Vanderbilt Law Review

Volume 28
Issue 1 *Issue 1 - January 1975*

Article 1

1-1975

Truth in Financial Statements: An Introduction

Douglas W. Hawes

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Accounting Law Commons, and the Securities Law Commons

Recommended Citation

Douglas W. Hawes, Truth in Financial Statements: An Introduction, 28 *Vanderbilt Law Review* 1 (1975)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol28/iss1/1

This Symposium is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

VANDERBILT LAW REVIEW

VOLUME 28 JANUARY 1975 NUMBER 1

SYMPOSIUM ON ACCOUNTING AND THE FEDERAL SECURITIES LAWS

Truth in Financial Statements: An Introduction

*Douglas W. Hawes**

Accounting, auditing and financial reporting are today the focus of great attention from professional accounting organizations, the Securities and Exchange Commission, the plaintiffs bar, the courts, academicians and others. Disturbing cross-currents are at work. While a strong push for greater certainty and uniformity in financial statements is occurring, the uncertain economic atmosphere casts a pall over all accounting deliberations. Some of the stresses and strains are familiar such as management's desire to put the best face on the company's financial statements; others are unfamiliar, for example, double-digit inflation and its implications for an accounting system grounded on historical cost.

The courts increasingly are being called upon to judge financial statements in a literal flood of litigation.[1] These cases tend to be brought under various antifraud provisions of the federal securities statutes, which present the critical question to the courts: "What is a true financial statement?"[2] This question derives from the statutory (and regulatory) language of these provisions, which encompass both an "untrue statement of a material fact" and an omission of a material fact necessary in order to make the statements made not misleading. Accordingly, truth under the antifraud rules, and

* Adjunct Professor of Law, Vanderbilt University; B.A. 1954, Principia College; J.D. 1957, Columbia University; M.B.A. 1961, New York University. Member, New York Bar.

1. A 1973 count showed that more than 500 companies have litigation or claims in process involving auditors. *See* Arthur Andersen & Co. ANN. REP. 4 (Mar. 31, 1973).

2. *See, e.g.*, Securities Act of 1933, §§ 12(2), 17(a), 15 U.S.C. 77l(2), 77q(a) (1971); Securities Exchange Act of 1934, §§ 10(b), 14(a), 14(e), 15 U.S.C. §§ 78i(b), 78m(a), 78m(e) (1971); Rule 14a-9, 17 C.F.R. § 240.14a-9 (1974); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974).

as the term is used in this article, means true *and* complete. Given the definition of truth under the antifraud rules what then is a true financial statement? Is it a financial statement prepared in accordance with generally accepted accounting principles (GAAP)?[3] Is it a statement that "presents fairly" the financial position of the company, and if so, does or should this standard differ materially from GAAP?[4] Further, under certain circumstances, does "truth" include supplemental disclosures by management in textual material accompanying financial statements?[5] To these long standing conundrums hus been added a very modern one—can financial statements that ignore the effect of double-digit inflation be said to "present fairly" the financial position or to constitute full disclosure?[6] Unfortunately, these academic-sounding questions have important practical implications because their answers are being determined in court decisions imposing not only civil, but in some instances criminal liability for auditors and others.[7] The accounting solutions are neither neat nor easy and the problem is compounded because to some extent the general public, the business community and, most importantly, the courts, appear to cling to a basic misconception that accounting is as simple and precise as arithmetic. In short, as recognized by the President of the American Institute of Certified Public Accountants (AICPA), Mr. Wallace E. Olson:

---

3. AICPA, Accounting Principles Board Statement No. 4, ¶ 31, 2 CCH APB ACCTG. PRINCIPLES at 9,065 (1971); *see* Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201 n.7 (1975).

4. For an authoritative view of what "fairly presents" means in an auditor's opinion see Carmichael, *What Does the Independent Auditor's Really Mean?*, J. OF ACCOUNTANCY, Nov. 1974, at 83, 86, and APB Statement No. 4, ¶ 189 (definition of "presents fairly") 2 CCH APB ACCTG. PRINCIPLES at 9099-9100 (1971). It is recognized that at least in a certain sense "fair presentation" is itself a generally accepted accounting principle. GAAP is used in this introduction, however, without specifically including fair presentation.

5. See text accompanying notes 46-49 *infra*. *See also*, a pioneering article on the issue of truth in financial statements, Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151, 1192-94 (1970) [hereinafter cited as Kripke]. The term "financial statements" includes, of course, the footnotes.

6. The Consumer Price Index showed an increase of 12.1% for the 12 months ended November 30, 1974. 4 CCH LAB. L. REP. ¶ 7770, at 12,910 (1974).

7. Accountants from Peat, Marwick & Mitchell have recently been convicted in connection with the *National Student Marketing* case, SEC NEWS DIGEST Nov. 25, 1974, at 3, the second such conviction in recent years (the first was of the Lybrand accountants in United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)). On February 7, 1974 a federal jury in Oklahoma acquitted 2 Arthur Andersen accountants and was deadlocked on a third in the *Four Seasons* case. SEC Commissioner Irving Pollock (Former SEC head of enforcement) has described the Commission's criterion for bringing criminal charges against auditors. He said that if it was not simply a case of a mistake and the facts were so obvious and readily available that an auditor could not miss them, the auditor has a duty to be a knave and not a fool. Olson *infra* note 8, at 57.

