

1-1975

The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards

James F. Strother

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



Part of the [Securities Law Commons](#)

Recommended Citation

James F. Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 *Vanderbilt Law Review* 201 (1975)
Available at: <https://scholarship.law.vanderbilt.edu/vlr/vol28/iss1/6>

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.

The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards

*James F. Strother**

I. INTRODUCTION

This article will discuss accounting principles and auditing standards and the respective roles played in their development and regulation by the Securities and Exchange Commission, the organized accounting profession and other public and private agencies. Accounting principles and auditing standards comprise two fundamentally different and distinct bodies of convention and practice. Generally accepted accounting principles and generally accepted auditing standards are those principles and standards which for a number of reasons have come to be accepted and applied by issuers, accountants, and auditors. Combined with the procedures and techniques attending their observation and application, generally accepted accounting principles and auditing standards comprise the two professional disciplines that are central to the preparation of financial statements and to the accountant's work as an independent auditor in examining and reporting upon audited financial statements. The complexity of generally accepted accounting principles and generally accepted auditing standards is belied, and perhaps obscured, by their familiar acronyms, "GAAP" and "GAAS." Also obscured are the important distinctions that inhere in their different natures, evolutions, purposes and applications. These distinctions are particularly important to an understanding of how generally accepted accounting principles and generally accepted auditing standards have come to be established differently, and why, to the extent they are within the reach of the Securities and Exchange Commission, they are regulated differently.

II. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES¹

If the preparation of financial statements could be delayed

*Member of the District of Columbia and Virginia Bars; B.S.M.E. 1960, LL.B. 1966, University of Virginia.

1. For a general discussion of the objectives of financial statements and of generally

until the winding up and liquidation of a business enterprise, the effort would be greatly simplified. So long as the documentations were adequate, every number appearing in the financial statements would have been derived from a completed transaction and reduced to an actual cash amount.² By need, custom, tradition, or law, however, financial statements routinely must be prepared on an interim basis, typically annually, so that investors, creditors, suppliers and regulatory authorities may have a sense of the financial position, results of operations, and changes in financial position for various periods in the life of the enterprise.

If one considers what is involved in the attempt to derive figures even roughly representative of the income and financial position of a business enterprise, a number of difficulties will be self-apparent. If an income figure for a period is to be derived, the revenues and expenses attributable to the period must be determined, notwithstanding the fact that their receipt and expenditure may be periods apart. Capital expenditures must be identified and allocated as depreciation expense to periods during which the related assets have useful life and contribute to earnings. One might consider, too, whether stated values of assets should be modified to reflect obsolescence or inflation, and what if any impact such revaluation should have on reported income.

As the period of the financial statements is lengthened to approach the full life of the enterprise, these problems diminish; as it is shortened, they increase.³ A year is short in relation to the life of most enterprises. An annual period, however, includes at least the four seasons; there may be within it something resembling an annual business cycle for a reporting enterprise. While annual derivations of income and financial position may inherently be lacking somewhat in precision, quarterly figures will be even more susceptible to error.⁴ One must wonder at the emphasis Wall Street puts upon them.

accepted accounting principles, see AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT OF THE STUDY GROUP ON THE OBJECTIVES OF FINANCIAL STATEMENTS (1973) [hereinafter cited as OBJECTIVES OF FINANCIAL STATEMENTS]. The American Institute of Certified Public Accountants, the national professional organization of certified public accountants, whose more than 100,000 members comprise the majority of practicing CPA's in the United States, will be referred to from time to time in this article as the "AICPA".

2. OBJECTIVES OF FINANCIAL STATEMENTS 23.

3. *Id.* The Securities and Exchange Commission thus forbids disclosure in a prospectus for a public offering of securities for which independent auditors have reviewed quarterly figures unless a full audit is performed, lest users attach undue significance to the review. SEC Accounting Series Release No. 62 (June 29, 1947).

4. See testimony of George O. May and memorandum of the American Institute of Accountants, note 69 *infra*.

Generally accepted accounting principles consist of the accounting conventions by which financial information is recorded, attributed to particular periods and summarily presented in the form of financial statements.⁵ Such principles are largely matters of convention⁶—accounting practices chosen from or prescribed in lieu of others which might also afford logical bases for accounting. Accounting principles are considered “generally accepted” if they have “substantial authoritative support,” which may derive in turn from a respectable constituency of usage or from promulgation by competent authority.⁷ Generally accepted accounting principles are not derived from scientific observation or natural law; they are not discovered, but declared.

The establishment of generally accepted accounting principles is difficult because it involves difficult choices and judgments; for example, should particular revenues and expenditures, or portions thereof, be matched together and allocated to a particular period or instead assigned together or separately to other periods; should depreciation and amortization expense be allocated among such periods. Further questions involve judgments as to the collectibility of accounts receivable, the valuation of inventories and an estimation of the remaining useful life and likely productiveness of assets. The list of such choices could extend for pages, and each involves the exercise of judgment. Even in similar circumstances, individual judgment can vary in this exercise, often for reasons that may seem equally valid. If such judgments are to be relied upon to any reasonable extent in the anonymous commercial and investment markets, criteria for judgment are required.

