and a committee of the American Institute of Accountants objected to the Commission's position. Subsequently, in December, 1944, the Committee on Accounting Procedure of the American Institute of Accountants issued a bulletin "Accounting for Income Taxes"[1] which differed substantially with the conclusions contained in the proposed Accounting Series Release. In response to what it considered to be the development of unsound accounting principles, the Securities and Exchange Commission issued Accounting Series Release No. 53 which contained the following conclusions:

> The purpose of this statement is to outline the Commission's views in the matter of so-called "Charges in lieu of income taxes" and of "provisions for income

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[1]American Institute of Accountants, Accounting Research Bulletin No. 23, (New York: American Institute of Accountants, 1944).

taxes" which are intentionally in excess of those actually expected to be payable; to give the reasons for that opinion; and to state its views on the points which certain accounting firms have made in connection with the principles discussed herein.

For some time there has been growing up a practice, tolerated by some accountants and sincerely advocated by others, pursuant to which the current income account is charged under the heading of income taxes or charges in lieu of income taxes, not only with the income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year. (In general, the unusual circumstances are based on differences in the accounting treatment of certain items for income tax purposes and for general financial purposes. For example, losses and expenses which had to be taken as income tax deductions in a given period were not also taken as deductions in the profit and loss statement for the same period. Instead, because of differences in accounting methods, such items had already been charged off against income in previous years, or were being charged off directly to surplus or reserves or were to be deferred and charged off against income in future years.) Certain public utility companies have included such charges and excessive income tax provisions among their operating expenses. This additional charge against income is, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The amount of the estimated reduction has been colloquially termed a "tax saving" and the general problem is loosely referred to as the "treatment of tax savings" (We think this terminology is undesirable in principle and possibly misleading.)

This practice with its variants has caused the Commission some concern and it seems desirable now to state our views as to the accounting procedures appropriate in such circumstances and to give reasons for them. In summary, our conclusions are as follows:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.
2. It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.
3. The use of the caption "charges or provisions in

lieu of taxes" is not acceptable.
4. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses written off.
5. The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.
6. It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.[1]

This release was the first issued by the Commission to take exception to a specific question of an accounting principle that the profession had already acted upon. After the release had been circulated the American Institute indicated its agreement with its conclusions by issuing a bulletin supplemental to Accounting Research Bulletin No. 23 entitled "The Use of Certain Procedures Suggested by Accounting Research Bulletin No. 23 in Statements Filed with the Securities and Exchange Commission."[2]

The feelings of the accounting profession were probably best indicated as follows:

> An example of regulation likely to be more restrictive than constructive is the Commission's release of November 16, 1945, on charges in lieu of taxes. For

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[1]Accounting Series Release No. 53.

[2]American Institute of Accountants, "Tax Reductions" in Statements of Income (New York: American Institute of Accountants, 1946).

> some years accountants have sought by various means to show more clearly the effect of unusual items upon taxes, and particularly to show an allocation of taxes payable as between earnings from regular operations and non-recurring items of loss and gain. The question was discussed, and certain recommendations made, in "Accounting Research Bulletin No. 23" of the American Institute of Accountants. It has been felt that such a showing would be helpful to those interested in trying to evaluate securities by studies of earning power.
>
> One would have supposed that such a showing would receive the support of a Commission interested in more information and full disclosure to the financial public. But in the release referred to, the Commission has, after very lengthy and somewhat captious discussion, issued flat rulings which prohibit some of the practices discussed, while allowing others. It is not necessary here to discuss the issues themselves, but only to express regret that the Commission should make a ruling which has the effect of blocking experimentation of this kind. . . Regulations of such character surely cannot pave the way to accounting progress.[1]

Accounting Series Release No. 53 has been considered to be the turning point in the use of accounting series releases as a vehicle for presenting opinions on accounting principles.[2] During the first seven years of issuing Accounting Series Releases, most of the releases dealt with specific questions of accounting principles that the accounting profession as a whole was not in a position to answer. Releases issued since 1945 have dealt more often with auditing standards, independence of accountants and disciplinary

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[1]Thomas H. Sanders, "A Review of Reviews of Accounting Progress," The Journal of Accountancy LXXXI (January, 1946), pp. 11-12.

[2]J. Arnold Pines, "The Securities and Exchange Commission and Accounting Principles," Law and Contemporary Problems (Durham, N.C.: Duke University Press, 1965), p. 732.

matters. Two of the reasons suggested for the decrease in the number of releases have been that there was an increasing consensus on accounting matters and that the Commission seemed to have determined sometime in the late 1940's, in response to urgings of the accounting profession, to give the profession an opportunity to undertake the formulation and dissemination of accounting principles.[1] At any rate, a period of approximately five years passed before the next release directly affected accounting principles.

Accounting Series Release No. 70, dated December 20, 1950, was issued by the Commission to reaffirm its support of the use of the "all-inclusive" income statement as opposed to the "current operating performance" income statement. The Securities and Exchange Commission first expressed its preference for the "all-inclusive" income statement shortly after the American Institute of Accountants issued Accounting Research Bulletin No. 32.[2] Accounting Research Bulletin No. 32 had approved the use of the "all-inclusive" income statement but recommended the exclusion of extraordinary items in the determination of net income.[3] The text of Accounting Series Release No. 70 contained the

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[1] Ibid.

[2] U.S., Securities and Exchange Commission, Annual Report, XIV (Washington: U.S. Government Printing Office, 1948), p. 111.

[3] American Institute of Accountants, Accounting Research Bulletin No. 32 (New York: American Institute of Accountants, 1947), p. 263.

following statement:

> The inclusion of this requirement, which states a long established policy of the Commission, is deemed necessary because of the not always consistent practice followed by some registrants of excluding certain items from the profit and loss or income statements with the result that the amount shown thereon as income or loss has been susceptible to misinterpretation by investors. Recognizing that there might be exceptional circumstances which would make it appropriate to deviate from this rule, but keeping in mind the Commission's responsibility for prohibiting the dissemination of financial statements which might be misleading to investors, Rule 5-03 Profit and Loss or Income Statements was amended to read:
>
> > Except as otherwise permitted by the Commission, the profit and loss or income statements filed for persons to whom this article is applicable shall comply with the provision of this rule. (Underscored phrase added in revision.)
>
> The purpose of this revision is to make clear to registrants that they are not forestalled from giving exceptional treatment to exceptional items when both the representatives of the registrant and the Commission are convinced that such treatment is appropriate.
>
> Notwithstanding this provision, representatives of the Executive Committee of the American Institute of Accountants appeared before the Commission and proposed that either Rule 5-03 (a) be eliminated from the regulation or the requirements with respect to the presentation of the final section of profit and loss or income statements be amended to permit, where appropriate, the exclusion of extraordinary items from those making up the caption "net income or loss."
>
> To accomplish this, additional items, described in Rule 5-03 (17) and (18), were added to those previously set forth in the regulation, and the last three items of the section pertaining to profit and loss or income statements (Rule 5-03) now appear as follows:
>
> "16. Net income or loss.
> "17. Special items.
> "18. Net income or loss and special items.[1]

[1]Accounting Series Release No. 70.

Reaction to Accounting Series Release No. 70 was immediate and recommended that accountants continue to follow the practice of reporting extraordinary items in the retained earnings account. In an article prepared by the Research Department of the American Institute of Accountants the following statement is made:

> Whether such items are shown as surplus items or tacked on after net income would not seem to be a matter of fundamental principle but rather one of presentation. Accordingly, simultaneous use of the two forms of display (one for the S.E.C. and the other for stockholder statements for the same dates and periods) would not require any exception in the opinion accompanying either set of statements nor would there be need for any note or other disclosure in either set of statements as to the form of presentation used in the other set.[1]

The same sentiments concerning the proper method of reporting the results of operations to stockholders was expressed by Mr. Carman G. Blough, Director of Research for the American Institute of Accountants, in an article as:

> It seems to us that the function of Rules 5-03 (17) and 5-03 (18) is to prescribe a method of disclosure of certain types of items. It follows that we do not believe that items reported to S.E.C. in conformity with these rules must be disclosed in the same manner in published reports to stockholders.[2]

Mr. Blough went on to caution accountants that where a special item was so extraordinary and material as to require

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[1]American Institute of Accountants, "Suggestions for Operating Under the S.E.C.'s New Rules Governing Financial Statements," The Journal of Accountancy, XCI, (February, 1951), p. 236.

