Accounting Historians Journal

Volume 13
Issue 2 *Fall 1986*

Article 10

1986

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Recommended Citation

Chatov, Robert (1986) "William O. Douglas on the transfer of the Securities and Exchange Commission's authority for the development of rules for financial reporting," *Accounting Historians Journal*: Vol. 13 : Iss. 2 , Article 10.
Available at: https://egrove.olemiss.edu/aah_journal/vol13/iss2/10

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The Accounting Historians Journal
Vol. 13, No. 2
Fall 1986

HISTORICAL NUGGETS

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WILLIAM O. DOUGLAS ON THE TRANSFER OF THE SECURITIES AND EXCHANGE COMMISSION'S AUTHORITY FOR THE DEVELOPMENT OF RULES FOR FINANCIAL REPORTING

Abstract: As an SEC Commissioner, William O. Douglas favored active SEC participation in the development of rules of accounting for financial reporting under the Securities Acts. A retrospective letter dated September 29, 1973 indicates that the pre-War SEC Commission did not contemplate the virtually complete transfer to the private sector of the authority for development of corporate financial reporting that characterizes the position of today's SEC.

The present initiative for corporate financial reporting rules is in the hands of the private sector, and there are serious doubts in the minds of some contemporary Congressmen about the wisdom of that arrangement. As of this writing, a year-long series of hearings was being conducted by a major House subcommittee into Securities and Exchange Commission oversight of the accounting profession. The hearings covered arrangements for the development of rules for corporate financial reporting and auditing standards. The manner in which those rules became institutionalized in the private sector has been spelled out elsewhere [Chatov, 1975] and need not be covered in this paper. What is at issue at the present time is the question of the vesting in private groups of functions originally specified as governmental responsibilities. Regardless of the desirability of having a self-regulating, profit-oriented professional group control the rules under which they carry out their business operations, over a period of some fifty years the control of those functions has become increasingly institutionalized in private hands. This clearly makes for a form of

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legitimacy through de facto operations, rather far from any kind of authorized de jure process or intention.

Accordingly, it is appropriate to inquire into the origins of that process and to see what were the views of the original members of the Commission when the transfer of authority to the private sector began to occur. One Commissioner was William O. Douglas, appointed SEC Commissioner in January, 1936, and Chief Commissioner in September, 1937 (on James M. Landis' resignation) until in April, 1939 he resigned to take a seat on the U.S. Supreme Court. His thirty-six years on the bench of the Supreme Court was the longest tenure of any Supreme Court Justice in U.S. history. Douglas' views on law are well known, and he was regarded as an important champion of civil and constitutional rights. His views on business were influenced by his studies of corporate financial operations as a member of the Yale Law School faculty, studies which served him well on the Securities and Exchange Commission. He was known as "firm" when it came to the business sector, but was not considered an enemy [*New York Times*, 1980]. Douglas was an activist in most matters, and this characterized his attitude while an SEC Commissioner, and was reflected in his view that the SEC should take a leading role in the regulation of corporate financial reporting.

In response to an inquiry I sent to him in connection with the background to the initial transfer of authority for corporate financial reporting from the SEC to the private sector in the latter part of the 1930s, Justice Douglas first wrote that the events were far enough back that he would have to do some research and recollection before he could respond. Subsequently, I received from him the following letter, which is reproduced below in its entirety.

Supreme Court of the United States
Washington, D. C. 20543

Chambers of
Justice William O. Douglas — September 29, 1973

Dear Professor Chatov:

I have your letter of August 22nd and as I wrote you the answer to your questions entailed research on problems raised nearly 40 years ago.

In 1936 and 1937 Robert E. Healy and I thought the Commission should take the lead in formulating accounting principles as it was

empowered to do under § 19 (a) of the 1933 Act. No one in the Commission thought it should be abdicated. All of us had seen even partners in the best of firms walk perilously close to the line both as respects civil and criminal liability. Landis in his speech of December 4, 1936 before the Investment Bankers said that our experience with accountants led us to conclude that the form of financial statements should not be left "to professional responsibility alone" that the SEC had a responsibility to see to it that financial statements were not permissible if they were misleading.

Carmon A. Blough stated on December 13, 1937 that SEC action on statements required immediate action but the Commission often did not have time to do the extensive research necessary to formulate the correct accounting principles in a given case. Even though the practice used seemed "improper," the Commission (over the dissent of Healy and me) often accepted a statement provided there was in a footnote, a "complete" disclosure of the questionable matters."

On February 12, 1938 the Commission appointed an intra-agency committee to work on "rules prescribing accounting practices and procedures."

Healy's view and mine were reflected in a Commission Release No. 4 on April 25, 1938:

> 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 disclosure 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.

As I recall George Matthews dissented from that position.

Healy had anticipated that ruling in an address on December 27, 1937 before the American Accounting Association when he said the Commission was undertaking "to express a few standards as to principles which we believe are accepted by a majority of good accountants, especially those who do not assume the role of special pleaders for their more lucrative clients."

One example he gave was preferred stock issued at $80 a share with a par value of $40. On its balance sheet the company showed $40 per share for the preferred and $10 a share as "paid-in-surplus." The company claimed the $10 could be used to pay dividends to the common stock. Healy denounced that practice. He listed others of like gravity and gave instances where the Commission was divided, the majority clearing registration statements, though in Healy's view and in mine they were misleading. It was our view that "if an earnings statement and a balance sheet reflect the results of improper accounting they amount to misrepresentative and misleading statements in violation of the Security Act."

Healy said that "The Commission will continue its efforts to develop a body of accounting principles through its decisions."

What happened in my time was a common-law development of precedents — case by case. Some principles were established by Commission rulings; others by opinions of the Chief Accountant.

I speak only of the period ending in April 1939 when I left the Commission. I have not followed the problem since then.

Yours faithfully,
William O. Douglas

Justice Douglas' letter indicates several things about the subject during his term as SEC Commissioner. First, two of the five commissioners, including Douglas, wanted the SEC to lead in accounting rule development. The initial mandate to the private sector had been given in December, 1936, and the first steps toward institutionalizing it there taken in the following year [Chatov, 1975, 106-32]. Just as important is Douglas' statement that "No one in the Commission thought it should be abdicated." The next sentences in his letter leave no doubt about why the Commissioners held that belief. There was the problem of temptation, and the SEC had an obligation to see that the rules developed were appropriate to the purpose intended under the Securities Acts. The text of the SEC's Accounting Series Release No. 4 indicated, as far as

Douglas was concerned, that the SEC would remain an active participant in accounting deliberations. Also of note is Douglas' endorsement of Healy's views, quite evident in the above letter.

One can conclude that the present arrangements for the development of financial reporting rules, endorsed in full by the present SEC Commission, and reaffirmed in Chief Commissioner Shad's statement before the Dingell Committee on March 6, 1985 [Shad, 1985] were not at all contemplated or endorsed by the members of the pre-World War II Commission, regardless of the initial transfer of authority to the American Institute of Accountants in 1936-38.

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