# ACCOUNTING - CHANGING PATTERNS

## The Impact of Regulatory Agencies

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## The Impact of Regulatory Agencies 1/

The impact of the requirements of regulatory agencies upon the development of accounting and auditing, whether for good or evil, has been the subject of discussion by experienced practitioners, present and past members and employees of such agencies, teachers and students. There is extensive literature on the subject, so much that it seems unnecessary to review it in any detail. However, one such discussion may be cited which covers the subject more broadly than seems necessary today. A past Chief Accountant of the SEC participated in "A Symposium on the Interrelationship of Law and Accounting" which is reported in 36 Iowa Law Review 270 (1951) and in expanded form may be found elsewhere under the title "The Influence of Administrative Agencies in Accounting." 2/

I shall confine my remarks to a discussion of some of the major changes in accounting practice necessary to good financial reporting in a dynamic and expanding economy during a period in which there has been a continual increase in public participation in financing such expansion.

### The Securities Acts

The SEC is relatively a newcomer as a regulatory agency when compared with the Interstate Commerce Commission, but the laws which it administers created some consternation in accounting circles when they were proposed in Congress. This was caused in part by the civil liability provisions of the Securities Act and in part by the prospect that the Securities Exchange Act would impose uniform accounting requirements on all industry similar to the uniform systems of accounts applicable to railroads.

The only practicing public accountant to testify during the legislative hearings on the Securities Act of 1933 urged that the required financial statements be certified by independent public accountants. Another leading accountant in a memorandum regarding this legislation said:

> "In so far as accounting information is concerned, it seems to me fundamentally important to recognize that the accounts of a modern business are not entirely statements of fact, but are, to a large extent, expressions of opinion based partly on accounting conventions, partly on assumptions, explicit or

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2/ William W. Werntz, Chapter 4, Handbook of Modern Accounting Theory, edited by Morton Backer, New York; Prentice-Hall, 1955.

implicit, and partly on judgment. As an English judge said many years ago when business was far less complex than it is today, 'The ascertainment of profit is in every case necessarily a matter of estimate and opinion.'" 3/

This quotation expresses a point of view necessary to an understanding of financial statements, yet it is difficult to explain to laymen and to some accountants. This difficulty may be an indication that the profession may have over-stressed the importance of accounting principles and failed to emphasize independent objective judgments. The same accountant, in an address on December 6, 1933, before the Illinois Society of Certified Public Accountants here in Chicago, 4/ expressed the view that "there is reason to fear that responsible people will refuse to accept the unfair liability imposed on them by Congress under the Act, and will continue to refuse until juster provisions are enacted." He also said that he would "be extremely sorry if the effect of the Securities Act should be to place the distribution of securities and all the work attendant on such distribution in the least responsible hands." By some time in 1934, after some experience with the Commission and its staff, 5/ these fears seem to have been dispelled, at least to a considerable extent.

Mr. May was an important witness in the hearings on the Securities Exchange Act of 1934. In these hearings his objections to a uniform system of accounting were developed after his opening remark that "The fact of the matter is that accounting, especially industrial accounting, is essentially a matter of judgment, and you cannot put judgment in strait-jackets." 6/ His testimony questions critically the results to be obtained by such regulation as getting "a superficial uniformity which is not real." Elsewhere, Mr. May expressed the hope and expectation that the SEC would "not be led astray by the deceptive promise of uniform accounting, * * *," and would "no doubt use all its great influence to bring about by voluntary action as great a degree of uniformity in different industries as is obtainable, and will insist on consistency from year to year in the accounting of each corporation subject to its regulation." 7/ Whether these opinions were influential at the time or not in convincing the Congress that more could be accomplished by cooperative action than by rigid control, the Securities Acts as enacted were expressed in terms of general authority over accounting and have been implemented by regulations specifying the form and content of financial statements but not in terms of a uniform system of accounts. However,

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3/ George O. May, Twenty-five Years of Accounting Responsibility, Vol. 2, p. 52, New York, American Institute Publishing Co., Inc., 1936.

4/ *Ibid.*, pp. 70, 84.

5/ *Ibid.*, p. 113.

6/ *Ibid.*, p. 97.

7/ *Ibid.*, p. 116.

under the Securities Exchange Act the Commission did adopt bookkeeping requirements for brokers and dealers in securities and does make inspections to insure compliance. The Public Utility Holding Company Act of 1935 authorizes, and the Commission has adopted, uniform systems of accounts for holding companies and mutual service companies; and the Investment Company Act of 1940 in Section 31(c) gives the authority for "providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements * * *." Rules adopted and presently in effect as to accounting records are expressed in general terms, and the financial statements are governed more specifically by pertinent parts of the Commission's accounting regulations.

Certification Requirements

The SEC, or rather its predecessor, the FTC, for a short time, appears to be the first Federal agency with authority to require certification of financial statements by independent accountants. We should remember, however, that the Federal Reserve Board in 1917 requested the American Institute of Accountants to prepare the bulletin "Approved Methods for the Preparation of Balance Sheet Statements."