In the evolution and prescription of the generally accepted accounting principles providing such criteria, a number of governing and influential considerations are apparent. The first of these is the desire for comparability, which involves at least two purposes. On the one hand, each interim⁸ report of an enterprise should be drawn

5. AICPA, Accounting Principles Board Statement No. 4, ¶ 31, 2 CCH APB ACCOUNTING PRINCIPLES at 9065 (1971).

6. Cf. *Cornucopia Gold Mines*, 1 S.E.C. 364, 367 (1936).

7. See Graham, *Some Observations on the Nature of Income, Generally Accepted Accounting Principles, and Financial Reporting*, 30 LAW & CONTEMP. PROB. 652, 666-72 (1965). As indicated in the text at note 36 *infra*, the thought that certain prevailing accounting principles might be justified by pervasive usage, or “general acceptability,” was expressed in correspondence beginning in 1932 between an AICPA Committee and the Committee on Stock List of the New York Stock Exchange. The author has not attempted to determine whether the concept can be traced to earlier sources. It is hardly surprising, however, that in trying to improve the methods of corporate accounting in those years the 2 committees would have attempted to build upon existing practice.

8. Conventional usage distinguishes interim reports from annual reports, and refers to

as nearly as practicable against the same standards that have been applied to earlier reports of that enterprise, so that its relative progress will be discernible from period to period, and its earnings trends may be plotted to some reasonable extent. Secondly, there is the hope that if all enterprises, or at least those within particular commercial or industrial categories, can be led to observe the same ground rules, users of financial statements can draw some conclusions as to the relative profitability of enterprises.

Intra-enterprise comparability is more easily achieved than is comparison among different enterprises, and it is justifiably sought. The possibility that management may manipulate earnings from period to period by making changes in accounting principles, deferring research and development expenses, or switching from accelerated to straight line depreciation in lean years is patently repugnant. Yet not all changes of accounting principles are so indefensible, and there are problems in defining criteria too narrowly. For example, if expensed immediately, a sensible and well-conceived investment in research and development, or in a new operation expected to produce a good return in subsequent periods may suggest to unsophisticated users of financial statements an adverse earnings trend that in fact should not be regarded as significant.⁹ But if enterprises are given too much discretion to capitalize such expenditures, thus spreading and deferring their impact on earnings to subsequent periods of return, opportunistic or overly optimistic enterprises will gain the chance to defer their costs, thus achieving an unjustified appearance of increasing profits.

Comparability between financial statements of different enterprises is a more difficult objective. It is relatively more possible to achieve such comparability among enterprises within a single industrial or commercial category, or among enterprises in similar categories, than between enterprises in markedly different categories. There are difficulties in seeking such comparability. Recognition of a single set of accounting principles for application by a group of enterprises may force the exclusion of one or more principles that best describe the experience during a given period of an

quarterly shareholder reports and filings with the Securities and Exchange Commission [hereinafter cited as the "Commission" or the "SEC"] on Form 10-Q, 17 C.F.R. § 249.308a (1974), as interim reports. It should be emphasized, however, that so-called "annual" financial statements are interim financial statements as well. The true distinction between quarterly and annual interim financial statements consists in the distinctions in the inherent limitations on their precision which in turn relates to the length of the period covered by the statements.

9. Research and development costs are now required to be allocated to the periods in which they are incurred. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 2, ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS ¶ 12 (1974).

individual enterprise. Thus, whatever comparability apparently achieved among the group is offset to some extent by a distortion of the financial statements of individual enterprises.

A related potential for distortion exists between the poles of easy summarization and painful detail. Where financial statements are overly summarized a seemingly knowledgeable reader may miss their complexity; yet many users of financial statements are easily drowned in detail, or worse still, simply ignore it. Although the recent performance of the stock market has effected something of a cure, readers of financial statements too long have been encouraged to seize upon a single number, earnings per share, as an indication of the investment merit of an enterprise. It is a mischievous notion.¹⁰

The tensions between summarization and detail evoke serious and important problems, including questions regarding what is relevant or material for purposes of disclosure in financial statements, and whether the same conventions that apply to publicly traded enterprises should be applicable to privately held concerns. Related questions that urgently require analysis concern the specific purposes to be served by disclosure in financial statements. Calls for "full and fair disclosure"¹¹ obscure and impede analysis of the different and sometimes conflicting purposes that might be served or disserved by disclosure. It might well be in the interest of a sleeping plaintiff such as the Internal Revenue Service or the Antitrust Division of the Justice Department, for example, to learn from financial statements that it has a claim against their issuer, but such disclosure would hardly be in the interest of existing shareholders. Simi-

10. The organized accounting profession has recognized the problems in inviting undue reliance on earnings per share, and, indeed even a figure for the net income:

In its deliberations concerning the nature and purpose of the income statement, the committee has been mindful of the disposition of even well-informed persons to attach undue importance to a single net income figure and to *earnings per share* shown for a particular year. The committee directs attention to the undesirability in many cases of the dissemination of information in which major prominence is given to a single figure of *net income* or *net income per share*.