[2]Carman G. Blough, "The Accountant's Problems Arising Under Revision of S-X," The Journal of Accountancy, XCI (February, 1951), p. 241.

exclusion from the income statement presented to stockholders and yet was required to be included in net income by the S.E.C., that the accountant might have no alternative but to qualify his certificate in the report filed with the S.E.C.[1]

Mr. Blough's warning was based upon a letter from the Chief Accountant of the Securities and Exchange Commission written to Mr. Blough at the time Accounting Research Bulletin No. 32 was issued. In disagreeing with certain aspects of that bulletin, the letter stated:

> Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32.[2]

It was Mr. Blough's opinion that it would be unreasonable to give an unqualified opinion that both statements fairly present the results of operations in accordance with generally accepted accounting principles when the statements differ materially as to the amount shown as net income.[3]

The position of the American Institute of Certified Public Accountants remained unchanged and Accounting Research Bulletin No. 41, issued in July, 1951, reaffirmed its

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[1]*Ibid.*, p. 242.

[2]Letter from Earle C. King to Carman G. Blough, December 11, 1947, *The Journal of Accountancy*, LXXXV (January, 1948), p. 25.

[3]Carman G. Blough, "Accountant's Problems," op. cited., p. 242.

statement that either the form recommended in Accounting Research Bulletin No. 35 or the form required by Regulation S-X was acceptable and that it was permissible for a company to use one form in one statement and a different form in another statement covering the same fiscal period.[1] When Accounting Research Bulletin No. 43 was issued by the American Institute of Accountants the "current operating performance" approach to income reporting was included as Chapter eight.[2]

The difference of opinion between the Commission and the Institute remained until December, 1966. At that time the American Institute of Certified Public Accountants issued Opinion No. 9, "Reporting the Results of Operations,"[3] which changed the method of reporting the results of operations to the "all inclusive" concept of reporting net income. The pertinent part of the Board's opinion is:

> The Board has concluded that net income should reflect all items of profit and loss recognized during the period with the sole exception of the prior period adjustments described below. Extraordinary items should, however, be segregated from the results of ordinary operations and shown separately in the income statement, with disclosure of the nature and amounts

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[1] American Institute of Accountants, Accounting Research Bulletin No. 41 (New York: American Institute of Accountants), p. 304.

[2] American Institute of Accountants, Accounting Research Bulletin No. 43 (New York: American Institute of Accountants).

[3] American Institute of Certified Public Accountants, Opinions of the Accounting Principles Board No. 9 (New York: American Institute of Certified Public Accountants, 1966).

thereof.[1]

With the release of this opinion, a long-standing difference of opinion between the Securities and Exchange Commission and the accounting profession was settled.

Accounting Series Release No. 76 points to another occasion where the Securities and Exchange Commission used a release in the area of accounting principles. In Accounting Research Bulletin No. 37,[2] and Accounting Research Bulletin No. 43,[3] the American Institute of Accountants considered the problem of measuring the amount of compensation to be recognized when a corporation granted stock options to its executive and key employees. In both bulletins the amount of compensation was considered to be the difference between the fair market value of the stock and the option price of the stock on the date the option was granted. Other dates considered to be important in measuring compensation were the date the option became exercisable and the date the option was exercised.[4]

Accounting Series Release No. 76, was issued because Securities and Exchange Commission had found "an apparent lack of unanimity of opinion among corporate and public accountants as to the appropriate manner," for measuring

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[1] *Ibid.*, p. 2.

[2] American Institute of Accountants, *Accounting Research Bulletin No. 37* (New York: American Institute of Accountants, 1948).

[3] Accounting Research Bulletin No. 43, Chapter 13.

[4] *Ibid.*

the amount of compensation to recipients of stock options to be charged to income.[1] The principal point of disagreement was the time at which the determination should be made. The Commission concluded that the propriety of using any one of the three dates mentioned above had not been established, and that it would be inappropriate to prescribe a procedure for determining the amount of cost, if any, of stock options to be reflected in income statements.

In the Commission's new rule prescribed in Accounting Series Release No. 76, significant data as to the stock option plan, the number of shares under option, the option price, the fair value and the total value at each of the three dates, and a statement as to the basis of accounting followed had to be furnished the Commission.[2]

Accounting Series Release No. 85 was issued on February 29, 1960, after several months of hearings, to announce its administrative policy regarding the balance sheet treatment of the credit equivalent to the reduction of income taxes arising from the deduction of costs for income tax purposes at a more rapid rate than for financial statement purposes.[3] Release No. 85 was issued because of differing views concerning the treatment of deferred income taxes which existed even though the position of the American

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[1]Accounting Series Release No. 76.

[2]*Ibid*.

[3]Accounting Series Release No. 85.

Institute of Certified Public Accountants had been made clear in Accounting Research Bulletin No. 44 (revised).[1] In this bulletin the recommended treatment of the credit equivalent to the reduction of income taxes arising from the deduction of costs for tax purposes at a more rapid rate than for financial statement purposes was as follows:

> There may be situations in which the declining-balance method (of depreciation) is adopted for income tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting recognition should be given to deferred income taxes if the amounts thereof are material.[2]

The Commission noted that some accounting firms that appeared before it at the oral presentation had urged that it was appropriate to designate as a part of earned surplus the credit arising from deferred tax accounting despite the contrary opinion of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants.[3] The Commission stated that it disagreed with such accounting firms and added:

> Moreover, the fact that there may be some authoritative support for different methods of classifying this deferred tax account does not preclude the Commission from determining for the future the manner in which the item should be classified in financial statements filed with it. In fact, as enunciated by the Commission in Accounting Series Release No. 4, dated April 25, 1938,

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[1]American Institute of Accountants, Accounting Research Bulletin No. 44 (New York: American Institute of Accountants, 1958).

[2]*Ibid.*, p. 1.

[3]Accounting Series Release No. 85, p. 2.

the question of authoritative support is pertinent only when the position of the Commission has not previously been published in official releases.[1]

The release as adopted by the Commission contained the following conclusion:

> Any financial statement filed with this Commission which designated as earned surplus (or its equivalent) or in any manner as a part of equity capital (even though accompanied by words of limitation such as "restricted" or "appropriated") the accumulated credit arising from accounting for reductions in income taxes resulting from deducting costs for income tax purposes at a more rapid rate than for financial statement purposes will be presumed by the Commission to be misleading or inaccurate despite disclosure contained in the certificate of the accountant or in footnotes to the statements, provided the amounts involved are material.[2]

The Commission also answered those critics who had questioned the statutory authority of the Commission to deal with the subject of the release by issuing such a statement of policy. The Commission noted:

> Under various statutes administered by it, the Commission has the authority and the corresponding responsibility to require that the financial statements filed with it be prepared in a manner which provides adequate and fair disclosure. This statement of policy is designed to advise all interested persons of the Commission's views as to the presentation in financial statements filed with the Commission of the credit arising when deferred tax accounting is employed . . . It is not intended to direct or establish any system of accounts or to specify the manner in which a particular item shall be recorded on the books of the reporting companies, nor is it intended in any way to affect the requirements of any other government agency, Federal

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[1] _Ibid._

[2] _Ibid._, p. 3.

> or state, with respect to the manner in which such books or accounts shall be kept.[1]

Accounting Series Release Number Ninety-Five was issued by the Commission to indicate that exception would be taken to financial statements which included profits from the sale of real estate where the circumstances indicated that profits were not earned at the time the transactions were recorded. This release was in response to companies choosing to report profits on sales in accordance with Accounting Research Bulletin No. 1 which states that "profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sales price is not reasonably assured."[2] The Commission's report stated the following position:

> The recognition of profit at the time of sale, in accordance with generally accepted accounting principles, is appropriate if it is reasonable to conclude, in the light of all the circumstances, that a profit has been realized . . . Thus, recognition of profit is appropriate only when a bona fide sales transaction has taken place, and then only to the extent that the consideration received in the transaction can be reasonably evaluated. In some of the situations coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities. Moreover even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale. Circumstances such as the following tend to raise

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[1] *Ibid.*

[2] Accounting Research Bulletin No. 1, p. 6.

a question as to the propriety of current recognition of profit: (1) Evidence of financial weakness of the purchaser. (2) Substantial uncertainty as to amount of costs and expenses to be incurred. (3) Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., nonrecourse notes, non-interest-bearing notes; purchaser's stock, and notes with optional settlement provisions, all of indeterminable value. (4) Retention of effective control of the property by the seller. (5) Limitations and restrictions on the purchaser's profits and on the development or disposition of the property. (6) Simultaneous sale and repurchase by the same or affiliated interests. (7) Concurrent loans to purchasers. (8) Small or no down payment. (9) Simultaneous sale and leaseback of property.