> There is a substantial gap between the thinking of the profession and what the courts as well as others are saying about the responsibilities of auditors. The answers are being thrashed out principally in the courts.[8]

Underlying these questions of truth in financial statements are the basic issues relevant to financial reporting:

1. What are the objectives of financial statements?
2. For whom are financial statements written?
3. What should the financial reporting standards be and with what certainty should they be constituted?
4. Who should set the standards for financial reporting—professional accounting organizations, the SEC, the courts or all of these groups?
5. What is the role of the independent public accountant, what should auditing standards be, who should set them and to what extent should the independent public accountant be liable to third parties for failure to adhere to either financial reporting or auditing standards?

The *Vanderbilt Law Review* is presenting this Symposium to contribute to the general discussion of these singularly important issues. When used in relation to a periodical, the word "symposium" refers to "a collection of opinions on a subject."[9] The word derives from the Greek "sympinein," to drink together, and originally was applied to a drinking party in which conversation and intellectual entertainment played a vital part. To our "party" we have invited a distinguished group of authors representing in some cases widely differing points of view. They have contributed articles dealing with various aspects of these problems of financial reporting and auditing. We leave to you, the reader, and to those engaged in the continuing debate the final judgment on what constitutes truth in financial statements, what is the best method of achieving the desideratum and what is the role of the independent accountant in that process. Before turning specifically to the articles, this introduction will first examine certain landmark developments in accounting and financial reporting in recent years that bear on the questions posed, secondly, review a few seminal cases that focus on truth in financial statements and thirdly, discuss the implications of inflation in relation to truth in financial statements.

Recent Landmark Developments

The initial significant recent development worthy of note is the

8. Olson, *A Look at the Responsibility Gap*, J. OF ACCOUNTANCY, Jan. 1975, at 52, 57.
9. WEBSTER'S THIRD INTERNATIONAL DICTIONARY 2318 (1961).

formation of the independent, full time Financial Accounting Standards Board (FASB).[10] Following the Wheat Study in 1972, the American Institute of Certified Public Accountants (AICPA) designated the FASB to establish accounting principles.[11] While the FASB has issued only a few new accounting standards or interpretations to date (on relatively minor issues, *e.g.*, Disclosure of Foreign Currency Translation Information,[12] Accounting for Research and Development Costs[13] and Reporting Accounting Changes in Interim Financial Statements[14]), it has appointed advisory panels of experts to issue discussion memoranda, held hearings, issued exposure drafts and deliberated on setting and revising accounting standards on such hhorny topics as leasing, business combinations, materiality, accounting for contingencies and segment reporting.[15] Moreover, the FASB studies on the "Conceptual Framework for Accounting and Reporting"[16] and "Reporting the Effects of General Price-Level Changes in Financial Statements,"[17] both of which are commented upon below, are of a more fundamental and potentially far-reaching nature, both generally and in relation to the question of truth in financial statements.

In retrospect, the second anniversary of the formation of the FASB in the fall of 1974 may have marked the end of the honeymoon period for the FASB, because friend and foe alike are now pressing for some solid evidence of achievement. From all indications the difficult topic of the accounting treatment of leases will provide the first accurate basis on which to judge the FASB's performance.[18] That judgment will weigh the wisdom of the FASB's pronouncements, and the clarity of its accounting standards as well as its ability to defend them.

The second recent landmark development to be noted is the publication in October 1973 of the Report of the AICPA Study Group on "The Objectives of Financial Statements:" (the True-

10. The FASB is a committee of the Financial Accounting Foundation which was established on June 30, 1972, following the recommendation of the AICPA sponsored REPORT OF THE STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES (March 29, 1972) under the chairmanship of former SEC Commissioner Francis M. Wheat.

11. *Id.*

12. FASB, Statement of Financial Accounting Standards No. 1 (Dec. 1973).

13. FASB, Statement of Financial Accounting Standards No. 2 (Oct. 1974).

14. FASB, Statement of Financial Accounting Standards No. 3 (Dec. 1974).

15. For a general review of FASB operations to date see Sommer, *Setting Principles of Accounting: An Elusive Thing*, N.Y.L.J., Dec. 16, 1974, at 44-45. [Hereinafter cited as *Setting Principles*].

16. FASB Discussion Memorandum (June 6, 1974).

17. FASB Discussion Memorandum (Feb. 15, 1974).

18. FASB Discussion Memorandum (July 2, 1974).

blood Report).[19] The charter of that Study Group was to refine the objectives of financial statements and specifically to consider the following questions:

1. Who needs financial statements?
2. What information do they need?
3. How much of the needed information can be provided by accounting?
4. What framework is required to provide the needed information?