AICPA, *Comm. on Accounting Procedure*, Accounting Research Bull. No. 43, ch. 8, ¶ 14, 2 CCH APB ACCOUNTING PRINCIPLES at 6030.

Earnings per share information is nonetheless required by the Securities and Exchange Commission in financial statements. *E.g.*, SEC Reg. S-X, 17 C.F.R. § 210.5-03 (1974); SEC Form S-1, Item 6, 17 C.F.R. § 239.11; SEC Form 10-K, Item 2, 17 C.F.R. § 249.310, Item 10, and even quarterly reports, "if appropriate," SEC Form 10-Q, General Instr. H(k), 17 C.F.R. § 249.308A, General Instr. H(k), filed with the Commission. The Accounting Principles Board has prescribed detailed criteria for the computation of earnings per share, APB Op. No. 15, "earnings per share," 2 CCH APB ACCOUNTING PRINCIPLES at 6609, in recognition of the inescapable fact that such a figure must be presented if uniform criteria are required. *See also*, L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 10.44-49 (3d ed. 1972).

11. *See, e.g.*, Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,574, at 95,999 (S.D.N.Y. May 29, 1974).

larly, information as to undiscovered claims might well be of interest to potential purchasers of an issuer's securities, but if the trading market is thin such disclosure could well injure a larger present number of shareholders for whom the financial statements may have been prepared.¹²

Still other problems arise when generally accepted accounting principles outrun their time, and underlying assumptions are no longer valid. Depreciation computations are conventionally based on the historical cost of assets, in conformity with the presumption that historical cost is objectively ascertainable and relatively immune from manipulation, and provides a logical basis for evaluating management's performance with its investments in productive assets. A good case can be made, however, for grounding depreciation computations on the replacement value of the equipment being depreciated, so that depreciation reserves will more likely be of sufficient amount to effect a replacement when the useful life of the asset has expired. "FIFO"¹³ is the generally accepted method of inventory accounting which best conforms to the actual sales and shipping practices of an enterprises, but in the present period of accelerating inflation "LIFO"¹⁴ may offer a more realistic presentation of profit. "NIFO"¹⁵ might perhaps provide even a better presentation of profits both in inflationary and deflationary times. One suspects that if depreciation were grounded on replacement costs, and inventories on LIFO or NIFO, reported earnings of many enterprises would disappear or be adversely affected to a substantial degree.¹⁶

12. For materials pertaining to the current controversy between auditors and the bar regarding auditors' requests of lawyers for information concerning clients' contingent liabilities see, e.g., Carmichael, *Representation Letters from a Company's Legal Counsel—Auditing and Reporting Considerations*, J. OF ACCOUNTANCY, Nov. 1973, at 76-78; Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 BUS. LAWYER 947 (1953); Report of American Bar Association Comm. on Corp. Law and Accounting, *Scope of Lawyers' Responses to Auditors' Requests for Information*, 29 BUS. LAWYER 1391 (1974); AICPA, *Lawyers' Letters, Commentary of the Auditing Standards Executive Committee* (1974), published in 1 CCH AICPA PROF. STANDS. AU § 1001 (1974). The appropriate committees of the AICPA and American Bar Association are currently consulting in an effort to resolve the controversy.

13. "FIFO," or "first-in, first-out" assumes that inventory is sold in the order of its acquisition. FIFO accounting overstates profit in times of inflation and understates it in times of deflation.

14. "LIFO," or "last-in, first-out" assumes that the inventory most recently acquired is the first sold. LIFO accounting reduces the impact of inflation on reported profits and taxes.

15. "NIFO," or "next-in, first-out" is not yet an accepted method of accounting. NIFO accounting, if employed, would value inventory for purposes of computing income at the estimated cost of its replacement. If that were correctly estimated, NIFO would eliminate distortions to profits from either inflation or deflation.

16. See address by James J. Needham, Chairman, New York Stock Exchange, to Commonwealth Club, San Francisco, Nov. 8, 1974, in BNA SEC. REG. & LAW REP. No. 277 (Nov. 13, 1974).

