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Problems of Accountants under the Securities Act of 1933*

By James Hall

Introductory

Mr. Gordon, in his paper on "Accountants and the securities act" has analyzed with skill and clarity the provisions of the securities act relating to the responsibility of accountants under the act, the defenses available to them in case of suit and the extent of their liability. But the most important part of the paper, from the viewpoint of practising accountants, is the discussion under the head of "Standard of reasonableness," of the fiduciary relationship imposed upon accountants by the provisions of section 11 (c) of the act.

In concluding, Mr. Gordon expresses the opinion that under the securities act, in regard to the parts of the registration statement attributable to the accountant, with his consent, the liability of the accountant is greatly broadened:

"(1) As to the persons who may recover in cases other than those of fraud: they need have no contractual relationship with the accountant.

(2) As to the injury: this may be caused in part by events other than the negligence or fraud of the accountant.

(3) As to the amount of the damages recoverable: this has been increased by section 11 (e) (1) and perhaps by section 11 (e) (2)."

And moreover—quoting again from Mr. Gordon's paper—"All other rights and remedies that may exist at law or in equity remain."

The opinion expressed by Mr. Gordon as to the liability of accountants under the securities act is far from comforting; in fact, Mr. Gordon's remarks rather suggest that acceptance of engagements for examinations that involve the registration of securities under the provisions of the securities act may be fraught with serious consequences to accountants because of the possibilities in the way of legal blackmail and unjust claims by disgruntled investors.

*Address delivered at the annual meeting of the American Institute of Accountants, New Orleans, Louisiana, October 17, 1933.

Accountants must, therefore, for their own protection, consider seriously the problems that they are likely to encounter should they decide to accept engagements for examinations that involve the registration of securities under the provisions of the securities act regardless of the risks presented. Of the many problems that accountants would be likely to encounter in the course of such engagements, the following are suggested as being, perhaps, the most important.

Cash

First, as to the item "cash." It has been customary for accountants, when examining national organizations with numerous branches, to rely upon acknowledgments from branch managers or other custodians as to the existence of cash funds at points not visited during the examination. Should it develop subsequently that a number of these unverified cash funds were overstated or non-existent at the date as of which he had certified the balance-sheet, it might be that the accountant, by reason of the fiduciary standard imposed upon him by the act, could be held liable on the grounds that in accepting certificates from others, as to such cash, he had not fulfilled his obligation to the investor.

Accounts Receivable

Now as to accounts receivable. It is only in exceptional cases that accountants are authorized to confirm accounts-receivable balances by communicating with the debtors. And even when accountants are authorized to confirm the balances, they are seldom able to obtain acknowledgments for more than 75 or 80 per cent. of the balances. Yet it may be that nothing short of a 100 per cent. confirmation of the balances would be required of a fiduciary. Until the courts rule upon the point, however, accountants would seem justified in extending very materially their scrutiny of the accounts receivable. They might be justified also in insisting upon confirmation of exceptionally large or otherwise unusual balances. It goes without saying, of course, that accountants should explain at some length in their reports or certificates the scope and results of their inquiries in regard to the accounts receivable.

Reserves for Doubtful Notes and Accounts

The regulations (instruction 9—balance-sheet) call for a statement as to "whether in the judgment of the issuer, all notes and

accounts receivable known to be uncollectible have been charged off and whether adequate reserves have been provided for doubtful notes and accounts." But there is nothing in the regulations to indicate how the accountant should proceed in the event of a difference of opinion as to the adequacy of the reserves. Possibly it would be proper for the accountant to certify the accounts subject to an estimated deficiency of blank amount in the reserves for doubtful notes and accounts. On the other hand, it may be that the accountant, as a fiduciary, should not certify the accounts until the issuing corporation adjusts its reserves in conformity with the accountant's estimate of the requirements.