The Study found that "the basic objective of financial statements is to provide information useful for making economic decisions."[20] The Report listed twelve objectives of financial statements and concluded that:

1. Financial statements should emphasize information about transactions and other events that significantly affect enterprise earning power or changes in it. This information should be stated in terms of actual or prospective cash impact and should facilitate comparisons.
2. Financial statements should report both facts and interpretations about transactions and other events.
3. Financial statements should assist in the assessment of the uncertainties with respect to the amount and timing of cash receipts and disbursements.
4. Financial statements should report on series of transactions and other events, including value changes, in terms of earnings cycles.[21]

The Trueblood Report was followed by an FASB discussion memorandum entitled, "Conceptual Framework for Accounting and Reporting,"[22] which listed the twelve objectives stated in the Report and asked for comments "as the initial step in what will be an on-going project and in recognition of the primacy of the objectives of financial statements in its adoption of financial accounting standards."[23]

Third in the list of recent landmark developments to be noted is the SEC's reaffirmation in Accounting Series Release No. 150 of its historical position of looking to "the standard-setting bodies designated by the profession to provide leadership in establishing and

19. AICPA (Oct. 1973) (named for its Chairman, the late Robert M. Trueblood of Touche Ross & Co.).

20. *Id.* at 13.

21. *Id.* at 63-64.

22. FASB Discussion Memorandum (June 6, 1974).

23. *Id.* at 2.

improving accounting principles."[24] It was, and is, the Commission's position that "the determinations by these bodies have . . . with minor exceptions, [been] responsive to the needs of investors."[25] The Commission referred to Accounting Series Release No. 4[26] in which it had enunciated the policy that financial statements prepared in accordance with accounting practices unsupported by substantial authority were presumed to be misleading. In Accounting Series Release No. 150, the Commission stated that for the purpose of this policy, pronouncements of the FASB would be considered to have the requisite substantial authoritative support. At the same time, the Commission reserved for itself the responsibility to assure that adequate information is provided to investors and that appropriate methods of disclosure are used to meet investors' needs. If the FASB is unable adequately to fulfill its purpose, doubtless the SEC will move to fill the resultant vacuum. One Commissioner, Mr. Sommer, stated as much in a recent article in which he said:

> It is generally realized that the ultimate power for the determination of accounting principles to be used in connection with filings with the Securities and Exchange Commission (and I think by everyone's agreement the principles and practices with regard to those financial statements are almost universally followed in other statements as well) lies with the Commission and it is assumed that in the event of an irreconcilable disagreement between the Financial Accounting Standards Board and the Commission with regard to proper accounting principles and practices, the Commission has the statutory authority to prevail.[27]

The threat of SEC intervention gives the accounting profession (in its broadest sense) one of its greatest incentives to ensure the FASB's success.

In August of 1974, the Chisf Accountant of the SEC, John C. Burton, discussed the subject, "The SEC, the FASB and the Setting of Reporting Standards."[28] Mr. Burton first outlined the ways in which the Commission staff maintains open lines of communication with the FASB and in general praised the FASB as a sound concept. He then focused on the residual role he sees for the SEC, namely a responsibility to continue to respond to investor needs as the SEC perceives them. He stated:

> We believe that the general approach of distinguishing between disclosure requirements and matters of accounting measurement is not a bad way of

24. SEC Accounting Series Release No. 150 (Dec. 20, 1973).
25. *Id.*
26. SEC Accounting Series Release No. 4 (1938).
27. *Setting Principles, supra* note 15, at 44-45.
28. Address by John C. Burton to the American Accounting Association, Aug. 21, 1974.

identifying spheres of influence, but this was never intended as a hard line of demarcation.[29]

Obviously, the SEC prefers a role secondary to the FASB, but the extent of the Commission's adoption of such a role will depend on the actions of the FASB.[30]

Commissioner Sommer in his article describes the SEC-FASB relationship as a kind of "dynamic tension" but concludes that "the Commission and the accounting profession, through its appointed body [the FASB], will continue to resolve any controversies in a fashion consistent with the public interest."[31]

The relationship between the SEC and the accounting profession was also thoroughly considered in the drafting of the relevant section of the Federal Securities Code.[32] The distinguished Reporter for the Code, Professor Louis Loss, stated that he had reason to anticipate that the language of section 1503(a),[33] which describes the SEC's power in the accounting area, would prove to be agreeable to both the SEC and the AICPA. In summarizing section 1503(a), Professor Loss commented:

> This draft of § 1503(a) is advanced on the assumption (1) that nothing in it is designed to subtract from the authority (express or implied) that the Commission already has under all the source provisions, or to change the basic relationship between the Commission and the accounting profession, and (2) that § 1503(a) necessarily subsumes a degree of authority with respect to the scope (or standards) of, and the procedures to be followed in, audit examinations.[34]

Accordingly, while the ultimate authority with respect to accounting principles and practices is destined to remain in the Commission, if one can judge by the statements of two of its ablest spokesmen in this area (Sommer and Burton), no dramatic change in the

---

29. *Id.*

30. Professor Kripke has argued that "it is most unfortunate that the Commission has not asserted its powers more vigorously." Kripke, *supra* note 5, at 1177, *passim* 1176-88.