Although other problems concerning generally accepted accounting principles doubtless will be covered by other contributors to this symposium, a final problem, which will be pertinent in the following discussion of the establishment of such principles is the political, as well as the economic impact of accounting principles. The illusory profits presently being reported by enterprises using FIFO accounting and historical depreciation afford an easy example; given the state of nerves presently pervading the stock market, rare will be the politician or regulator who would effect a reform that would cause many or even a majority of reporting enterprises to show steady and prevailing losses.¹⁷

17. The impact of political considerations upon the establishment of accounting principles can be illustrated by two attempts of the Accounting Principles Board to establish a uniform method for accounting for the investment tax credit, and the Financial Accounting Standards Board's current consideration of accounting for leases. As an incentive to business expansion, the Revenue Act of 1962 allowed a percentage of the cost of newly acquired assets to be credited against income taxes in the year of acquisition. The APB determined that a substantial portion of the credit should be amortized against income over the depreciable life of the assets giving rise to the credit; it rejected an alternative proposal for "flow-through" accounting that would have permitted income to have been increased in the year of acquisition by a substantial amount of the credit. APB Op. No. 2, Accounting for the "Investment Credit" (1962). The Opinion issued in the face of considerable opposition from proponents of flow-through accounting. The Securities and Exchange Commission then indicated that it would accept either method of accounting, SEC Accounting Series Release No. 96, Accounting for the Investment Credit (Jan. 10, 1963), and the APB was forced to conform its earlier Opinion to that of the SEC. APB Op. No. 4 (Amending No. 2), Accounting for the "Investment Credit" (1964). The investment credit was apparently intended to encourage investment in plant, not only by affording a tax rebate, but also by permitting enterprises that so invested thereby to report increased current income to their shareholders, thus enhancing both "business confidence" and the market price of securities. From an investor's standpoint, the merits of such accounting appear questionable.

Reinstitution of the credit in the Revenue Act of 1971, INT. REV. CODE OF 1954, § 46, led the APB to expose a draft Opinion which again would have required that the credit be amortized. The proposed Opinion was never adopted, for proponents of "flow-through" accounting were successful in persuading the Congress to preclude either the APB or the SEC from requiring amortization. See COMMITTEE OF CONFERENCE REPORT, REVENUE ACT OF 1971, CONFERENCE REPORT No. 92-708, 92d Cong., 1st Sess. (1971); Treasury Dept. News Release (Jan. 10, 1972).

The new Financial Accounting Standards Board is presently considering issues relating to accounting for leases. See FINANCIAL ACCOUNTING STANDARDS BOARD, DISCUSSION MEMORANDUM, AN ANALYSIS OF ISSUES RELATED TO ACCOUNTING FOR LEASES (July 2, 1974). One of the principal reasons for leasing, rather than purchasing an asset is that the lessee is permitted under current conventions to present the financial effect of the transaction "off balance sheet," by showing only the annual rental expense in the financial statements, with supplementary footnote disclosure. See SEC Reg. S-X, 17 C.F.R. § 210.3-16 (1974); SEC Accounting Series Release No. 147 Oct. 5, 1973; NOTICE OF ADOPTION OF AMENDMENTS TO REGULATION S-X REQUIRING IMPROVED DISCLOSURE OF LEASES. Rule 3-16 has apparently undercut the arguments of proponents for off balance sheet financing, since much of what they would seek to have omitted from the tabular portion of financial statements is required by the Release to be disclosed in the footnotes. The issue will probably be taken to the Congress, and there are presently indications that "the pressures in Washington have already begun." Wall Street J., Nov. 25, 1974, at 16, cols. 2-3.

III. GENERALLY ACCEPTED AUDITING STANDARDS

Generally accepted auditing standards define, among other things, the obligations of due and professional care which attend an independent auditor's examination and his report upon audited financial statements. Ten standards have been adopted by the membership of the American Institute of Certified Public Accountants,¹⁸ and provide in general terms a reasonable definition of an auditor's legal and professional responsibilities:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.¹⁹

The three headings under which the accounting profession classifies its generally accepted auditing standards overlap somewhat,

The experience of the APB with regard to the investment credit is indication enough that the establishment of accounting principles, whether by the SEC or a private agency, will from time to time be subject to overriding political pressures that can forestall a worthwhile accounting reform. The efforts of the FASB and the SEC to improve accounting for leases, however, may indicate that the 2 organizations together will be better able to withstand such pressures.

18. AICPA, Statement on Auditing Standards No. 1, § 150 (1972), published in 1 CCH AICPA PROF. STANDS. AU § 150.02 (1974). [Statements on Auditing Standards hereinafter cited as "SAS"].

19. *Id.*

and can be seen to involve four categories rather than three: (1) the first two "General Standards" require that an auditor who holds himself out as competent and independent be so qualified; (2) the third "General Standard" and the three "Standards of Field Work" call for reasonable care in the conduct of an audit; (3) the four "Standards of Reporting" govern the manner in which a report should be framed; and (4) the third "General Standard" instructs an auditor to exercise reasonable care in preparing his report, and thus in formulating his opinion, if any, regarding the financial statements he has examined.