Inventories

Heretofore accountants have relied, to some extent at least, upon the certificates of responsible officers in the client's organization as to the correctness of the quantities and descriptions of the individual items in the inventories of materials and merchandise. As fiduciaries, however, it may be that accountants will be required to assume complete responsibility for the correctness of the quantities and descriptions in inventories. In that event, accountants will be under the necessity of extending the scope of their examination of the inventories as at the closing date of the three-year period—possibly to the point where they would actually oversee the taking of the inventories, either alone or in conjunction with recognized experts in the particular lines of material or merchandise to be inventoried: some clients, undoubtedly, would protest most strenuously against the expense that such an extension of the accountant's activities would entail, but that is a feature of the matter that we need not discuss at this time. Only a limited examination would be possible, of course, in respect of the inventories applicable to the opening date of the three-year period and those prepared as at the end, respectively, of the first and second years of the three-year period: it should be stressed, however, that the opening and intermediate inventories are not to be ignored.

With further reference to inventories, many accountants are willing—or, perhaps I should say, eager—to admit their limitations as valuers. But with the securities act imposing a fiduciary standard, accountants, sooner or later, may find that the rôle of valuer has been forced upon them. Accordingly, it would seem desirable for accountants to extend the scope of their investiga-

tions into inventory values to an extent that will enable them to accept a reasonable degree of responsibility as to values.

Plant and Equipment

Now let us consider charges to the plant and equipment accounts in respect of capital expenditure. It is clear that the charges for the period of three years for which profit-and-loss accounts are required should be examined more or less thoroughly, according to the effectiveness of the system of internal control and the proportion of the work undertaken by the construction staff of the issuing corporation. But to what extent should the accountant examine the expenditures from the inception of the enterprise to the beginning of the three-year period referred to above? A superficial examination of the expenditures for the prior period would not be conclusive and might expose the accountant to charges of negligence. On the other hand, the cost of a thorough examination for the prior period might be prohibitive in the case of a long-established company.

Another important point connected with property and plant accounts is the extent to which the accountant could be held liable in case he failed to detect abandonments of property and plant that had not been charged off in the accounting records. Possibly the accountant would be entitled to rely upon a certificate from a responsible officer of the issuing corporation as to the nature and amount of any unrecorded abandonments, either consummated or contemplated.

As to the responsibility for establishing legal ownership of the properties carried on the books of the issuing corporation as owned, this would seem to be a matter for which the attorneys retained by the bankers should assume undivided responsibility. Probably the accountant, in his report or certificate, could elect whether to disclaim all responsibility in regard to titles or, alternatively, indicate that he has relied entirely upon the search made by the attorneys.

Problems incidental to the adjustment of the property and plant accounts to conform with appraisal values may not demand attention for some time to come. But while on the subject of appraisals it would be well to consider for a moment how the accountant can best protect himself against claims arising out of errors in appraisal values reflected in the balance-sheet certified by the accountant. Regardless of the standing of the organiza-

tion responsible for the preparation of the appraisal, the accountant should make such comparison of the appraisal with the property and plant accounts as may be necessary to ensure, among other things, that no leased property has been included in the appraisal as owned property, that as regards recent acquisitions listed in the appraisal, corresponding entries have been made in the financial records of the issuing corporation, and, last but not least, that no items of supplies, repair parts or similar items, included by the issuing corporation in its inventories, have been duplicated in the appraisal. When the appraisal shows a substantial overage as compared with the book value, the accountant should, in addition, make such further comparisons of the appraised and book values as will enable him to account substantially for the overage. Similarly, any parts of the property that have been out of service for an extended period should be identified and shown separately on the balance-sheet.

Depreciation and Depletion

In considering depreciation and depletion, it is of interest that the issuing corporation is required, under instruction 2 relating to the balance-sheet, to make a reasonably complete disclosure both as to policy and amounts appropriated. When the amounts appropriated appeared to be adequate, the accountant would not, of course, have any hesitation in certifying the balance-sheet and profit-and-loss account. In case the amounts appropriated were based on rates furnished by an independent appraiser or engineer it might seem advisable for the accountant to mention in his report or certificate the authority for the rates used.