31. *Setting Principles, supra* note 15, at 44.

32. The proposed Federal Securities Code is a project of the American Law Institute. *See* Reporter's Revision of Tentative Draft Nos. 1-3 (Oct. 1, 1974).

33. ALI Fed. Securities Code § 1503(a), Comment (2) (Tent. Draft No. 3, 1974), which provides:

> *[Accounting and records.]* (a) *[Rulemaking authority.]* For purposes of this Code and in addition to its authority under Section 1502, the Commission, by rule, may (1) define accounting terms, (2) prescribe the form and content of financial statements and the accounting principles and standards used in their preparation, (3) require the examination of and reporting on financial statements by independent public accountants, (4) establish standards of independence for public accountants insofar as they practice before it, and (5) prescribe the form and content of tbe independent public accountant's report.

34. ALI FED. SEC. CODE Comment (2) § 1503(a), (Tent. Draft. No. 3, 1974).

SEC's present relationship with the profession is foreseeable in the near future.

Levels of Truth

Having noted the recent landmark developments in the evolution of accounting, auditing and financial reporting, it is appropriate to consider four key cases bearing on the truth of financial statements. The cases referred to are familiar ones: *United States v. Simon*,[35] *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*,[36] *Gerstle v. Gamble-Skogmo, Inc.*[37] and *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*[38] Judge Friendly's opinion in the *Simon* case has been the subject of much discussion and interpretation.[39] That case held that auditors may be guilty of criminal fraud[40] for certifying financial statements that do not fairly present the financial position of the company even if prepared in accordance with generally accepted accounting principles.

Judge Friendly summarized the holding this way:

> Defendants contend that the charge and refusal to charge constituted error. We think the judge was right in refusing to make the accountants' testimony so nearly a complete defense. The critical test according to the charge was the same as that which the accountants testified was critical. We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made. Such evidence may be highly persuasive, but it is not conclusive, and so the trial judge correctly charged.[41]

---

35. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

36. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,574 (S.D.N.Y. May 29, 1974).

37. 478 F.2d 1281 (2d Cir. 1973).

38. 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

39. For a relatively narrow reading of *Simon* see the article by the outside counsel to the AICPA, Isbell, *The Continental Vending Case: Lessons for the Profession*, J. OF ACCOUNTANCY, Aug. 1970, at 33, 35-36 [hereinafter cited as Isbell]. A more liberal construction is found in Sommer, *Survey of Accounting Developments in the 60's; What's Ahead in the 70's*, 26 BUS. LAWYER 207 (1970). (Sommer, summarizing Judge Friendly's opinion in *Simon*, said, "In a word, 'present fairly' was a concept separate from 'generally accepted accounting principles' and the latter did not necessarily result in the former." *Id.* at 209). *See also* Note, *Generally Accepted Accounting Principles and Fair Presentation*, 43 U. COLO. L. REV. 51 (1971) [hereinafter cited as Colorado Note]. In addition, virtually every contributor to the Symposium discusses the *Simon* case.

40. False statements and mail fraud, 18 U.S.C. §§ 1001, 1341 (1970) and fraud under the Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1970).

41. 425 F.2d 796, 806 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). In commenting on *Simon*, Mr. Olson warned that:

Essentially the same thought was put in more earthy terms in a recent case, *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath.*[42] A district court responded to an argument by auditors that they had complied with GAAP by stating:

> We think that this misses the point. Our inquiry is properly focused not on whether [the auditor's report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of [the corporation] as of November 30, 1969, to the untutored eye of an ordinary investor.[43]

In *Herzfeld*, the auditor reviewed the financial statements of a company whose only transaction was the purchase and resale of nursing home properties where little cash changed hands and required the company to defer profit of 1.65 million dollars and take only 235,000 dollars as current income. In addition, the auditor qualified its opinion as "subject to the collectability of the balance receivable on the contract of sale." Nevertheless, the auditors were held liable to investors under Rule 10b-5.

Accordingly, at least some courts have found a level of "truth" beyond GAAP—fair presentation. To ensure that this fair presentation standard is satisfied, some auditing firms require as an internal procedure that a partner not involved in the audit review the financial statements from a broad, nontechnical point of view.[44] In any

---

> The profession might well prefer to deny any such responsibility on the grounds *that a prudent auditor's test is too vague and subjective.* However, if the gap is to be closed in this area, auditors must assume responsibility to apply their best judgment when they encounter unusual transactions for which there are no standards.

Olson *supra* note 8, at 56.

42. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,574 (S.D.N.Y. May 29, 1974).

43. *Id.* at 95,998. In less colorful language, the court further stated: "The policy underlying the securities laws of providing investors witb all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company. In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately." *Id.* at 95,999. The court in *Herzfeld* quotes from a much earlier SEC view expressed in *In re* Associated Gas & Electric Co., 11 S.E.C. 975, 1058-59 (1942): "[T]oo much attention to the question whether the financial statements formally complied witb principles, practices and conventions accepted at tbe time should not be permitted to blind us to the basic question whetber the financial statements performed the function of enlightenment, which is their only reason for existence." *Id.* at 95,999.