Any such circumstances, taken alone might not preclude the recognition of profit in appropriate amount. However, the degree of uncertainty may be accentuated by the presence of a combination of the foregoing factors.[1]

The Commission included the following illustrative cases where it deemed it inappropriate to recognize gross profit as having been realized at the time of the sale:

Case No. 1: On the last day of its fiscal year a registrant engaged principally in the development of real estate sold a block of 1,000 lots to a non-affiliated construction company for $1 million, receiving a cash payment of $100,000 and a nonrecourse note of $1 million due in 1 year, secured only by the lots transferred. Interest was limited to 6 percent for 1 year or $120 per house. A profit of $500,000 before taxes was recorded on the transaction.

The transaction was subject to, among others, the following conditions and arrangements:

a. Each lot was to be released upon payment of $1,000 plus interest at the time of closing the sale of a house and lot.

b. The registrant was to make the determination of when the houses were to be constructed and to arrange the construction loans.

c. The registrant was to be exclusive sales agent for the construction company, arrange financing and

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[1]Accounting Series Release No. 95.

conduct closings with the home buyers.
d. The construction company was to be paid a maximum of $500 profit and an additional $100 to cover overhead expenses on each house sold. Profits to be received by the construction company were to be applied against the note owed by the registrant.

Case No. 2: In September 1961 a registrant sold a block of improved properties to another corporation for consideration of $3,500,000 in cash, a $3,500,000 noninterest-bearing note, and 50,000 shares of the Class A stock of the purchaser which had a current market price of $15 per share. This sale was recorded at these amounts and showed a gain of $2 million after provision of $500,000 for possible loss and $1 million for Federal income taxes. The noninterest-bearing note is payable during the period from 1970 to 1980. Until 1968 the purchaser has the option of liquidating the note by the issuance of capital stock, the number of shares to be determined by dividing the face amount of the note, $3,500,000 by the lesser of $15 per share or 125 percent of the then current market price. After 1968 registrant may call for payment of the note in stock at $17 per share, and, if such call is made, the purchaser may elect to pay the note in full in cash.

Case No. 3: In September 1961 a registrant acquired approximately 500 acres of undeveloped land for $300,000 in cash and a mortgage of $900,000 and immediately sold the property to an affiliate of the original seller for $2,200,000. The purchaser paid $300,000 in cash, issued a $1 million noninterest-bearing deed of trust note maturing in 18 months, and assumed the $900,000 mortgage. Simultaneously the registrant loaned $1 million to the purchaser on a 6 percent note maturing in 18 months and made a commitment to loan an additional $1 million. Registrant recorded a gross profit of $1 million against which a reserve for possible loss in the amount of $260,000 was provided.

Case No. 4: In June 1961 a registrant purchased 20,000 acres of undeveloped land for $1 million cash and 5 percent note for $3 million. Simultaneously, the registrant sold the property to another company for a $2 million noninterest-bearing deed of trust note payable in installments of $1 million in June 1962, $500,000 in June 1963, and $500,000 in June 1964, and for the assumption by the purchaser of the $3 million first lien note. A gross profit on the sale of $1 million was recorded and a reserve of $400,000 was provided for a possible loss.

Case No. 5: A registrant purchased a tract of land for a cash payment of $100,000 and a 10-year nonrecourse noninterest-bearing note in the amount of $800,000 with annual maturities of $80,000. On the same date the land was sold to a nonaffiliated group for a cash payment of $15,000 and a nonrecourse noninterest-bearing purchase money note for $1,785,000. The latter obligation requires annual payments of approximately $1,100,000 at the end of the 8th year. At the time of the sale the registrant also advanced to the purchaser $350,000 for use in advertising. The proceeds from the sales of land by the purchaser are assigned to the registrant until the $350,000 advance is paid. The registrant recorded a profit of $900,000 at the date of sale.

Case No. 6: Shortly before the close of its fiscal year a registrant recorded the sale of a block of 150 lots for a total consideration of $375,000. Cash of $75,000 was paid on the settlement date and the purchaser then took title to 30 lots. The balance of the consideration consisted of four notes of $75,000 each bearing interest at 5 percent per annum, due 6, 12, 18 and 24 months after settlement. The purchaser was to take title to 30 lots at the time of settlement of each note. The notes were secured only by a mortgage on the property, and there was no personal liability on the purchaser to complete the payments. In a registration statement filed shortly after the close of the fiscal year this transaction was recorded as a sale in the total amount of $375,000 with an indicated gross profit of $44,000 on the uncollected portion after provision for deferred taxes of $47,000.

Case No. 7: In early 1960 a registrant sold to an unaffiliated purchaser a manufacturing plant and another building used in its operations for a total consideration of $1,500,000 reflecting a profit of $600,000 after taxes. The consideration was realized in the form of cash and assumption of an existing mortgage. The seller simultaneously leased these same properties back at an annual rental of $160,000 for a period of 25 years. The registration statement as effective reported the profit as deferred and to be amortized against rental payments over the life of the leases.[1]

In each of the cases noted above, the Commission

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[1] <u>Ibid</u>.

indicated its belief that it was misleading to report profit in the year of sale. In 1966 the Accounting Principles Board issued a new statement concerning the installment method of accounting. The following comment was made:

> The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.)[1]

This statement by the Accounting Principles Board permits a departure from the principle of profit recognition at the time of sale but does not make a distinction as to when such departures should be made. Even though the Securities and Exchange Commission made its position clear that whenever substantial uncertainty as to collection of the sales proceeds existed that it would not permit the immediate recognition of profit, the problem of income realization continues to plague the accounting profession.

Recently the American Institute of Certified Public Accountants' eighteen member Accounting Principles Board announced that it had appointed a committee to study the accounting practices of land-development companies.[2]

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[1]American Institute of Certified Public Accountants, <u>APB Opinion No. 10</u> (New York: 1966), p. 5.

[2]"Accounting--Profits Without Honor," <u>Time</u>, March 9, 1970, p. 62.

Accounting for Franchise Fees--A New Problem. The latest serious question of the recognition of profit concerns the practice of operators in the franchise fast-food industry of taking nonrecurring franchise fees into income in the year the franchise is sold. This practice has become so widespread that it is now known as "Minnie Pearling" (based on a practice of Minnie Pearl's Chicken System, Inc., now Performance Systems, Inc.).[1] In commenting on the problems of pressures on profit margins of franchising operations, one writer noted:

> The high cost of money isn't wholly to blame; labor, food and construction costs all are rising too, and prices aren't keeping pace. Failing franchises (though seldom reported as such) are being bought out cheaply by their franchisers, a practice which bolsters franchiser profits but not profit margins, and which saps the classic allure of franchising itself. In a number of cases, franchisers not worth rescuing are simply being lopped off. Meanwhile, here and there the sharp pencil has been applied to P & L Statements. In order to create todays "recurring" income, profits which are potential (and properly deferred) at most, and extraordinary at least, are being run through the current income sheet.[2]

In the case of accounting for initial franchise fee revenue, the charge of creating "instant earnings" has a great deal of validity. The articles in Barron's and Time quoted above indicate an increasing lack of confidence in income statements which use questionable accounting practices

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[1]"Food Franchisers' Marry-go-round," Business Week, February 28, 1970, p. 122.

[2]J. Richard Elliott, Jr., "Speculative Bellyache?" Barron's, August 25, 1969, p. 17.

for initial franchise fees.

The Franchising Industry. A franchise company usually derives its revenue in two basic ways: (1) from the sale of initial franchises and related assets or services, and (2) from continuing fees based upon operations of individual units. The franchiser normally owns the trademarks, trade names, or patents, which for a fee he authorizes the franchisee to use. The franchiser provides services throughout the planning and operating stages for which he receives a fee based on a fixed per cent of the franchised units' revenue or from the sale of products, or both.

Two problems have been considered as pertinent to franchising: (1) When should the initial franchise fee be included in revenue? and (2) What is the collectibility of the receivable arising from the unpaid portion of the franchise fee?[1]

When consideration is given to the circumstances which the Securities and Exchange Commission said tended to raise questions as to the propriety of current recognition of profit in real estate transactions, no one can question the Commissioner's attitude toward franchising operations. A review of those points as they apply to franchising seems

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[1]Archibald E. McKay, "Accounting for Initial Franchise Fee Revenue," The Journal of Accountancy, CXXIX (January, 1970), p. 67.

appropriate:

1. Evidence of financial weakness of the purchaser. In many franchise sales only a small portion of the fee--sometimes as little as ten per cent--is paid when the agreement is signed. The remainder is usually in the form of notes with favorable interest rates. In some cases the franchisee could not obtain proper financing from outside sources. At times the franchisor had to depend on the franchisee's future profitable operations for payment on the notes.