As time goes on, we find an increasing number of governmental agencies requiring certified financial statements. The Small Business Administration has recently announced that under its regulations the financial statements of small business investment companies must be audited and certified by certified public accountants. 8/ The Rural Electrification Administration, which has utilized its own staff for audits required under the Act administered by it, recently announced that an increasing number of borrowers are being requested by the agency to provide for annual audits of their accounts by C.P.A.'s. 9/ Financial reports submitted to the Secretary of Labor for pension funds "must be 'sworn' to by the administrator, or certified by an independent or licensed public accountant." 10/

Bills introduced both in the House and in the Senate pertaining to the "Labor Management Reporting and Disclosure Act of 1959" provided for certification of annual reports by unions; and, although the Act, as finally passed, omitted such an explicit provision, it does give the Secretary of Labor broad authority to require annual financial reports

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8/ 13 CFR 107.302-3.

9/ REA Bulletin No. 465-1, "Audits of Telephone Borrowers' Accounting Records," dated October 31, 1958, Sec. 2.

10/ "Welfare and Pension Plans Disclosure Act," Sec. 306(b), Public Law No. 836, 85th Congress.

and to establish safeguards to insure their accuracy. 11/ The Housing and Home Finance Agency requires independent audits in certain phases of its work. 12/ Both staff members of governmental agencies and representatives of the accounting profession have urged Congressional committees to adopt the requirement of certified financial statements for other agencies.

As might be expected, the older governmental agencies such as the FPC, FCC, ICC and the state commissions which exercise accounting regulatory powers over companies through a uniform system of accounts have usually not required independent audits.

Management Services

It seems to me, however, that even in the area where accounting procedures are regulated by an agency, the independent audit would provide an objective check on management. In connection with independence and an objective report on management, I would like to inject a word on management services. This is a very popular term today with the small practitioner as well as the national firm. I suggest that the independent accountant in furnishing such services to management keep two questions in mind: first, am I remaining an adviser to management and not entering the decision-making area? second, am I sure that the audit of the financial statements will not involve checking my own work? If both questions cannot be answered in the affirmative, the accountant's independence as to furnishing an objective report on management is in question.

It has been suggested that the rendering of management services sets up a conflict of interests which would render the accountant not independent. Much of the present day emphasis on this subject seems to me to be no more than a renewal of interest possibly engendered by the startling improvements in equipment available to business for handling the accounting and statistical problems created by the growing complexities of business operations. Systems work, cost analysis, budgetary controls and other aspects of business management have long been the province of the public accountant. It could be possible for an accountant to become so deeply involved in performing managerial services for a client that he would lose his objective approach to his audit engagement. In such a case he should concentrate on one activity or the other and not attempt to do both.

In my conversations with accountants and officers of their clients I have been impressed with the number of situations in which the records

11/ Labor Management Reporting and Disclosure Act of 1959 (September 14, 1959), Public Law 86-257, 86th Congress, S. 1555.

12/ News Report, Journal of Accountancy, November 1958, p. 16.

have been inadequate, nonexistent for some periods, not up to date, and, particularly with respect to inventories, provide no book control over the assets of the companies. In these situations improvement in accounting control is important to investors as well as to management. The need for managerial services in these situations is obvious. The adoption of procedures which would result in better and more timely reporting to management might well be considered a prerequisite to an invitation to the public to entrust its funds to the venture. The need for such services is not limited to unregulated companies. Timely reports for management purposes are just as necessary in regulated companies and may be obtained while at the same time the needs of the regulatory agency are met.

Consideration of the public interest is the basis for our bookkeeping rules for securities brokers and dealers and also is behind our recent amendment of these rules to require that a trial balance be taken at least once a month. Procrastination by broker-dealers is dangerous as the Commission may suspend or revoke a broker-dealer's registration because of his failure to maintain proper records on a current basis or for failure to meet his capital requirements under the rules. A recent incident demonstrates the necessity for public accountants to be familiar with these rules. A broker who was found by our inspectors to be in violation of our net capital rule defended himself by alleging that his independent accountants had assured him that he was in compliance. The accountant had not made the determination in accordance with the rule. In this type of situation the accountant's work should be a protection to the broker as well as to the customer.

It may be noted here that the audit of a broker-dealer is most effective if made on a surprise basis. Our reporting rules recognize this need by not requiring a fixed reporting date or audits as of the close of the fiscal year. These reports often disclose matters which are followed up by our inspectors. Similar flexibility is provided under the Investment Company Act for certificates on security counts which, in the absence of a satisfactory custodian arrangement, must be made three times during the year, two of which are on a surprise basis with results reported directly to the Commission. I understand that other federal agencies require the independent accountant to render reports which can be used by the agencies in the enforcement of their regulations. More of this type of reporting is being considered.

Most of the work of independent accountants under the Securities Acts involves the rendering of an opinion on the financial statements after completion of an audit made in accordance with generally accepted auditing standards. In the staff review of these statements questions may be raised as to the propriety of the accounting followed or as to the adequacy of the audit. The answers to these questions must be those of an independent accountant rather than as an advocate for the client. Any other course invites trouble for both client and accountant.