While the result in *Herzfeld* was probably a correct one, the accounting profession is justifiably disturbed by some of tbe dicta. See Earle, *The Fairness Myth*, 28 VAND. L. REV. 147 (1975).

44. Isbell, *supra* note 39, at page 36. For a discussion of other cases and SEC pronouncements rejecting GAAP as conclusive of fairness, see Colorado Note, *supra* note 39, at 55-56.

event, no auditor can wisely ignore the concept of fair presentation.

In Mr. Olson's view, a more direct approach would be to change the wording of the auditor's opinion as follows:

> 1. That the financial statements *reflect the substance* of the underlying transactions.
> 2. That authoritative accounting principles were complied with, unless departures were necessary to reflect the substance of transactions in order to comply with the objectives of GAAP.
> 3. That the amounts are based on valuation methods as indicated in the financial statements.[45] (emphasis supplied).

Nevertheless, Mr. Olson concludes that an auditor cannot escape the duty to judge the difference between substance and form.[46]

The *Gamble-Skogmo* and *Chris-Craft* cases illustrate the proposition that under certain circumstances an obligation exists to provide supplemental information in textual material accompanying financial statements that goes beyond and may even contradict the information (a) prepared in accordance with GAAP or (b) that fairly presents the financial position from an accounting point of view. Symmetrically enough, the *Gamble-Skogmo* case involved an understatement of assets while the *Chris-Craft* case concerned an overstatement of assets. In neither case were the auditors named as defendants, nor were the financial statements as such found to be "untrue."

In *Gamble-Skogmo* the key issue was the value of certain plants owned by Gamble-Skogmo's majority-owned subsidiary, General

---

A related issue is whether the relatively recent embracing by the SEC of the doctrine of differential disclosure creates disclosure problems under Rule 10b-5. At least one Commissioner has stated that the answer to that question is that under § 23(a) of the Exchange Act, good faith reliance on a rule or regulation of the Commission is a complete defense. Sommer, *Differential Disclosure: To Each His Own*, J. OF ACCOUNTANCY, Aug. 1974, at 55, 57.

For a description of a similar type of quality control technique as applied by lawyers, see PLI Securities Law Institute, *Review of Securities Regulation*, Dec. 30, 1974, at 822.

The author understands that one of the issues raised in SEC v. Republic National Life Insurance Co., BNA SEC. REG. & L. REP. 243:A-11 (Mar. 13, 1974), is whether a fairness concept would override state insurance accounting regulation. Can an auditor opine as to financial statements prepared in accordance with statutory accounting principles where GAAP would more fairly present the financial condition of the company? Or, is the auditor required to disclose the effect of the variance from GAAP in order to fairly present the financial condition?

45. Olson, *supra* note 8, at 55.

46. *Id.* The then chairman of the SEC, William J. Casey, commenting on *Penn Central* stated:

> The whole pattern of income management which emerges here is made up of some practices which, standing alone, could perhaps be justified as supported by generally accepted accounting practices, and other practices which could be so supported with great difficulty, if at all. But certainly the aggregate of these practices produced highly misleading results.

THE FINANCIAL COLLAPSE OF THE PENN CENTRAL CO., STAFF REPORT OF THE SEC (1972).

Outdoor Advertising (GOA). Gamble-Skogmo, which controlled GOA, had pursued a policy of disposing of GOA's plants and in general GOA had realized substantially more than book value in such sales. In an opinion by Judge Friendly, the Second Circuit rested its finding of liability under Rule 14a-9 on the failure of Gamble-Skogmo to disclose adequately its intentions with respect to the plants against the background of the substantial profits over book value received for the plants already sold.[47] Nevertheless, the court stated that absent an SEC policy (now putatively changed according to the SEC's *amicus* brief in the case) against disclosure of fair value of assets as indicated by certain facts, the court would have found the omission of such facts materially misleading.[48]

In the *Chris-Craft* case, Bangor Punta Corporation (BPC) made a tender offer through a prospectus containing financial statements showing its investment in a railroad at 18.4 million dollars. The court held that BPC was required to disclose that it was negotiating for the sale of that asset at a price substantially below that amount even though the court recognized that the reflection on the books of the 18.4 million-dollar cost figure was in accordance with GAAP.

The conclusion can quickly be drawn from these cases that at least three levels of "truth" actually exist in relation to financial reporting: generally accepted accounting principles, fair presentation, and supplemental disclosure in textual material accompanying financial statements. The *Simon* case demonstrates that the requirement of fair presentation outweighs any reliance on GAAP, especially if the problem falls in the interstices between specific standards. Further, *Gamble-Skogmo* and *Chris-Craft* put an obligation on management to make additional disclosures outside of the financial statements. These cases also make it clear that differences between GAAP and supplemental disclosure requirements must be resolved in favor of the latter. A problem remains, however, because the notion that accounting should be done on an historical-cost basis with disclosure in csrtain instances of the "true" financial facts accomplished in textual material accompanying the financial statements would, as Professor Kripke so aptly put it, "reduce accounting to a decorative role."[49]

47. Judge Friendly commented that the SEC's policy on appraisals (generally prohibiting their use) "may have deprived those who must decide whether or not to sell their securities . . . of valuable information." 480 F.2d at 1294. *Cf.* Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) (failure to disclose probable increase in value of property due to discovery of oil on adjacent property not a violation).