2. Substantial uncertainty as to amount of costs and expenses to be incurred. The franchisor may have great difficulty in estimating possible losses from uncollectible notes and in estimating the cost of services to be performed in future periods.

3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., nonrecourse notes, noninterest-bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value. It is not unusual for the franchisee to borrow the initial franchise fee with the franchisor guaranteeing the borrowing. In some cases a franchisor may retain an interest in the operation.

4. Retention of effective control of the property by the seller. Some franchisors sell to and control the operations of the franchisee to such an extent that the franchisee is for all practical purposes an affiliate of the

franchisor.[1]

5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property. Some franchise agreements contain an option to repurchase. Such options would be exercised when operations are successful.

6. Simultaneous sale and repurchase by same or affiliated interests. An example of related franchise manipulations was Leisure Foods of America, Inc. LFA's primary assets are franchise rights in other fast-food operations.[2]

7. Concurrent loans to purchasers. In some operations franchisors accept notes from franchisees and then discount the notes to obtain cash.

8. Small or no down payment. Most franchise sales are made with down payments not exceeding ten per cent.[3]

9. Simultaneous sale and leaseback of property. Although the franchisor does not normally use this technique, he usually assists in the site selection, negotiation of the lease, and the construction activity, including financing and designing the building.

The Securities and Exchange Commission can be expected to exercise its authority, as outlined in Accounting Series

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[1] Ibid., p. 68.

[2] "Food Franchisors Marry-Go-Round," p. 122.

[3] McKay, "Accounting for Initial Franchise Fee Revenue," p. 67.

Release No. 95, with respect to franchise operations. Perhaps in a sense of anticipation of such action by the SEC, Mr. Leonard Savoie, Executive Vice President of the American Institute of Certified Public Accountants, warned the accounting profession that they should reject the common practice of franchising firms of counting as current income the payments that franchise operators agree to make over a period of years.[1]

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[1]"Accounting: Profits Without Honor," p. 62.

CHAPTER V

THE ACCOUNTING PRINCIPLES BOARD

Background of the Accounting Principles Board

Throughout its existence the Committee on Accounting Procedure of the American Institute of Certified Public Accountants met resistance from members of the accounting profession. The Committee issued a total of fifty-one research bulletins from September 1, 1939 to September 1, 1959, when it was superseded by the Accounting Principles Board. The Accounting Principles Board was founded for the purpose of advancing research in accounting principles. The objectives of the Board as stated in the charter of the Accounting Principles Board are as follows:

> The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and it should, take definite steps to lead in the thinking on

unsettled and controversial issues.[1]

It is apparent from reading the above paragraph in the charter of the Accounting Principles Board that there is need for the support of the Securities and Exchange Commission in the profession's attempts to establish sound accounting principles on an authoritative basis. One objective was to narrow the areas of difference and inconsistency in practice. It was with such problems in mind that the American Institute of Certified Public Accountants undertook a greatly expanded research program in 1959.

Composition of the Board and Research Procedures Followed

The Accounting Principles Board is composed of twenty-one members made up of fifteen accountants in public practice, three accounting professors and three accountants from industry. The Board is supported by full-time professional research accountants.

In arriving at opinions, the Board follows these general steps:

1. The Chairman of the Accounting Principles Board and the Director of Accounting Research make the decision as to which research projects to undertake. Ordinarily this decision is based on a prospectus outlining the accounting issues to be investigated. These issues are discussed and approved by the full Board as being worthy of a research

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[1] Leonard M. Savoie, "The Accounting Principles Board," Financial Analysts Journal, XXI (May-June, 1965), p. 53.

project.

2. The Director assigns the research project to a project director who may be a member of the Accounting Research Division Staff, a university professor, a member of an accounting firm or an employee of a corporation. A preliminary outline of the study is prepared by the project director and agreed upon by the Director of Accounting Research.

3. A Project Advisory Committee is appointed by the Director of Accounting Research with the approval of the Accounting Principles Board Chairman. This committee ordinarily consists of several prominent people who are knowledgeable in the subject area. The study is intended to cover clearly (a) definition of the problem, (b) theoretical considerations, (c) practical considerations and (d) conclusions or recommendations.

4. After a research project is completed and published, the Accounting Principles Board receives comments from interested persons. After numerous reviews a draft of an opinion is prepared which is voted on by members of the Accounting Principles Board. Each member of the board must assent, dissent or assent with qualification in which case the member's objection is published with the Opinion.[1]

The establishment of the Accounting Principles Board marked a new attempt by the American Institute of Certified

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[1] *Ibid.*, p. 54.

Public Accountants to establish a single authority responsible for the development of accounting principles. In pleading for more uniformity in accounting principles one writer expressed this view of the role of the Accounting Principles Board:

> It may be that the Accounting Principles Board will be the body which will start the movement from a mass of textbook literature, quasi-official statements by accounting organizations, and piecemeal recognition of some accounting principles and procedures by the courts and executive agencies to a systematic codification of accounting methods and principles.[1]

One of the statements made in a leaflet "The New Accounting Research Program," describing the work of the Accounting Principles Board, was that pronouncements of the Board would be the authoritative determination of the applicable accepted accounting principles.[2]

Not all accountants were as optimistic about the future of the Accounting Principles Board. Mr. Leonard Spacek expressed grave doubts about the status of generally accepted accounting principles as follows:

> Illustrations of nonacceptability . . . can be found whenever accounting principles become factors in lawsuits or in claims before our courts.[3]

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[1]Maurice E. Peloubet, "Is Further Uniformity Desirable or Possible?" The Journal of Accountancy, CXI (April, 1961), p. 35.

[2]Council of the Special Committee on Research Program "The New Accounting Research Program," The Journal of Accountancy, CVI (December, 1958), p. 62.

[3]Leonard Spacek, "Are Accounting Principles Generally Accepted?" The Journal of Accountancy, CXI (April, 1961), p. 42.

Mr. Spacek used the following quotation from Forbes to further illustrate his point:

> There is also another symptom of the Company's new order of efficiency, but it is perhaps more suggestive than conclusive. In every year since 1955, whether or not its sales volume was temporarily trending up or down, the company has been able to increase its earnings. There are so many ways of accomplishing this by mere bookkeeping tricks that financial specialists are wont these days to view any such performance skeptically. So many costs can at option legitimately be anticipated or deferred, expensed or capitalized, that no corporate earnings figure is now regarded by sophisticates as absolute and objective. Windfalls such as those deriving from favorable market prices for a commodity can have a pleasant but misleading effect on stated earnings; so can variations in the rate of remitted dividends from foreign subsidiaries.[1]

In 1959 when the Accounting Principles Board was founded accountants were in general agreement that there was a lack of authoritative support for the accounting practices followed by the profession.[2] At this relatively late date the profession had not set up the means by which to question or judge whether the accounting being followed in a given case was proper. Mr. Spacek urged the professional accounting committees to have the intestinal fortitude to require adherence to established principles of accounting so that substandard practices would be discovered and dealt with.[3]

The Securities and Exchange Commission still remained the only real authority to make the determination of what

[1] Ibid., p. 42.

[2] Ibid., p. 44.

[3] Ibid., p. 45.

was a substandard practice.

Opinions of the Accounting Principles Board

After the Board was founded on September 1, 1959, slightly more than three years passed before it issued its first official opinion. Opinion No. 1 "New Depreciation Guidelines and Rules" was issued during November, 1962, and was accepted as a necessary result of Internal Revenue Service Revenue Procedure 62-21 which dealt with the depreciation deductible for income tax purposes.

