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Editorial

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EDITORIAL

Interpreting the Securities Act

Accountants are still laboring under a heavy cloud of uncertainty because of the potential perils which seem to have been thrown around their practice by some of the provisions of the federal securities act. Conferences, formal and informal, have been taking place during the summer, for the purpose of determining, if possible, exactly what additional liability may attach to the signing of an accountant's certificate and what may be the range beyond which an accountant can not venture safely. As every reader of this magazine knows, the act requires that prospective issuers of securities shall present financial statements certified by public accountants, and it fixes a definite responsibility upon the accountants who certify. The federal trade commission, which is charged with authority to administer the act, has promulgated regulations which prescribe to some extent the content of the accountant's certificate, and the commission has also issued a form of registered statement which specifies in some detail the information which the accountant must disclose and the manner in which he shall disclose it. The registration statement and schedules required by the federal trade commission should, of course, be carefully studied by every practising accountant and, in fact, by every other person or firm or corporation which may by the terms of the act be laden with a responsibility for the accuracy of statements.

The Liability

The first consideration which will engage the attention of practitioners is naturally that which relates to instructions as to procedure. Every accountant will desire to comply so far as he may do so with the specifications laid down. Probably the requirements do not impose a burden impossible to be borne. The second consideration, however, is less easily understood. This is the question of liability. Under the heading, "civil liabilities on account of false registration statement," section 11 of the act provides that, in cases of untruths or material omissions in a registration statement, any person acquiring the security may sue the signers of the registration statement and the experts, including accountants, who with their consent have been named as having prepared or certified any part of the statement. The section recognizes certain defenses and provides for contribution among parties held liable. On this highly important point it is difficult to predict what fate will follow the administration of the act. It is provided in section 11 (a) that in case any part of the registration statement contained an untrue statement of a material fact or omitted to state a material fact, every person who signed the registration statement, every accountant, engineer or appraiser, or any person whose profession gives authority to a statement made by him, may be sued by any person acquiring a security issued in conjunction with the registration statement. Further, the person acquiring the security does not have to show that he was misled by the incorrect statement or omission or even that he had ever read the registration statement or any part of it, unless it is proved that at the time of acquisition of the security he knew of such untruth or omission. The clause, which has been paraphrased, laying liability upon every person whose profession gives authority to a statement made by him seems to be all-embracing. It certainly must include accountants, lawyers, engineers, appraisers, architects, bankers and probably many others. Consequently, the scope of liability is enormous. In order to sue the accountant, however, the statement which purports to have been prepared or certified by him must be considered separately, and it must be found to contain an untrue statement of a material fact or an omission to state a material fact before there is a basis for a suit against the accountant. He is not responsible for statements or omissions in other parts of the registration statement.

The Defense

After the question of liability there follows, of course, the question of defense. Here we discover a novelty in American law, for it appears that the burden of proof under the securities act is upon the defendant and not upon the plaintiff. In suits under section 11, the plaintiff must sustain the burden of proof that there has been in the part of the registration statement attributed to the accountant an untrue statement of a material fact or the omission of a material fact which should have been stated to avoid misleading the reader, and the plaintiff must also sustain the burden of proof that the security has been acquired and that the name of the accountant had been used with his, the accountant's, consent. After the plaintiff has made this proof, the burden is placed on the defendant to establish the defenses allowed under 11 (b). The term, burden of proof, has been discussed in innumerable cases. Perhaps the definition contained in an old New Hampshire case, *Lisbon v. Lyman*, is as good as any. In that case Chief Justice Doe said:

“The burden of proof (in this case on the subject of emancipation) was on the plaintiff; and this burden was not sustained, unless the plaintiff proved it by a preponderance of all the evidence introduced on the subject. But it was not necessary for the plaintiff to produce anything more than the slightest preponderance. . . . Before any evidence was introduced, the scales in which the jury were to weigh the evidence were exactly balanced; if they remained so after all the evidence was introduced, emancipation was not proved; if they tipped ever so little, in favor of the plaintiff, emancipation was proved.”

The defenses which are common to all suits naturally apply in cases arising under the securities act, and it is unnecessary to consider them here; but there are some doubtful points which will have to be tested in order to obtain authoritative interpretation. The accountant can be sued only with respect to matter which purports to have been prepared or certified by him. But even in a profit-and-loss statement or balance-sheet certified by an accountant there may be items as to which he in turn has relied upon another expert. As to such statements section 11 (b) (3) (C) apparently imposes upon the accountant only the duty of having reasonable ground to believe and in fact believing that they were true, etc., and that they fairly represented the state-

ment of the expert, etc. It will be noted that the accountant is not required here to make a "reasonable examination." Apparently this means that the accountant does not have to make an examination himself but may rely upon the other expert to do so. Reasonable ground to believe that the statements of the other expert were true and belief that they were true may well be grounded upon a knowledge of the good reputation of the other expert, unless something should arise which would put a reasonable man on suspicion. But reasonable ground to believe that the registration statement fairly represents the statement of the other expert or was a fair copy of or extract from his report or valuation should be grounded upon an examination by the accountant of the original report or valuation of the expert and upon a comparison with the statement contained in the registration certificate.