48. *See* Schneider, *Nits, Grits & Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972).

49. Kripke, *supra* note 5, at 1194.

As illustrated by the *Gamble-Skogmo* and *Chris-Craft* cases, this conflict between accounting convention and "truth" in a disclosure sense is a problem even without inflation. The next section of this Introduction steps gingerly in direction of exploring that further dimension of the problem.

Inflation Accounting

The question in regard to accounting in an age of inflation is no longer whether any changes are required, rather it is the determination of what changes should be made. In February 1974, the FASB issued a discussion memorandum on price level accounting, held hearings the following April, and issued an exposure draft in early January 1975.[50] Under price-level accounting, conventional or historical-dollar financial statements are restated in terms of dollars of constant purchasing power by the use of index numbers (e.g., the Gross National Product Implicit Price Deflator or the Consumer Price Index). The price level accounting approach of the FASB is questioned in a very important quarter, however—the Chief Accountant of the SEC, Mr. Burton, who favors replacement value accounting.[51] Under that system expenses are based on the current cost of replacement of the particular assets sold or used. To the argument that great practical difficulties arise in auditing the valuations used by management in replacement value accounting, Mr. Burton replies that "[a]s long as accountants are prepared for some tolerance for imprecision, it appears that a practical system can be achieved."[52] His criticism of price-level accounting is that "since the impact of inflation falls differently on various sectors of the economy and various parts of companies, the relationship of historical [purchasing power units] to current cash outflows is tenuous at best."[53] In addition, the SEC Chief Accountant points out that the

50. FASB Discussion Memorandum, *Reporting the Effects of General Price Level Changes in Financial Statements* (Feb. 15, 1974). The Memorandum also contains an excellent recapitulation of prior pronouncements on the subject. *Id.* at 2. FASB Exposure Draft, *Financial Reporting in Units of General Purchasing Power* (Dec. 31, 1974). For another excellent summary of the historical development of accounting for general price level changes, see Comment, *The Feasibility of Adjusting for Inflation in Computing Taxable Income*, 49 WASH. L. REV. 873, 885-88 (1974) [hereinafter cited as Comment]. Price level adjusted financial statements are now recommended as supplemental information for listed companies in England.

51. Burton, *Accounting That Allows for Inflation*, BUS. WEEK, Nov. 30, 1974, at 12. Indeed the SEC is proposing to require companies to show the impact of inflation through "footnote disclosure of replacement cost information and the effect on income of using such an approach." BNA SEC. REG. & L. REP. 284:A-10 (JAN. 8, 1975).

52. *Id.*

53. *Id.* at 12-14. "The essential difference between replacement cost accounting and

ability of companies to raise prices as costs rise varies widely, further reducing the usefulness of price-level accounting.

Of perhaps greater concern is the fact that the Chief Accountant criticized price-level accounting in terms that have an unfortunate connotation under the antifraud statutes, *viz.* "affirmatively misleading" and "significant potential for misleading investors."[54]

Perception of the tremendous implications of inflation is only beginning. The first act of Arthur Andersen & Co.'s newly appointed public review board was to send a letter to President Ford warning that conventional accounting is fueling inflation by exaggerating corporate profits.[55] While the inadequacies of historical-dollar financial statements have been discussed for many years, and other countries, notably Brazil, have departed from historical-currency financial statements, price-level accounting or replacement value accounting, even as supplemental information, would represent a major change for the United States.

What are the implications of an official recognition of the inadequacies of historical-dollar financial statements? One is the probability that users will gain a better understanding of the real function of financial statements. As pointed out so well by Mr. Burton, in a speech in January 1974:

> One of the problems of the financial accounting world is that there has been too great a tendency to encourage childlike faith in both the truth of financial statements and the scope of audits which is just not realistic.[56]

If the introduction of some form of inflation-adjusted financial statements as supplemental information causes users to recognize that accounting is a tool for use in evaluating an enterprise and not the exercise of counting currency in a box, the job of the accounting profession will be easier. Another implication, however, is the possible confusion that may be caused by the explicit recognition by the FASB and the SEC that historical-dollar financial statements are inadequate. As early as 1936, the SEC recognized that the real function of requiring the audit of financial statements was to ensure that

---

price level cost accounting is the timing of gain or loss recognition. Under the latter, gain or loss, as under the present system, is recognized only when the asset is sold or transferred; under the former, unrealized gains and losses are recognized during the time the asset is held . . . . Thus, we have two distinct problems—profit and loss recognition and profit and loss measurement." Comment, *supra* note 50; at 884, 885, n.50.

54. Burton, *supra* note 51, at 12-14.

55. Andrews, *Present Inflation Is Fueling Inflation, Andersen Panel Says,* Wall Street J., Sept. 25, 1974, at 21, col. 1.