Opinion No. 2 was issued during December, 1962, and almost immediately became the most controversial accounting issue in years.[1] Opinion No. 2 was issued in response to another Internal Revenue Service law which provided for an "investment credit" as a credit against a tax liability. The credit was, in general, equal to a specified percentage of the cost of certain depreciable property purchased after 1961. The amount available in any year was used to reduce the amount of income tax payable for that year. APB Opinion No. 2 offered three possible solutions as to the substance of the investment credit: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount

[1]"Spotlight on Accounting," The Journal of Accountancy, CXV (February, 1963), p. 39.

to future accounting periods.[1]

The first possibility, subsidy by way of a contribution to capital was rejected by the Board and only the second and third received serious consideration. Discussion of the options was as follows:

> Tax reduction: The argument for this concept essentially is that since the investment credit is made available by the Revenue Act of 1962 it is in substance a selective reduction in taxes related to the taxable income of the year in which the credit arises.
>
> A refinement of the tax reduction concept advocates that 48% of the investment credit (the maximum extent to which the credit normally can increase net income, assuming that the income tax rate is 52%) should be recorded as a reduction of tax expense of the year in which the credit arises; the balance of 52% should be deferred to subsequent accounting periods . . . because of the statutory requirement that the basis of the property be reduced for tax purposes by the amount of the investment credit.
>
> Cost reduction: We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles.[2]

The Accounting Principles Board then made the following statement:

> We conclude that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.
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> A number of alternative choices for recording the credit on the balance sheet has been considered. While we believe the reflection of the allowable credit as a

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[1]American Institute of Certified Public Accountants, APB Opinion No. 2, Accounting for the Investment Credit (New York, 1962).

[2]*Ibid*., p. 1.

> reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.
>
> We believe it preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth above. Nevertheless, reflection of income tax provisions, in the income statements in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.[1]

Even before the Board released its opinion there was disagreement among its members. The opinion was adopted by the vote of fourteen members, the minimum number of votes needed to adopt an opinion. The dissenting members disagreed with the conclusion that there was only one acceptable accounting treatment of the investment credit and urged the Board to adopt the tax reduction method as well as the cost reduction method.[2] One of the dissenting members was the Chairman of the Accounting Principles Board, Mr. Weldon Powell, who, along with members Herman W. Bevis and Hassel Tippit, noted that they believed that "the pertinent factors preponderantly supported the view that the investment credit was in substance a reduction in income taxes."[3] They believed

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[1] Ibid., p. 2.

[2] Ibid., p. 3.

[3] Ibid.

that the generation of taxable income for the year in and by itself, rather than the future productive use of the related property, affected the realization of the credit.[1]

Shortly after the Board released Opinion No. 2, several articles appeared in periodicals and newspapers commenting upon the disagreement which existed among accountants. In an issue of Barron's the following comment was made:

> Financial information is being weighed more carefully, for footnotes, which most people tend to overlook, are getting a hard scrutiny. Then, too, the incident of criticism of a company's financial statements by two brokerage firms serves as a timely reminder of something few investors bother to consider: that accounting is a very fluid practice. Accounting varies from industry to industry. In fact, even among companies in the same field practices are so diverse as to make comparisons of earnings less than meaningful . . . The auditor functions chiefly as an advisor. He can make suggestions, but there is nothing to keep a company from using any accounting method it deems best for its own purposes. "We report what the company does:" maintains one CPA, "not what it ought to do."[2]

In the midst of the confusion resulting from the issuance of Opinion No. 2, the Securities and Exchange Commission contributed to the turmoil by issuing an Accounting Series Release.

Accounting Series Release No. 96, dated January 10, 1963, entitled "Accounting for the 'Investment Credit'" contained the following text:

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[1]Ibid.

[2]Steven S. Anreder, "Pitfalls for the Unwary", Barron's, December 24, 1963, p. 15.

In view of the extensive public discussion of the accounting for the investment credit provided in the Revenue Act of 1962 and the fact that the Accounting Principles Board of the American Institute of Certified Public Accountants has concluded that the investment credit should be reflected in income over the productive life of the acquired property, the Securities and Exchange Commission deems it appropriate to respond to inquiries with respect to the application of the Commission's accounting and disclosure requirements to this matter.

In Accounting Series Release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting Series Release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which gained general acceptance.

In recognition of the substantial diversity of opinion which exists among responsible persons in the matter of accounting for the investment credit, the Commission will accept either a method which reflects 48 percent of the investment credit (the maximum extent to which the credit can normally increase net income) in income as a reduction of the tax expense of the year in which the credit arises and defers the balance of 52 percent to subsequent accounting periods during which depreciation allowances for tax purposes are reduced because the statutory requirement reduces the basis of the property for tax purposes by the amount of the investment credit. The amount of such deferral should be segregated from taxes currently payable. The 100 percent flowthrough to income of the investment credit benefit in the year in which it arises will be accepted in the case of regulated industries when authorized or required by regulatory authorities. In all cases full disclosure of the method of accounting followed and amounts involved should be made where material.

In any case it is the Commission's opinion that the credit should not be made directly to the asset account. Income tax expense should not be stated in excess of the amount payable for the year. No objection will be taken to the recording of additional depreciation equal to the amount of the deferral arising from the above method of accounting for the investment credit. The amounts involved should be segregated at least in the appropriate notes and schedules required by our accounting regulations.

The certification rules of the Commission require that the accountant's certificate shall state clearly the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein. The term "accounting principles and practices" should be read in the light of the discussion of broad principles and practices in the booklet "Audit of Corporate Accounts," which was recognized as a significant guide to the profession at the time of drafting our original accounting and certification requirements.

It is recognized that an accountant who certifies to financial statements reflecting a method of reporting contrary to the majority opinion of the Accounting Principles Board is assuming the burden of justifying departure from the recommended procedure and must take into consideration whether he is departing from an accepted procedure and consequently whether he must qualify his certificate with respect to the fairness of the presentation in the financial statements or to a departure from generally accepted accounting principles and practices. In the usual case where an accountant takes exception to a principle or practice followed, the amount involved is material. In view of the substantial diversity of opinion as to the proper method of accounting for the investment credit, if an accountant deems it necessary to qualify his opinion under various circumstances the Commission will accept certificates containing appropriately worded qualifications in accordance with Rule 2-02(d) of Regulation S-X when an alternative accounting treatment acceptable to the Commission is followed by the registrant.[1]

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[1]Accounting Series Release No. 96.

The reference to the booklet "Audits of Corporate Accounts" in the above release was to a booklet which consisted of a series of letters passing between the American Institute's "Special Committee on Cooperation with Stock Exchanges" and the "Committee on Stock List" of the New York Stock Exchanges during the years 1932-1934. The letters represented an attempt to make the accounts published by corporations more informative.[1] This joint effort resulted in the conclusion that certain accounting principles were so generally accepted that they should be followed by all companies and the adoption of these principles as rules by the American Institute of Accountants in 1934.[2] The booklet also served as the starting point for the development of an accountant's certificate which was more informative and more clearly understood by investors and which is substantially the same as the certificate used today.[3]

Shortly after the Securities and Exchange Commission issued Accounting Series Release No. 96, the international accounting firms of Price Waterhouse & Company, Haskins and Sells and Ernst & Ernst announced their decision to ignore the ruling of the Accounting Principles Board that the investment credit be spread over the life of the asset

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[1]See page 24 for a discussion of the circumstances of the formation of the committee.

[2]Audits of Corporate Accounts, op. cit.

[3]Ibid.

acquired.[1] This action prompted Thomas G. Higgins, CPA, a member of the Accounting Principles Board, to note that it was the first time in his memory that a major firm had "thumbed its nose" at the recognized authority in the profession.[2]

When widespread controversy continued after action was taken by the Securities and Exchange Commission and the American Institute of Certified Public Accountants, Jack M. Whitney II, Commissioner of the Securities and Exchange Commission made the following comments in a speech to the Washington, D.C., Society of Investment Analysts:

> A reliance upon "generally accepted accounting principles," as developed by the accounting profession has left a great deal of room for variation in the accounting practices and principles observed by companies, whether or not they are subject to the requirements of the commission. The unanswered question presented by this history, to which analysts might well help us find an answer, is whether the Commission's restraint (in exercising its powers to prescribe the methods to be followed in the preparation of accounts) has been and continues to be in the public interest and in the interest of investors. Do the disclosures of accounting principles followed, as contained in the prospectus, really make it possible for an anaylst to make a side-by-side comparison of two companies' earnings statements? I doubt it. I do not suggest that unvarying application of uniform accounting principles is a desirable end in itself. I don't like strait jackets. However, we may not have gone as far in this direction as we should.[3]

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[1] "A Matter Of Principle Splits CPA's," Business Week, January 26, 1963, p. 56.

[2] Ibid.

[3] "SEC Commissioner Seeks More Uniformity in Accounting Practice," The Journal of Accountancy, CXV (March, 1963), p. 9.