Two Schools of Thought

These opinions are merely the results of a preliminary study of the act and regulations. Nothing has yet come before the courts, and it is impossible to foresee what adjudication may follow the trial of causes arising from the act and its administration. There is a wide difference of opinion among accountants themselves. There is a school of thought, commendable if not exactly practical, which holds that an accountant should never hesitate to assume full financial and moral responsibility for every figure in the accounts of every company whose balance-sheet bears his certificate. Members of this school aver with a great deal of apparent reason that no accountant should seek to evade or avoid the absolutely full liability which by any stretch of imagination may be considered his. To support this theory there is the fundamental principle of professional integrity and rigid independence. On the other hand there is another school, more numerous and probably much more representative of the profession, which maintains that the assumption of all-embracing liability may carry with it an overwhelming burden. Members of this second school point out that an accountant's certificate is at best merely an expression of his honest opinion and if he is to be held to a full legal liability for every figure, he may become the bearer of a burden of which he can have had no foreknowledge.

**The Accountant's
Position**

There have been arguments presented in some of the daily papers and elsewhere that the consternation which the federal securities act has created in the minds of many accountants is merely an indication of the accountants' desire to escape the penalty of inaccurate work. Such statements are ill-considered and unjustified. Every accountant knows and every experienced business man should know that no accountant can possibly be sure that there is a total lack of error or fraud in every figure presented to him. The accountant never claims infallibility—at least we can not imagine an accountant who would be so foolhardy. Even with the utmost care and the employment of the keenest mind there may come mistakes, unimportant in themselves, which under a strict interpretation of the federal securities act could be construed, if the courts were meticulous rather than equitable, into a failure to detect an inaccuracy. We do not believe that any court of justice would so literally construe the act or any of the regulations promulgated under it as to inflict a penalty upon an accountant who had certified a statement in the firm belief that it was correct after a proper investigation and the utilization of proper professional ability. Nevertheless, there is inherent in the act a grave danger, and this it is which is causing accountants so much doubt as to the practice of their profession under the new law. It can not be too vehemently repeated that the accounting profession will do its utmost to observe to the letter all laws which are fairly drawn and properly applied. They are charged with a responsibility which is heavy, but their opportunity to serve well the public and the country is almost unparalleled. They rightly feel that if they do all that can be reasonably expected of them they should not be placed in jeopardy or be called upon to meet a responsibility quite out of keeping with justice and fair play. To illustrate in a somewhat fantastic manner the dangers which some accountants think they have detected in the act, let us assume that the XYZ corporation, whose securities are listed on the principal stock exchanges of the country and are selling today at one hundred dollars each, should find its business declining and as a result the market prices of the securities should fall to ten dollars. A purchaser of a thousand shares of this stock might, it is said by extremists, discover that there had been a minor error in a financial statement issued by the XYZ Corpora-

tion and certified by an accountant. The investor whose thousand shares of stock had declined in value from one hundred thousand dollars to ten thousand dollars could then sue the accountant for ninety thousand dollars, alleging that he had based his purchase upon reliance on the accountant's certificate and that the loss was therefore attributable to the accountant's negligence in failing to detect the error in the accounts. This, of course, is *reductio ad absurdum*. Nevertheless, there are portions of the act which lend at least a color of possibility to the argument.

What to Do If the responsibility attaching to the accountant is to be expanded inordinately as it may be pending adjudication of the act, it is certain that the accountant must do something to protect himself from those perils which, however improbable, are still possible. The vast extent of financial liability which might be involved is staggering. The accountant can not insure himself against any such world-wide liability as has been suggested. He may raise his fees four-fold or a hundred-fold and still remain in danger. He may carry insurance of colossal amount and still be inadequately protected from every possibility of disaster. Naturally no reputable accountant believes that he should escape the proper penalty for negligence, but we are concerned at present not with negligence but with inadvertence. It has been said in these pages many times that accountancy is not and can never be an exact science. It is only the exercise of experience, knowledge and integrity applied to the consideration of a group of facts and figures. Every accountant may err. No accountant denies the possibility of error. And consequently certificates are not statements of mathematical precision but the honest expression of carefully weighed opinion. This is an element which seems to have been overlooked in the language of the act, and consequently it remains for the courts to determine where the accountant's responsibility begins and, more important yet, where it ends. And what is true of the accountant is true also of the lawyer, the appraiser, the engineer and everyone else who is in any way associated with the affairs of companies whose securities are offered for sale. Probably the experience of a few years, if the act remain in force so long, will dissipate the needless fears and will witness the establishment of a fair and sensible inter-

pretation, but in these chaotic days of experimentation the accountant may well be pardoned for looking askance at some of the developments which are taking place. It is not a time for captious criticism. We are wandering somewhat blindly in the fog of new ideas. We hope that out of all this muddle there may come justice and prosperity once more. Every good citizen will earnestly endeavor to help the bringing in of better days. The accountants certainly will do their part to the best of their ability. More than that no man can do and no man must be expected to do.