Certified public accountants usually refer to any steps they take in carrying out the work required to satisfy any of the ten generally accepted auditing standards quoted above as "auditing procedures." Steps taken by an auditing firm to ascertain the competence of its personnel, however, are largely unrelated to the conduct of a particular audit. Likewise, procedures that an accounting firm might perform to assure itself that it is independent²⁰ of a particular client may be distinguished from its audit of that client's financial statements. Such procedures are an internal matter involving the maintenance of an attitude of professional objectivity and checks of the investments and affiliations of personnel within the accounting firm. The large majority of procedures that auditors perform in observation of generally accepted auditing standards consist of procedures relating to the planning and execution of an audit,²¹ and to the formulation and expression of an opinion, if one can be reached, in their report²² upon financial statements. Proce-

20. It is a fundamental precept of certified public accountants that they be independent of audited clients in appearance and in fact. See, e.g., AICPA, Code of Professional Ethics, Rule 101 & Interpretations as cited in 2 CCH AICPA PROF. STANDS. ET §§ 101.01-.04 (1974).

21. 1 CCH AICPA PROF. STANDS. AU §§ 310-38 (1974); see also AICPA Industry Audit Guides and Statements of Position *id.* at AU App. E.

22. 1 CCH AICPA PROF. STANDS. AU §§ 410-30; § 420.

The recommended customary auditors' short form report for expression of an unqualified or "clean" opinion is as follows:

We have examined the balance sheet of X Company as of December 31, 19____, and the related statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19____, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

1 CCH AICPA PROF. STANDS AU § 511.04 (1974). If auditors are restricted from performing auditing procedures which they believe to be required by generally accepted auditing standards they will modify the first paragraph of their report to indicate that their examination

dures relating to the planning of an examination include a study of the issuer's internal controls, including the adequacy of its accounting systems and its internal checks upon the performance and discretion of its employees. Such a study is performed with an eye to a tentative determination concerning the work necessary to permit a reasonable and informed assessment whether the financial statements are fairly presented in conformity with generally accepted accounting principles consistently applied. Auditors test their client's transactions on a selective basis rather than testing all transactions—the extent of their tests depends upon an assessment of how well the issuer keeps its own house.²³ With regard to audit performance, an auditor will generally be held to the exercise of good faith and reasonable care.²⁴ His exercise of reasonable care will be measured against the standard of other auditors' performance in similar circumstances—the customary practices of his profession,²⁵ so long as those practices are reasonable.²⁶

Procedures relating to an auditor's formulation and expression of an opinion involve not the extent of work to be performed in an examination, but rather how its results are to be expressed. At first glance, criteria pertaining to the auditor's report might seem to comprise conventions similar in some respects to accounting principles, but the analogy should not be indiscriminately applied. The formulation and expression of the auditor's report depends even more upon the circumstances of a particular engagement than does the application of generally accepted accounting principles, and depends as well upon his seasoned, professional and intuitive reac-

has been restricted in "scope" and will appropriately qualify the opinion expressed in the second paragraph or disclaim an opinion. Should they conclude that the financial statements are in material respects not presented in conformity with generally accepted accounting principles consistently applied they will issue an "adverse" opinion. See generally 1 CCH AICPA PROF. STANDS. AU § 420 (1974).

If independent accountants (a word deliberately chosen over "auditors") are associated with financial statements by providing services not amounting to an examination in accordance with generally accepted auditing standards, and thus not affording a basis for an opinion regarding the financial statements, they will require that the financial statements be labeled as "unaudited" and accompanied, with certain exceptions, by their disclaimer of opinion. 1 CCH AICPA PROF. STANDS. AU § 516 (1974). One may assume in using financial statements which are so identified that the accountants are unaware of any undisclosed material departures from generally accepted accounting principles; he may not assume that they have affirmatively satisfied themselves of the absence of any such departures to the extent required for an expression of opinion.

23. 1 CCH AICPA PROF. STANDS. AU § 320 (1974).

24. An auditor is subject to liability to his client and possibly to limited categories of other persons for negligence at common law. *E.g.*, *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

25. See, *e.g.*, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

26. *Cf.*, *The T. J. Hooper*, 60 F.2d 737 (2d Cir. 1932).

tion to those circumstances. An auditor will be held to any representations he expresses or implies.²⁷ Any public or private agency that would prescribe such conventions must take into account not only the extent to which information required to be disclosed by applicable accounting principles is susceptible to auditing, but also the difficulties and limitations that are inherent in auditors' performance of their field work. Reporting criteria must thus be established with an eye to both the limitations and the potentialities of the field work that underlies them. Were such criteria to require representations of an auditor that his underlying procedures of audit performance could not support, use of the criteria would be tantamount to fraud. Thus, like generally accepted accounting principles, criteria for reporting upon financial statements can be prescribed, but they must be carefully drawn to reflect the reasonable auditor's practical capacity for due diligence.

For the purposes of this article, auditing standards and procedures may thus be regarded as criteria of audit performance pertaining to the nature and extent of work to be performed in an examination of financial statements, and as reporting criteria relating to the form and content of an auditor's report upon the results of his examination.