56. Address by John C. BURTON, *The SEC and the Changing World of Accounting,* UCLA, Jan. 17, 1974, at 7.

> . . . present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, *as nearly as accounting conventions will permit*, the truth about the financial condition of the enterprise . . . .[57] (emphasis supplied).

It is not likely the courts will generally hold that present historical-dollar financial statements are "untrue" within the meaning of the antifraud statutes recognizing that historical-cost-based financial statements are an accounting convention known as such to readers of such statements. A danger exists, however, that the courts will find that disclosure in the text accompanying financial statements in formal documents like prospectuses, proxy statements and annual reports is misleading if it does not point up the inadequacies of the historical-cost-based statements. The SEC may have enhanced unintentionally the likelihood that the courts will hold that such formal documents involve material misstatements or omissions if they fail to comment on the effects of inflation by its issuance of Accounting Series Release No. 151.[58] In that Release, the SEC stated that while a continuation or acceleration of the present rate of inflation might require a fundamental change in basic accounting, even before such a change "it does not seem appropriate that registrants and accountants should simply ignore the impact of rapidly changing prices on financial statements."[59]

Thus, the SEC in its Release asserted that material variations in the financial statement caused by inflation should be disclosed. While the Commission focused on the impact of "inventory profits" on reported earnings and pointed out that when such profits are material, disclosure of their impact on reported earnings is important information, it largely ignored other effects of inflation such as under-depreciation and losses from holding monetary assets. In any event, the Release left to management the determination of the best method of calling attention to the impact of inventory profits. This red flag approach of the Commission is probably based on the idea that rule adoption is a premature way of dealing with significant and difficult problems whose impact on different companies varies. It does not appear, however, that many issuers have followed the SEC's suggestion. ASR 151 presents the question of what method a company should employ to disclose properly the impact of inventory profits but does not answer it authoritatively. Again, the lack of an

---

57. *Cornucopia Gold Mines*, 1 S.E.C. 364, 367 (1936), quoted in Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 Nw. U.L. Rev. 1, 3 (1973).

58. CCH Fed. Sec. L. Rep. ¶ 72,173, at 62,390 (Jan. 3, 1974).

59. *Id.*

authoritative pronouncement by the SEC is consistent with its policy expressed in Accounting Series Release No. 150 of permitting the profession to act first after the issues have been thoroughly vented. Nevertheless, as companies and their auditors have been learning to their sorrow in recent litigation involving the "truth" of financial statements, the standards applied by courts are not necessarily limited by the suggestions or even the pronouncements of the SEC or the accounting profession.

The matter of disclosure of the impact of "inventory profits" on earnings recently became even more difficult when the Internal Revenue Service issued a Revenue Ruling specifically prohibiting companies that switch from FIFO to LIFO inventory accounting from stating to stockholders, other than in a footnote, what the earnings would have been under FIFO. Because such information in the usual case would be material information and mere footnote disclosure inadequate, a clear conflict with SEC disclosure requirements is presented.

Perhaps then, a fourth level of truth must be added—truth based on financials that reflect more accurately the effects of inflation (or other economic phenomena). Imagine a financial statement that has two columns: Column A is headed "Historical Cost" and Column B is titled "Historical Cost Restated to Reflect Purchasing Power of 1973 Dollar." Then conjure an auditor's letter, the second paragraph of which opines that the accompanying financial statements as shown under Column A *present fairly* the financial position of the Corporation, and the third paragraph of which states:

> In our opinion, however, the accompanying financial statements shown under Column B *more fairly* present the financial position of the Corporation . . . as recognition has been given to changes in the purchasing power of the dollar, as explained in Note 1(a). (emphasis supplied).

Surprisingly, the financials and accompanying auditor's report described are real—the financials are those of the Indiana Telephone Company included in their 1973 Annual Report (which have followed the same pattern for ten years). They were audited by Arthur Andersen & Co. from whose letter the opinion was quoted.[60]

Conclusion

Of course no real levels of truth are present in financial statements. A financial statement either contains an untrue statement or omission of a material fact or it does not. It is both important and a legal obligation under the federal securities statutes, however, to

60. Indiana Telephone Company, 1973 Annual Report at 10.

provide investors with a meaningful financial picture of enterprises in which they have invested or want to invest. This Introduction has intended to suggest that courts are likely to consider the truth of financial statements in several ways: First, are they prepared in accordance with GAAP? Secondly, in any event, or at least in the absence of a specific GAAP, do the financials fairly present the financial picture? Thirdly, even if the financial statements are prepared in accordance with GAAP and fairly present the financial picture, is some further disclosure required, at least by the issuer? Lastly, does inflation present any special requirement of further disclosure? Issuers and auditors who focus only on GAAP do so at their peril.[61]

The Articles

This Introduction is not intended as a review of the articles in the Symposium. Accordingly, no verbal applause will be offered individually for each author. The Symposium does, however, represent an unusually fine collection of articles on a subject of enormous importance in the corporate securities field today. Not only is the quality of the contribution high, but the authors represent a distinguished cross-section of experts.