But, on the other hand, when the accountant can not see his way clear to concur in the policy of the issuing corporation as regards depreciation and depletion, would it be proper for the accountant to certify the statements subject to the adequacy of the amounts appropriated by the issuing corporation in respect of depreciation and depletion, or would he be under the necessity of refusing to certify? It might be mentioned here that, in many cases, it would be practically impossible for the accountant to determine, with any degree of certainty, the amount of the deficiency in the provision for depreciation and depletion.

Intangible Assets

One can only conjecture as to the extent to which the accountant could be held responsible for the reasonableness of the values

at which intangible assets are stated in the balance-sheet of the issuing corporation and the adequacy of the amounts charged off in the profit-and-loss account of the issuing corporation in respect of amortization. Here, again, the only safe course will be for the accountant to make a complete disclosure in his report or certificate.

Accounts Payable

As to accounts payable, inasmuch as the certified balance-sheet is required to be available within ninety days after the date thereof, it would be unreasonable to expect the accountant to assume unlimited responsibility for the omission from such balance-sheet of undisclosed liabilities—particularly if the issuing corporation happened to be national or international in scope. But for the present, at least, all that the accountant can do is to take the usual precautions and, in addition, qualify his report or certificate.

Contingent Liabilities

With regard to contingent liabilities (the more important of which are listed in the regulations under instruction 27—balance-sheet), it is obvious that where items of this nature do not appear in the financial or corporate records of the issuing corporation relating to the period examined, the accountant is under the necessity of relying upon the disclosure made by the issuing corporation when it certifies for purposes of the accountant as to the nature and extent of the unentered liabilities. Incidentally, the registration statement contains provision for a statement of pending litigation (item 17) and a statement of material contracts (item 46); both of these statements would be helpful to the accountant in ascertaining the contingent liabilities of the issuing corporation. Nevertheless, the accountant should indicate in his report or certificate the scope of his inquiries in regard to contingent liabilities and the extent of his reliance upon the assurances of the officers of the issuing corporation.

Non-Recurring Income and Expenses

One requirement of the securities act that should prove acceptable to accountants generally is that non-recurring items of income and expenses must be included in the profit-and-loss account forming part of the registration statement (see instruction

8 in regard to profit-and-loss account). Often, in the past, it has been a good deal of a problem, when preparing earning statements for inclusion in prospectuses, to decide whether the inclusion or exclusion of such items would afford the more correct forecast of future earning capacity.

Confirmation of Arrangements

When arranging for the examination, the accountant should insist upon a definite, written understanding as to the scope and limitations of the work to be undertaken. Moreover, the accountant should insist upon this understanding—which, usually, would take the form of a proposal made by the accountant to the issuing corporation—being formally accepted on behalf of the issuing corporation by a duly authorized representative. Any subsequent modifications or extensions of the original understanding should, of course, be reduced to writing and confirmed in like manner.

It is hardly necessary, perhaps, to suggest that before accepting the engagement, the accountant should satisfy himself that the officers of the issuing corporation can be relied upon to fulfill their commitments and that they and the bankers interested are of good repute.

Accountant's Records

In view of the fact that the burden of proof is transferred, under the securities act, to the accountant, and on the assumption that each engagement accepted in connection with an issue of securities will carry with it the possibility—if not the probability—of litigation, it is appropriate that some consideration should be given to the accountant's working papers and other records relating to the engagement. Of the many precautions that should be taken when working papers and other records may have to be produced in court, the following are, perhaps, the most important:

Each working paper should be signed by the accountant who prepared it and should show the date on which it was prepared and from what records. Where a working paper is the subject of discussion with officers or other representatives of the issuing corporation, the names of the persons present at the discussion and the date, purpose and result of such discussion should, also, be noted on the working paper by the member of the accountant's organization conducting the discussion.

The detailed time reports of the staff members of the accountant's organization should set forth in reasonable detail the nature and extent of the work done in relation to each book or account or other matter upon which work has been done. Conferences with members of the client's organization in regard to matters arising during the examination should also be referred to in the detailed time reports.