IV. THE ESTABLISHMENT OF ACCOUNTING PRINCIPLES AND AUDITING STANDARDS BY THE ACCOUNTING PROFESSION

From the beginning, accounting principles and auditing standards have evolved from the practices of issuers and their auditors as periodically modified by the actions of the American Institute of Certified Public Accountants and its predecessors,²⁸ the recently established Financial Accounting Standards Board,²⁹ and, since 1934, the Securities and Exchange Commission.³⁰ To some extent it is arbitrary to defer discussion of the role of the Securities and Exchange Commission until after that of the AICPA; the AICPA, however, was the first such organization to exercise responsibility in this area and thus will precede the Commission in this discussion.

The evolution of generally accepted accounting principles and auditing standards has been principally a process of innovation and

27. See *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972).

28. See note 1 *supra*. The history of the organization and evolution of the AICPA and the accounting profession is recounted in I & II J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION FROM TECHNICIAN TO PROFESSIONALS, 1896-1936* (1969) [hereinafter cited as J. CAREY].

29. See note 45 *infra* and accompanying text.

30. See notes 61-106 *infra* and accompanying text.

acceptance, subject to the supervision of regulatory bodies and the courts. To have left the evolution of accounting and auditing principles solely to individual enterprises and accountants, however, would have been intolerable, not only to persons making use of audited financial statements, but also to their issuers and auditors.

To the extent that accounting principles, auditing standards and the procedures for their application can be prescribed or generally made known in advance of their employment, they serve both public and private interests. Financial statements are more useful if established ground rules are observed in their preparation. One using audited financial statements can better assess the degree to which he can rely upon them if he knows the auditor has observed established standards in his examination. Issuers and auditors alike are more comfortable if the principles, standards and procedures that they have applied in the preparation and examination of financial statements can be supported by reference either to published and well-regarded literature, rules of a competent authority, or generally prevailing practice. Without such established or generally prevailing standards there would be no safe harbor to which either issuer or auditor could repair. The creation of such a harbor is not solely or even principally a matter of avoiding potential legal liability. Issuers and auditors have reputations to preserve, and reputation is a matter of particular concern to all professional persons, including certified public accountants.

The establishment and enforcement of such standards have been accomplished largely through the efforts of the organized accounting profession, under the leadership of the American Institute of Certified Public Accountants and its predecessor organizations. Enforcement has been effected in part through the Institute's disciplinary³¹ and monitoring³² procedures, which are seriously regarded

31. The AICPA has established a committee on professional ethics with a full-time staff which investigates disciplinary cases and prosecutes them before a trial board where prosecution appears warranted. See 2 CCH AICPA PROF. STANDS. BL § 600 (1974) (AICPA Bylaws). The AICPA and many state societies of certified public accountants are presently attempting to integrate their disciplinary procedures by establishing joint trial boards whose decisions would be binding on both state and national organizations. Private trial boards of course lack subpoena power, and can impose no harsher penalty than expulsion and publicity, but those are serious sanctions. State boards of accountancy, which have authority to revoke or suspend licenses to practice, and the SEC, which exercises similar authority pursuant to its Rule of Practice 2(e), 17 C.F.R. § 201.2(e), also enforce ethical standards. For a compendium of state laws pertaining to the regulation of accountancy see 1 & 2 CCH ACCOUNTANCY L. REP.

32. An AICPA committee regularly reviews auditors' reports coming to its attention and comments privately to such auditors if it believes the reports to be deficient. The AICPA also sponsors various programs by which members can have their firms' work product and internal procedures selectively reviewed by panels made up of members of other firms. Other such

by its member accountants, and within the past decade, with increasingly important impact, by the courts. The courts have recognized the entitlement of a professional organization to establish such standards,³³ and, accordingly, have applied them in litigation involving issuers and accountants.³⁴ Thus, the pronouncements of the Institute and the agencies that it recognizes for the purpose of establishing such standards have considerable authority. Issuers and auditors choosing to ignore them do so at their peril.

Other private agencies conceivably could have exercised more of a role than they have in the establishment of accounting principles.³⁵ Notwithstanding the particular concern of issuers with accounting principles, those principles touch the practice of accountancy continually and broadly, and it has been the accounting profession, its instrumentalities and progeny to which the business and financial community have largely deferred for definition of limitations upon accounting practice. This deference makes good sense: first, because the accounting profession has more of the necessary expertise, and secondly, because too many voices could lead to conflict and confusion. Auditing standards, of course, concern the auditor not only broadly but directly, and it was even more to be expected that their development would be guided by the accounting profession as it became aware of the need for such development.