As an activist, Chief Accountant of the SEC, John C. "Sandy" Burton has already left his mark on the accounting field. He has recognized that it is very difficult and undesirable to isolate the SEC impact, because the SEC actions are really part of a broad effort and can only succeed with the goodwill of the accounting profession and the financial community. Nevertheless, through disciplinary proceedings Mr. Burton and the Commission are having a real and direct impact on the way accountants conduct themselves, specifically in the matter of quality control.[62] Accordingly,

61. Professor Kripke, writing before inflation escalated to double-digit proportions nonetheless recognized the bind auditors are placed in by the historical cost system: "The accountants' position with respect to civil and criminal liability cannot rest on the assumption that all readers understand that GAAP permits assets to be shown at cost (thus concealing or overstating the value of assets) . . . the SEC has both suhstantively and administratively created a dangerous dilemma hetween its insistence on the cost basis of accounting and its own full disclosure and antifraud concepts." Kripke, *supra* note 5, at 1195.

62. In Augnst 1972 Mr. Burton proposed that the AICPA launch a compulsory program of outsiders' reviews ("Peer reviews") of procedures for achieving uniform quality of professional accounting and auditing services by multiple-office firms. After careful study, the proposal was rejected by a select AICPA committee in part from a concern that negative conclusions in such reviews would provide harmful evidence in damage actions. Instead, the AICPA Auditing Standards Executives Committee issued Auditing Statement No. 4, "Quality Control Considerations for a Firm of Independent Auditors" (Jan. 1975). The Standard encompasses the following areas: independence, personnel assignment, consultation within

the philosophy behind such disciplinary proceedings and the quality controls imposed are important for the accounting profession to understand. Mr. Burton's article represents a unique contribution toward this understanding. Now that the SEC has for the first time imposed quality controls on a law firm in *In re Ferguson,*[63] Mr. Burton's article may profitably be read by lawyers searching for approaches to defining their own quality control standards to prevent (in the original sense of the word, meaning to anticipate by action, preparation, etc.) the SEC from imposing such controls.

When quality control fails, the liability of the accountant to third parties becomes an issue. Professor Ted J. Fiflis, co-author of a leading textbook on accounting and the law,[64] traces the law from the earliest cases through *Ultramares*[65] to *Hochfelder v. Ernst & Ernst*[66] and *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*[67] and suggests the future direction of decisions in this area. Apart from its relevance to accountants, the article is required background to any study of the evolving liability of lawyers to third parties.

It would be difficult to find two authors more at opposite ends of the accounting spectrum than Victor M. Earle, III, general counsel of Peat, Marwick & Mitchell, and Dr. Abraham J. Briloff, an academic accountant. Professor Briloff's article presents yet another attack by him on "creative accounting," the art of the sixties and seventies, which had much to do with the formation of FASB and the general clamor for certainty in accounting standards. For the defense, Mr. Earle focuses on the unfairness of judging the accounting profession by an open-ended standard, namely "fair presentation" unrelated to GAAP or GAAS.

In his article, James Strother, with an expertise appropriate to a legal adviser to AICPA, discusses the respective roles of the accounting profession and the SEC in establishing accounting princi-

---

the firm, supervision, hiring, professional development, advancement, acceptance and continuance of clients and inspection. One legal problem with quality controls, whether established by professional bodies or individual firms, is that any deviation may provide a basis for liability when an error occurs. Accordingly, it is noteworthy tbat in contrast to Rule 202 of the AICPA Code of Professional Ethics, which requires that members justify departures from Statements on Auditing Standards, the Statement on Quality Control provides that:

> The sentences generally worded, 'Policies and procedures should be established . . . ' are provided only as guidelines, no one of which is necessarily applicable to any one firm.

63. SEC Securities Act Release No. 5523 (Sept. 3, 1974).

64. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS (1971).

65. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

66. 503 F.2d 1100 (7th Cir. 1974).

67. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,574 (S.D.N.Y. May 29, 1974).

ples and auditing standards, a subject touched upon in this Introduction. The article also includes a commentary on the approach taken to accounting matters in the draft Federal Securities Code.

When we struggle with difficult problems, it is useful to see how others are faring with similar issues. Hence, a comparative analysis of the United States and the United Kingdom is appropriate on the issues of setting accounting standards, the impact of disclosure requirements and the liability of accountants to third parties. Professor George J. Benston has taught in England as well as in the United States and is highly qualified to treat this subject. His article raises some questions about the emphasis in the United States on more explicit accounting standards and suggests that the more flexible approach in England, leaving more to the judgment of the accountant, is perhaps preferable at least given a fairly strong professional organization. The movement of the United States courts (and to some extent the SEC) toward an overall fairness doctrine, when compared to the flexible approach to standards in England, suggests that the two systems are trending together, albeit along quite different routes.

It would be neither useful nor possible to synthesize the views expressed in this Symposium any more than one would do so at the end of any "party." It is possible to say this much: When the opinion held by the public, and more importantly the courts, about the proper function of financial statements and auditors differs significantly from the views of the accounting profession, the legal consequences are likely to be grave. This Symposium should help to narrow the gap between those views through the thoughtful explications of these complex subjects.