Dives in Coma A leader in a great industry is reported to have said lately, "There is one expression formerly common in our language which no longer has any meaning at all—'a rich man.' There are no more rich men." This aphorism was much quoted and nearly everyone smiled a little indulgently. "Oh, that is just a bit of rhetoric," said many folk. "He is still rich himself." But there were others who thought they could look below the surface of traditional things and fancied that they could find that there was stark truth instead of a figure of speech in this brief dirge. Of course there are men richer than other men, but that is a question of comparison rather than degree. It is probably almost safe to say that there are very few rich men today; but that has little bearing upon history, past and future. The old title "rich man" has been cherished so long that it bears letters patent throughout the world. We have it even in our nursery rhymes. We are brought up to despise wealth as the root of all evil, but without much attempt at secrecy we all look forward—all of us, whatever our ages—to the day when our ship shall come in and we shall be rich. Of all the noble theorists who have decried wealth few have not yearned for its possession. The pursuit of riches is our principal concern. We want to be rich men. Once upon a time quite a good many achieved their ambition. And now comes the cold, experienced voice of a man who long since arrived at the goal telling us: "There is no rich man any more." It is a severe shock to us if we believe him. Far better, then, we say, to remember that he is joking. He is merely trying to let us know that he and some of his playmates in the universal game have been losing part of their winnings in this period of tumbling values and shattered hopes. He was not jesting,

however, but perhaps he was not quite right. There is a great deal of talk about the passing of wealth. Some very cautious thinkers in the practical school are saying among themselves that the rich man is no more, and possibly he never will return. They hold with increasing firmness to the conviction that this day of God-only-knows is really a transition to something hitherto undreamt and they say, softly and fearfully when no one who would not understand can hear; "Even if a rich man were discovered in some remote refuge from revolution he would no longer be rich. Taxes, confiscation, the slightly veiled communism of the new day would strip him bare. He would have to worry along with a loin cloth and a pair of sandals like the rest of us."

**The Old Order Will
Return**

It is not only here in America that the lament for wealth is heard. There is a vibrant echo of it in Britain and in France. It is almost a pæan of joy in the lands which are coming out of their miseries through the vision and power of benevolent dictators. Throughout the civilized world—we cling to convention—there is a great deal more of weeping by the catafalque of Dives than most of us, who like to go our even way, would care to believe. The reason is evident and convincing. Wealth made rather a sorry mess of the business of ruling. It had its day, like all other potentates. Now the sun has gone down and the night is pretty dark. Some people think it is the end of a dynasty. Labor, the proletariat—which no one can define, but the word sounds well and terrifies the timid—the middle class—in which no one for a moment admits membership—any one or all of these will reign in the stead of the dethroned Wealth—at least it is so predicted. But it may be worth while, if for no better purpose than mental exercise, to remember one everlasting verity—one that will defeat all the precious hopes and prophecies of the present iconoclasm. The truth is we all love and revere this god of yesterday. We are loyal to him, let us damn him as we may when the frenzy of reform is on us. We want him to reign over us, and tomorrow morning before the sun comes we shall all run up the eastward hill and strain our eyes for the first glint of the regal crown. If we did not love this beautiful, hard god it would be different. We should keep him out forever. But we will bring him back so long as the blood

runs in our veins, because he is our king. We can not do without him. Few of us can ever touch the fringe of his robe, but we demand the right to reach out for it. And so the old Olympian will return and take up his kingdom. If governments or rulers or legislators or parties or cults or giants or pygmies oppose, it will all be one in the end. We want our golden tyrant and he can not be kept from us.

**The Restoration
of Riches**

This is not metaphor only. It is blunt pragmatism. We should like to see a just distribution of wealth, so that the old abuses could never return; but whatever laws we make or whatever pious vows we offer we can not prevent the gaining or losing of wealth, so there will be rich men and poor men also, alas. When the world seems topsy-turvy the astrologers and soothsayers make their voices heard; but the world is more stable than we think it, and it is in the grip of immutable law. It will come out of the present fearful theorism into reality again. A few years from now a dozen men will look down the square vistas of Wall Street and laugh over the reminiscences of the reconstruction period as it was called. One of them will say, "And Charlie Schwab said there were no more rich men. He was a great joker, and some people took him seriously." We are inclined to agree with that man of tomorrow. It may be wrong in morals and discouraging to the threadbare idealist, but there will be rich men again, many more than there were. But we think there will be fewer poor. All this will be when we shall have come to our senses—which God send soon.