Significant involvement of the AICPA and its predecessor or-

programs are specifically tailored to large firms with many offices. Special panels of AICPA members have been constituted at the specific request of the SEC and various accounting firms to conduct a review of the firms' internal procedures. See Laventhol, Krekstein, Horwath & Horwath, SEC Accounting Series Release No. 144 (May 23, 1973); Touche Ross & Co., SEC Accounting Series Release No. 153 (February 25, 1974). The SEC does not have the authority to order such a review; accounting firms may consent to such a measure, however, in order to demonstrate to the SEC that other enforcement action would be ill-founded or extreme.

33. *Appalachian Power Co. v. American Institute of Certified Pub. Accountants*, 177 F. Supp. 345 (S.D.N.Y. 1959), *aff'd per curiam*, 268 F.2d 844 (2d Cir. 1959), *cert. denied*, 361 U.S. 887 (1959).

34. Such standards were applied with precision and understanding and a judgment for the auditors was reversed, in *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972). They were applied with somewhat less understanding in *Hochfelder v. Ernst & Ernst*, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,781 (7th Cir. Aug. 30, 1974), and were wholly misapprehended in *Herzfeld v. Levanthol, Krekstein, Horwath & Horwath*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,574, at 95,999 (S.D.N.Y. May 29, 1974).

35. The Financial Executives Institute, the Financial Analysts Federation, the National Association of Accountants and the American Accounting Association now have a hand in selecting the trustees of the Financial Accounting Foundation, which in turn appoints the members of the new Financial Accounting Standards Board. See text accompanying note 43 *infra*.

ganizations began in 1932,³⁶ when, in a letter to the Committee on Stock List of the New York Exchange, a committee of the American Institute of Accountants made a number of recommendations for improvement of financial statements of companies listed with the Exchange. The letter dealt with two alternative proposals for establishing a more orderly framework of financial reporting. One alternative would have required that all listed companies within a particular industrial or commercial category adhere to a detailed system of accounting methods promulgated by some competent authority; another would have permitted such enterprises to choose their methods of accounting, within reasonable limits, provided that such methods were consistently followed from year to year and were publicly disclosed. The Institute committee recommended the latter approach, suggested the use of a form of auditor's certificate attesting to the preparation of the financial statements in accordance with the methods of accounting that the issuer regularly employed, and set forth five general principles of accounting to govern such financial statements. These included:

- (1) a prohibition against crediting unrealized profits to income,
- (2) a prohibition against using capital surplus to relieve the income account of charges against it,
- (3) a prohibition against using earned surplus of a subsidiary created prior to acquisition by its parent to increase the earned surplus or income of the parent,
- (4) a prohibition against crediting dividends on treasury stock to income, and
- (5) a requirement that amounts due from officers and affiliates be segregated on the balance sheet.

These recommendations largely were put into effect by the Exchange in 1933, save for the suggestion that the methods of accounting employed by listed companies be publicly disclosed. The Exchange also required listed companies to file independently audited

36. There were earlier efforts. During the years 1909 through 1915 an American Association of Public Accountants committee on accounting terminology agreed upon suggested definitions of some 900 or more accounts, words and phrases used in the preparation of financial statements. 1 J. CAREY, *supra* note 28, at 76-77. In 1917 the Federal Reserve Board issued, and reissued with some revisions in 1918, a bulletin containing some recommended uniform accounting and auditing practices, which apparently were substantially derived from a document prepared for internal use by Price Waterhouse & Co. *Id.* at 132-35. The bulletin was again revised and reissued by the Federal Reserve in 1929 and 1936 with the assistance of the American Institute of Accountants, which was then the name of the AICPA. *Id.* at 159-60.

financial statements, and, for the internal use of the Exchange, information on the scope of the auditors' examination and the accounting principles followed in the preparation of the financial statements. Published in 1934, the correspondence between the Institute and Exchange included a letter from the Committee on Stock List to the Governing Committee of the Exchange recommending that the five accounting principles suggested by the Institute committee be regarded as "so generally accepted that they should be followed by all listed companies."³⁷ This letter is apparently the source of the concept of generally accepted accounting principles.

From 1939 to 1953 the Institute's committees on terminology and accounting procedure promulgated forty-two Accounting Research Bulletins; primarily these bulletins put forward definitions of accounting terms and published the findings of research projects dealing with problems of immediate concern. The bulletins were codified, with some substantive changes, in ARB No. 43, which issued in June 1953 as the final publication of the committee on accounting procedure.³⁸

The Institute's committees on accounting procedure and terminology were superseded on September 1, 1959, by the Accounting Principles Board, a committee of Institute members, most of whom were in public practice. By the time of its dissolution in June 1973, the APB had issued thirty-one "Opinions" and four "Statements," which defined and narrowed the acceptable perimeters of accounting methodology.³⁹

The APB was established for the purpose of prescribing a broad framework of accounting principles from which suitable accounting methods could be derived. It was given a permanent staff of AICPA employees to assist in drafting and research. A review of its pronouncements⁴⁰ indicates, however, that like its immediate predecessors it became increasingly involved in dealing with problems of immediate concern.