Concerning the file of documents generally referred to as the "permanent file," it would seem desirable to have any unsigned copies of such documents authenticated by the secretary of the issuing corporation. To facilitate identification of the documents in court, the date of receipt and the names of the persons who, respectively, tendered and received the documents should be noted thereon.

Accountant's Report or Certificate

Until the situation is clarified by modification of the securities act and related regulations, or by court decisions on cases arising under the provisions of section 11 of the act, the accountant should include in his report or certificate a comprehensive statement descriptive of the scope of the examination. He should include in his report or certificate, also, whatever qualifications are necessary in respect of items in the balance-sheet and profit-and-loss account that have not been fully verified. And, finally, he should include in his report or certificate such explanations as are necessary to the end that the report will be completely informative. In one instance that came to my attention recently, the accountant's certificate had been expanded into a report of approximately thirteen hundred words.

Accountants' Statements

As to the form of the accountant's statements—and this applies equally to the balance-sheet and to the profit-and-loss account—it appears to be incumbent upon accountants to extend the captions and amplify the descriptions of the individual items in these statements to such extent as may be necessary to ensure that the statements shall be completely informative and readily understood by investors not familiar with accounting terminology.

"Pro forma" balance-sheets and profit-and-loss accounts are not mentioned either in the securities act or in the regulations relating thereto. This omission may, possibly, have some sig-

nificance, but it is questionable whether it justifies the conclusion that registration statements and prospectuses issued hereafter are not to contain "pro forma" statements. At the same time, accountants are entitled to take the position that they do not care to certify "pro forma" statements for inclusion in registration statements and prospectuses until the federal trade commission has expressed its views in regard to such statements.

Indemnification of Accountant by Issuing Corporation

And this brings us to the question as to whether the accountant should require from the issuing corporation an undertaking whereby the issuing corporation will agree to indemnify the accountant against any liability, costs or expenses resulting from suits that may be brought against the accountant by reason of the additional liability imposed upon accountants by section 11 of the securities act. One of the plans suggested takes the form of a letter from the issuing corporation to the accountant. It reads as follows:

"The undersigned, has requested you to make an investigation of its accounts for (period) and to make a certified report thereon which may be used in connection with the filing of a registration statement pursuant to section 6 of the securities act of 1933, for the purpose of registering thereunder the following:

(description of issue)

"In consideration of your making such investigation and report and of your consenting in writing to the use of such report in connection with such registration statement, the undersigned agrees that, in addition to paying the fee contemporaneously agreed upon with you it will indemnify you and save you harmless from and against all liability, costs and expenses which may be incurred by you or for your account (including the fees of your counsel) in or in connection with any suit or other proceeding which shall be brought or claim which shall be made against you under the aforesaid act based upon an allegation that such report contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, provided that such statement or omission was made by you in good faith."

Whether accountants should request, in reference to each examination accepted that involves the registration of securities under the securities act, that the issuing corporation shall undertake to indemnify them (that is, the accountants) for any claims

that may be made against them and expenses that may be incurred by them, in consequence of the extension of the accountant's liability under the securities act, will depend upon many things, including the financial responsibility of the issuing corporation and the attitude that the federal trade commission may take toward such undertakings. But at the moment, the weight of opinion seems to be in favor of requesting indemnification.

Fees for Examinations Under Securities Act

And, in conclusion, just a word on the subject of fees for examinations by accountants under the securities act. Unquestionably, accountants will be under the necessity of obtaining, in future, much larger fees than clients have been willing to pay in the past. One reason why a substantial increase in fees is imperative is that the fiduciary standard imposed by the act will force accountants to extend very materially the scope of their work, possibly to the extent of making detailed audits where tests of the transactions have sufficed in the past. Another—and probably more important—reason why a substantial increase in fees is imperative is that the act extends the liability of accountants to all the world, so to speak.