Faced with attacks from within the profession and outright opposition from the Securities and Exchange Commission, the following statement summarizes the feelings of the American Institute of Certified Public Accountants:

> The problem now confronting management and the accounting profession seems to boil down to this: can the evolutionary process of developing generally accepted principles, and narrowing the areas of differences in corporate reporting be accelerated? Closely related is the question whether comparability among the income reports of corporations can and should be facilitated by the adoption of only one approved method of accounting for each type of transaction, assuming similar circumstances, or whether alternative methods should be accepted so long as they are reasonable and supportable in logic and theory, and one is not demonstrably superior to the other.
>
> In the debate the top management of corporations should take a more active part than heretofore. The financial statements are the representations of the issuer. The independent auditor "attests" that they are fairly presented. The final result is a joint responsibility. The development of the underlying accounting principles should also be a joint responsibility. In the past some companies and industry groups have resisted changes proposed by the Institute which they believed might have an immediate adverse effect on their own reports of financial position or earnings.[1]

In an effort to expand its influence in the area of corporate financial reporting the Securities and Exchange Commission undertook a study of the securities market in 1962-1963. The most important recommendation affecting the accounting profession contained in the report was that existing laws and regulations governing securities sold on major stock exchanges should be extended to those traded on over-

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[1] "Top Management's Stake in Accounting Principles," The Journal of Accountancy, CXV (April, 1963), p. 34.

the-counter markets.[1] A questionnaire answered by companies whose securities are traded over the counter revealed that twenty-three per cent were not certified by accountants and sixty-four per cent failed to classify inventories according to S.E.C. standards and that many either made no reports to stockholders or the reports were meager and inadequate.[2]

The American Institute of Certified Public Accountants asked for comments from its members and reported the following statement as typical of those received concerning the S.E.C's expanded influence:

> Expanded S.E.C. coverage of financial reports means increased S.E.C. influence on regulation of the CPA profession and the evolution of accounting principles.
> A sense of urgency in the AICPA doing all it can to get its house in order before the S.E.C. moves in including quick action on accounting principles for banks and insurance companies . . .[3]

With its official position under attack and the authoritativeness of its two opinions seriously questioned, the Accounting Principles Board reached the point of almost complete chaos when it issued its Opinion No. 4. Opinion No. 4 (amending No. 2), "Accounting for the Investment Credit," was issued in March, 1964, in response to the widespread practice of ignoring the recommendations contained in Opinion No. 2. Opinion No. 4 contained the following

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[1]"Securities Market Study Urges Extensions of Controls," The Journal of Accountancy, CXV (May, 1963).

[2]Ibid.

[3]"S.E.C. Legislative Proposals Milder than Anticipated," The Journal of Accountancy, CXVI (July, 1963), p. 11.

pertinent statements:

> The Board concluded (in Opinion No. 2) that the investment credit "should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service."
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> In January, 1963, the Securities and Exchange Commission issued Accounting Series Release No. 96 in which it reported that in recognition of the substantial diversity of opinion among responsible persons in the matter of accounting for the investment credit the Commission would accept statements in which the credit was accounted for either as this Board concluded in Opinion No. 2 or as a reduction in taxes otherwise applicable to the year in which the credit arises. The Commission has recently reconsidered and reaffirmed that position.
>
> The Board's review of experience since the issuance of Opinion No. 2 shows that the investment credit has been treated by a significant number of companies as an increase in net income of the year in which the credit arose.
>
> The Revenue Act of 1964 eliminates the requirement imposed by the Revenue Act of 1962 that the investment credit be treated for income tax purposes as a reduction in the basis of the property to which the credit relates.
>
> It is the conclusion of this Board that the Revenue Act of 1964 does not change the essential nature of the investment credit and, hence, of itself affords no basis for revising our opinion as to the method of accounting for the investment credit.
>
> However, the authority of Opinions of this Board rests upon their general acceptability. The Board, in the light of events occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the Opinion effective.
>
> In the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph 13 of Opinion No. 2 should be considered to be preferable, the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable.
>
> The Board emphasizes that whichever method of accounting for the investment credit is adopted, it is essential that full disclosure be made of the method followed

and amounts involved, when material.[1]

The conclusions reached by the Accounting Principles Board were dissented to by five members of the Board. The dissenting members were led by Carman G. Blough, Leonard Spacek and Maurice Moonitz and the status of the Accounting Principles Board is summed up in their statements. Mr. Blough dissented because he believed that the conclusions reached in Opinion No. 2 were sound. His dissent also noted "the fact that there is substantial support for treating the investment credit as an increase in net income of the year in which the credit arose is not a sound reason to retreat from a position which the Board still considers to be preferable."[2] Mr. Blough believed that the Board could not carry out its major responsibility to determine appropriate practice and to narrow the areas of difference and inconsistency in practice if it withdrew its influence from the support of its considered opinion whenever that opinion was not immediately accepted by all influential persons.[3] Mr. Moonitz dissented because he believed that the investment credit could not be two different things at the same time and objected to the fact that identical items bought from the same

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[1]American Institute of Certified Public Accountants, APB Opinion No. 4 - Accounting for the Investment Credit (New York: American Institute of Certified Public Accountants, 1964), pp. 1-4.

[2]*Ibid*., p. 3.

[3]*Ibid*.

supplier at identical prices could be recorded at different "costs" depending upon the tax status of the purchaser and not upon the conditions prevailing in the transaction between the buyer and seller.[1] Mr. Spacek objected because of his belief that the Opinion illustrated the accounting profession's complete failure in its responsibility to establish accounting principles that would provide reliable financial statements that were comparable among companies and industries. He also stated that there was no justification for sanctioning two contradictory practices to accomodate the S.E.C. and other regulatory bodies and some C.P.A.'s.[2]

Unfortunately, accounting theory as defined in textbooks current at the time did little to contribute to the solution of this problem. One contemporary book outlined the procedure to be followed when the investment credit was treated as a reduction in asset cost and also when the investment credit was treated as a reduction in taxes without any indication concerning the author's preference.[3]

In the face of such widespread controversy, the American Institute of Certified Public Accountants renewed

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[1] Ibid.

[2] Ibid.

[3] Harry Simons and Wilbert E. Karrenbrock, Intermediate Accounting, Comprehensive Volume (Cincinnati, Ohio: South-Western Publishing Company, 1964), p. 422.

its efforts to define generally accepted principles.

On October 2, 1964, the Council of American Institute of Certified Public Accountants adopted the following recommendations:

> Generally accepted accounting principles are those principles which have substantial authoritative support.
> Opinions of the Accounting Principles Board constitute substantial authoritative support.
> Substantial authoritative support can exist for accounting principles that differ from Opinions of the Accounting Principles Board.
> If an accounting principle that differs materially in its effect from one accepted in an opinion of the Accounting Principles Board is applied in financial statements, the reporting member must decide whether the principle has substantial authoritative support and is applicable in the circumstances.
> If he concludes that it does not, he would either qualify his opinion, disclaim an opinion, or give an adverse opinion as appropriate . . .
> If he concludes that it does have substantial authoritative support: (1) he would give an unqualified opinion; and (2) disclose the fact of departure from the Opinion in a separate paragraph in his report or see that it is disclosed in a footnote to the financial statements and, where practicable, its effects on the financial statements.[1]

In August 1965, the Accounting Principles Board released an "exposure draft" of Opinion No. 6 - "Status of Accounting Research Bulletins" which published the results of the Board's review of all outstanding Accounting Research Bulletins. Included in this draft was a proposal to add a new paragraph to Chapter 3A of Accounting Research Bulletin No. 43 on the classification of deferred income taxes on the

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[1]American Institute of Certified Public Accountants, Special Bulletin - Disclosure of Departures From Opinions of Accounting Principles Board (New York: American Institute of Certified Public Accountants, 1964).

balance sheet. This proposal read:

> Whenever it is appropriate to record deferred income taxes, such deferred taxes should be classified as a current liability in the balance sheet to the extent that they are related to current assets which give rise to the tax deferment.[1]

When the Accounting Principles Board issued Opinion No. 6 in October, 1965, the proposed paragraph was completely eliminated. It has been suggested that members of the Accounting Principles Board believed that the inclusion of the paragraph on deferred taxes would have been inconsistent with what was then the predominant practice.[2] Regardless of the validity of the Board's arguments against including deferred taxes as current liabilities, reaction to the omission of the proposed paragraph was immediate and took a most unusual and unexpected turn. On October 4, 1965, a national firm of certified public accountants petitioned the Securities and Exchange Commission to issue an Accounting Series Release relating to the balance sheet classification of deferred income taxes arising from the use of the installment method of reporting gross profit for income tax purposes so that the classification would be consistent with the classification

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[1]American Institute of Certified Public Accountants, "Exposure Draft of Tentative Opinion: Status of Accounting Research Bulletin," The Journal of Accountancy, CXX (August, 1965), p. 58.

[2]Richard C. Lytle, "Accounting and Auditing Problems," The Journal of Accountancy, CXX (December, 1965), p. 72.

of the related accounts receivable.[1]

The petition asserted that the general practice was to include the installment receivables in current assets but to classify the related deferred income taxes as a noncurrent liability. Further asserting that the classification of the deferred taxes could have a significant effect on the determination of a company's working capital and credit rating, and that the lack of comparability in the financial statements of companies could not be justified on the basis of different circumstances, the petitioner noted that independent public accountants were giving opinions that both the consistent and the inconsistent method of classification were in conformity with generally accepted accounting principles.[2]

The petitioner then requested that, since the accounting profession and the American Institute of Certified Public Accountants through the efforts of the Accounting Principles Board had not been able to resolve the problem on a timely basis, the Securities and Exchange Commission should issue an accounting release that would require consistent classification (as current or noncurrent) of the installment receivables and the related deferred taxes.[3]

The request from a national public accounting firm

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[1]Pines, "The Securities and Exchange Commission and Accounting Principles, op. cit., p. 739.

[2]*Ibid.*

[3]*Ibid.*, p. 740.

that the Securities and Exchange Commission establish a "generally accepted accounting principle" through the issuance of an accounting series release marked the first time that such a request had been made of the Commission. When the Commission completed its study of the problem it concluded that action was necessary and on December 7, 1965, issued Accounting Series Release No. 102. The text of that release is as follows:

> It has come to the attention of the Securities and Exchange Commission that diverse practices exist regarding the balance sheet classification of deferred income taxes arising from the use of the installment method of reporting gross profit for income tax purposes. The majority of companies having installment receivables classify the related deferred income taxes as a noncurrent credit item, while some classify the deferred income taxes as a current liability or as a deduction from the receivables. It is understood, that, at the end of their current fiscal years, some registrants intend to change from current to noncurrent the classification of the deferred income taxes if other companies continue to classify the related deferred income taxes as a noncurrent item. The Commission's staff has noted that some companies have recently changed their reporting practices to show such deferred income taxes as a noncurrent item while retaining the related installment receivables among current assets.
>
> The classification of deferred income taxes related to installment receivables as noncurrent is significant when considered in light of the practice of classifying assets and liabilities as current or noncurrent in accordance with the normal operating cycle of the business. In Regulation S-X the Commission recognized the operating cycle treatment in the determination of working capital.
>
> The installment receivables and related deferred income taxes pertaining to the same operating cycle clearly are both either current or noncurrent. There is no justification from the standpoint of either proper accounting or fair financial reporting for the use of the operating cycle approach for installment receivables and not for the related deferred income taxes. Obligations for items which have entered into the operating

> cycle and which mature within the operating cycle should be included in current liabilities when the related receivables are included in current assets, in order to present fairly the working capital position.
>
> The deduction of the deferred income taxes from the related installment receivables is not considered to be an appropriate procedure; the current value of the receivables is not affected by the amount of the tax deferral. The deferral is not a valuation reserve but a credit item representing cash retained in the business by the deferral of tax payments under the alternative tax provisions.
>
> In view of the increasing use by many companies of installment sales and similar credit practices and the significance of the increasing amounts of the related deferred income taxes involved, the Commission deems it appropriate to state its opinion as to the proper reporting to be followed with respect to such deferred income taxes. Where installment receivables are classified as current assets in accordance with the operating cycle practice, the related liabilities or credit items maturing or expiring in the time period of the operating cycle, including the deferred income taxes on installment sales should be classified as current liabilities. Installment receivables not realizable within one year and the related deferred income taxes may be classified consistently as noncurrent items. In financial statements filed with the Commission for fiscal years ending on or after December 31, 1965, assets and liabilities entering into the operating cycle shall be classified consistently as current or noncurrent items. In addition appropriate disclosure of the classification followed and amounts involved should be given.[1]

Release No. 102 was issued after it became apparent that the profession was unable to reach agreement as to the proper accounting treatment to be accorded deferred taxes. The Chairman of the Securities and Exchange Commission made the following comments about the evolution of Accounting Series Release No. 102:

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[1]U.S., Securities and Exchange Commission, Accounting Series Release No. 102 (Washington, D.C.: Government Printing Office, 1965), pp. 1-2.

> The accounting profession has not resisted the freedom, and concomitant responsibility, given to it by the Commission to develop accounting principles. There are many who believe, however, that the accountants have not fulfilled that responsibility. Without minimizing the difficulties of the task, and with no intention to criticize, it is fair to say that the accounting profession has, in the past, been unable to achieve uniformity in many significant areas of financial reporting--that is, accountants have been unable to reduce significantly, if not eliminate, the variety of accounting principles deemed permissible in the reporting of similar financial conditions and results.
>
> What is being done about moving more quickly toward the goal of uniformity? Stronger leadership by the Commission is one avenue being followed. An example of this is Accounting Series Release No. 102 issued a few months ago, dealing with the proper method of reporting deferred income taxes arising from installment sales. At the time the release was issued, no fewer than four different reporting methods were used by companies for which the item was of considerable importance . . . Significantly, each method carried the opinion of an independent public accountant reporting that the financial statements had been prepared in accordance with generally accepted accounting principles.
>
> The American Institute of Certified Public Accountants had not ignored the problem but had up to then been unable to resolve it . . .
>
> A formal expression of opinion by the Commission seemed called for, and we obliged. The Commission determined that the most appropriate treatment is to require classification of the deferred taxes consistent with that of the related installment receivables. The release was issued in December and has been generally followed since, although not without some complaint over the contents of the opinion and the manner in which it was issued.[1]

The Commissioner concluded his discussion of Accounting Series Release No. 102 with this statement which contains a clear warning: "Although Accounting Series Release No.

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[1]Manuel F. Cohen, "Analysts, Accountants and the SEC--Necessary Joint Efforts," <u>The Journal of Accountancy</u> CXII (August, 1966), pp. 58-59.

102 was used to resolve one problem of uniformity, I do not believe it will be necessary for us to use that device with great frequency--although the option is always open to us. The extent to which action on our part is required will depend in large measure on the vigor and determination of the Accounting Principles Board of the American Institute of Certified Public Accountants, which has the primary responsibility of defining accounting principles to be used in financial reporting."[1]

Accounting Series Release No. 102 represented the last time (to date) that the Securities and Exchange Commission used a release to establish its position with respect to an accounting principle. During the period from 1950-1969, each time the Securities and Exchange Commission issued an accounting release the accounting profession's image suffered because it had failed to take action in a specific area. One contemporary writer, Mr. Leonard M. Savoie, CPA, executive vice president of the American Institute, commented on this inactivity as follows:

> If there is a common experience running through the problems of raising technical standards of the profession, it is that in the face of an irreversible trend toward tighter accounting standards, there persists in some quarters a reluctance to move ahead from the status quo. It seems to me that business should be willing to accept principles thoughtfully and painstakingly worked out by the accounting profession as a part of our private enterprise system in preference to regulation that might well otherwise be imposed by government.

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[1]*Ibid.*, p. 59.

> There is nothing penal about accounting principles that are applicable fairly and uniformly to all companies. Regardless of how businessmen may react to the profession's attempt to narrow differences in accounting practices, the only danger to the profession--and to business as well--lies in inactivity. As illustration one has but to recall the APB's 1965 withdrawal of a proposed pronouncement on classification of deferred taxes on installment sales and the resolution of this issue in the S.E.C.'s Accounting Series Release No. 102.[1]

A recent attack on the Accounting Principles Board concerned the Board's proposed opinion covering the accounting for intercorporate investments by the "pooling of interests" method. In commenting on the status of the Board this statement was made: "These critics (opposing APB opinions) are quite sensitive to the fact that the Accounting Principles Board is essentially a creature of S.E.C. regulation; APB opinions have no force in law and their effectiveness depends entirely on S.E.C. support which has generally been forthcoming."[2] This article also stated that several members of the "Big Eight" accounting firms which dominate the Accounting Principles Board have let their corporate clients know that they strongly disagree with certain parts of the proposed opinion, particularly the rule that shareholders of the acquired company must have at least a 25 per cent interest in the stock of the surviving company

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[1]Leonard M. Savoie, "Controversy over Accounting Principles Board Opinions," The Journal of Accountancy CXXV (January, 1968), p. 41.

[2]"Some Hard New Rules for the Merger Game," Business Week, April 11, 1970, pp. 50-51.

to permit pooling.[1] It seems clear that unless accountants can achieve more independence from their major clients then progress toward "generally accepted accounting principles" will be slow. Because of the risk of corporations changing auditors the degree of independence required to enforce compliance with Accounting Principles Board opinions is not likely to be attained in the immediate future.

[1] *Ibid.*, p. 51.

CHAPTER VI

SUMMARY OF FINDINGS

Securities and Exchange Commission Influence on Accounting Practice

Accountants' Liability: Early fears expressed by accountants centered around the liability provisions contained in the 1933 Act. Amid predictions that the potential liability of accountants to third parties would cause the death of the profession, very few suits have ever been filed against accountants under any of the Acts. The number of actions brought by investors against accountants has been estimated to be 77.[1]

Auditing Practices and Procedures: The changes which have occurred in auditing procedure since the formation of the Securities and Exchange Commission have been substantial. As a result of the Commission's investigation of McKesson & Robbins, Inc., and the recommendations contained in the report of that investigation many companies adopted the natural

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[1]Rappaport, SEC Accounting Practice and Procedure, pp. 23-8.

business year for accounting purposes. This practice had the beneficial effect of permitting public accountants to maintain a permanent staff and the discontinuance of the practice of hiring large numbers of temporary employees during the busy season.

Another important change in auditing procedure which was the result of the McKesson & Robbins, Inc., report was that there should be a proper evaluation of a company's internal control. This was ultimately adopted as one auditing standard. The report on the McKesson & Robbins case was responsible for the adoption of the procedure of confirming accounts and notes receivable by direct communication with the debtors and the procedure of observing the inventory-taking of a client.

The McKesson & Robbins investigation was responsible for the formation of the Committee on Auditing Procedure of the American Institute of Certified Public Accountants and, later, the Committee on Accounting Procedure. These two major committees carried on substantially all of the research conducted by the American Institute of Certified Public Accountants from 1939-1959.

<u>Auditing Standards</u>: Prior to the intervention of the Securities and Exchange Commission in Accounting Series Release No. 21, no attempt had been made to establish criteria for judging professional performance. Individual auditors and firms had certain standards which they set for themselves but no profession-wide auditing standards existed.

After the Securities and Exchange Commission pointed out the need for establishing minimum standards for the profession, the Committee on Auditing Procedure made a study which resulted in the issuance of a statement of auditing standards which remains in effect today.

Securities and Exchange Commission Influence on Accounting Principles

An indication of the function which the Securities and Exchange Commission intended to pursue in the development of accounting principles was contained in Accounting Series Release No. 1 when the Commission announced its policy of issuing "opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."[1] An even stronger statement was made by the first Chief Accountant of the Securities and Exchange Commission in 1937 when he served notice on the profession that unless it took steps to substantially reduce the areas of differences in accounting principles followed in corporate reports that the Securities and Exchange Commission undoubtedly would.[2]

Mr. Carman G. Blough, in commenting upon the influence of the Securities and Exchange Commission upon the development of accounting principles and practices, made the following statement:

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[1]Accounting Series Release No. 1.

[2]Carman G. Blough, personal letter, February 18, 1970.

> In the first place, the creation of the Committee on Accounting Procedure, which in 1959 was succeeded by the Accounting Principles Board, was originally due, I think, entirely to the necessity to prevent the Securities and Exchange Commission from itself issuing a comprehensive statement of accounting principles.[1]

Mr. Andrew Barr, Chief Accountant of the Securities and Exchange Commission has indicated his belief that the Securities and Exchange Commission has played a major role in the development of "generally accepted accounting principles."[2]

The Securities and Exchange Commission's current attitude toward the development of accounting principles is best illustrated by examining recent developments by the Commission and by the Accounting Principles Board. As early as 1950 the Securities and Exchange Commission indicated its preference for the so-called "all-inclusive" income statement, but it was not until 1966 that the American Institute of Certified Public Accountants endorsed that idea as an accepted principle. Throughout the intervening years the Securities and Exchange Commission insisted on registrants reporting all items of profit and loss on the income statement. In the face of an alternative practice permitted by the American Institute, the then Chief Accountant of the Securities and Exchange Commission, Earle C. King, addressed

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[1] Ibid.

[2] Andrew Barr, Private interview held during meeting of the American Accounting Association, South Bend, Indiana, August, 1969.

a letter to the Director of Research of the Institute in which he stated:

> Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32.[1]

The Commission took its position after making extensive studies of charges and credits to retained earnings which indicated that in many cases, gains or extraordinary credits were shown on the income statement while losses and extraordinary charges were deducted only from retained earnings.[2]

Another indication of the Commission's attitude toward conflicting opinions about the application of an accounting principle was contained in the following statement:

> Moreover, the fact that there may be authoritative support for different methods of classifying this deferred tax account does not preclude the Commission from determining for the future the manner in which the item should be classified in financial statements filed with it. In fact, as enunciated by the Commission in Accounting Series Release No. 4, dated April 25, 1938, the question of authoritative support is pertinent only where the position of the Commission has not previously been published in official releases.[3]

More recently the Securities and Exchange Commission

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[1]Letter from Earle C. King to Carman G. Blough, Dec. 11, 1947, The Journal of Accountancy LXXXV (January, 1948), p. 25.

[2]Pines, "The S.E.C. and Accounting Principles," op. cited., p. 737.

[3]Accounting Series Release No. 85.

took exception to an opinion of the Accounting Principles Board concerning the accounting treatment to be accorded the investment credit and permitted an alternative principle in filings with the Commission.[1] As a result of the Commission's action, the Accounting Principles Board issued an amended opinion recognizing as acceptable the treatment permitted by the Securities and Exchange Commission.[2]

In an over-all evaluation of the influence of the Securities and Exchange Commission upon accounting principles and practices comments by contemporary accountants must be given proper weight. Following are comments by leading writers and practicioners:

> The influence of the S.E.C. on accounting and auditing standards and practice was tremendous. Without doubt the Securities Act strengthened the position of independent auditors in insisting that clients follow sound principles and make adequate disclosures. The Commission's requirements also greatly increased the volume of auditing engagements. And it must be conceded that the S.E.C.'s goad prodded the profession to make improvements both in accounting and auditing that otherwise might have taken longer to achieve.[3]

Another author commented:

> There is no ground whatever at the present time on which to contest the statement that agencies of the federal, state and even local governments, charged with the administration and enforcement of all sorts of laws, have exerted and are exerting a powerful and, in some

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[1]Accounting Series Release No. 96.

[2]Accounting Principles Board Opinion No. 4.

[3]John L. Carey, The Rise of the Accounting Profession (New York: American Institute of Certified Public Accountants, 1969), p. 202.

areas such as public utilities, an almost dominating influence on the practice and development of accounting.[1]

A former Chairman of the Securities and Exchange Commission has stated:

> The Commission has been a strong influence in the development of accounting standards generally--the day-to-day informal activity of our staff accountants in dealing with registrants is of great importance, and our Chief Accountant, Andrew Barr, has been active and effective in liaison with the principle accounting organization and their working committees.[2]

Another Commissioner of the Securities and Exchange Commission noted:

> Our statutes deal in different ways with powers and authority concerning form and content of financial statements, rule-making, certificates and liabilities. But Congress made it abundantly clear in all of them that the ultimate responsibility for the quality, integrity and content of corporate financial statements filed with the Commission or prepared pursuant to these statutes rested with the Commission, and I think it is clear that it was intended that we use that power to discharge such responsibilities within the general policies and objectives stated in the various acts.[3]

Carman G. Blough, first Chief Accountant of the Securities and Exchange Commission and later Director of Research

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[1]William W. Werntz, William W. Werntz: His Accounting Thoughts, ed. by Robert M. Trueblood and George H. Sorter (New York: American Institute of Certified Public Accountants, 1968), p. 446.

[2]Manuel F. Cohen, "Analyst, Accountants and the SEC--Necessary Joint Efforts," The Journal of Accountancy, CXXII (August, 1966), p. 58.

[3]Byron D. Woodside, "A Review of the Commission's Administrative Policies Relating to Financial Reporting Under the Securities Acts," The Journal of Accountancy, CXXI (February, 1966), p. 49.

for the American Institute of Certified Public Accountants, with the unique position of viewing the question from both sides commented:

> However, I can say that I think the influence of the S.E.C. upon accounting principles and procedures has been very great.[1]

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[1]Carman G. Blough, personal letter, February 18, 1970.

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