The APB's strengths were also its weaknesses. Its members for the most part were partners of accounting firms who remained in

37. 1 J. CAREY, *supra* note 28, at 174-80.

38. Accounting Research Bulletin No. 43, 2 CCH APB ACCOUNTING PRINCIPLES 6003 (1971).

39. The pronouncements of the Accounting Principles Board and the committees which preceded it are collected in CCH APB ACCOUNTING PRINCIPLES, a looseleaf edition published under the auspices of the AICPA. For a discussion of the APB at a midpoint in its career see Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, 4 LAW & CONTEMP. PROB. 706 (1965).

40. See 2 CCH APB ACCOUNTING PRINCIPLES.

practice during their tenure on the APB, and who drew considerably upon the resources of their firms. Approval by at least two-thirds of the members of the APB was required for issuance of an Opinion, and this requirement could generally be counted upon to assure that the major accounting firms were satisfied of the merits of the Opinions. This contributed importantly to the stature and weight of the Opinions among accountants and their clients. It was sometimes difficult, however, to secure such agreement, and as a result some compromises were reached with which many observers on occasion were less than satisfied, and the issuance of pronouncements by the Board was sometimes substantially delayed.

In 1971 the Board of Directors of the AICPA convened a Study on Establishment of Accounting Principles under the chairmanship of Francis M. Wheat, who in his earlier capacity as a Commissioner of the Securities and Exchange Commission had directed the preparation of the Wheat Report.⁴¹ The Wheat Study,⁴² issued in March 1972, had an effect upon the establishment of accounting principles comparable in impact to that of the Wheat Report upon the regulatory policy of the SEC. The Study recommended that a body of seven full-time members be established as a Financial Accounting Standards Board, of whom only four would be certified public accountants drawn from private practice. It recommended that the new Board be augmented by a substantial research and administrative staff, and that it have the advice of a Financial Accounting Standards Advisory Council of approximately twenty members, serving part time, who would be drawn from various public and private disciplines. To provide for the selection and financing of the Board and Council, and to review their structure and operations, while safeguarding their independence from other organizations, the Study recommended creation of a Financial Accounting Foundation, which would consist of nine trustees, including the Chairman of the AICPA, and eight additional trustees appointed by the Board of Directors of the AICPA. Advising and assisting in the appointment of four of the eight additional trustees would be the Financial Executive Institute, the National Association of Accountants, the Financial Analysts Federation, and the American Accounting Association—organizations respectively representing business execu-

41. Disclosure to Investors—A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts, Report and Recommendations to the Securities and Exchange Commission from the Disclosure Policy Study (March 27, 1969).

42. AICPA, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS REPORT OF THE STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES (1972) [hereinafter cited as Wheat Study].

tives, corporate financial officers, financial analysts and accounting educators.⁴³

At the direction of the AICPA, the Financial Accounting Foundation was established on June 30, 1972, as a nonprofit Delaware corporation, governed by a Board of Trustees and including as constituent committees the Financial Accounting Standards Board and the Financial Accounting Standards Advisory Council recommended by the Study. The Foundation is qualified under section 501(c)(3) of the Internal Revenue Code, and is authorized to receive tax deductible contributions. The structure and operations of the Foundation, Board and Council conform in all material respects to the recommendations of the Wheat Study.⁴⁴ The Board's activities are conducted pursuant to the certificate of incorporation, the by-laws of the Financial Accounting Foundation and the Board's own rules of procedure.⁴⁵ These guidelines generally provide for research, the issuance of detailed discussion memoranda defining issues under consideration by the Board, the promulgation of exposure drafts of contemplated Statements of the Board, and public hearings prior to the issuance of a Statement in final form. The Board may also issue interpretations of its Statements and of presently outstanding pronouncements of the APB and its predecessors, which, as the Board has indicated in its rules, are to be regarded as continuing in effect until amended or supplanted by the Board.

The AICPA now attempts to restrict its involvement in the establishment of accounting principles to making its views known to the Financial Accounting Standards Board by means of position papers and other communications from the AICPA's Accounting Standards Executive Committee. Notwithstanding this self-

43. See generally, *id.*

44. There is only one variation from the Wheat Study that could be of potential significance. The Study recognized that the authority of APB Opinions, and the ability of the APB from time to time to reach a consensus, had been hindered in some instances by its practice of permitting its members to identify themselves, in the promulgated APB Opinions, as dissenters with supporting argument. The Study recommended that such dissents not be published in the Statements of the new Financial Accounting Standards Board, but that they be preserved instead in a public record of its proceedings. Wheat Study, *supra* note 42, at 38-39, 74. As originally adopted, the Foundation's bylaws, in conformity with the Study's recommendation, forbade the publication of such dissents. Financial Accounting Foundation, Bylaws, Art. II-A § 10 (Exposure Draft, October 13, 1972). By an amendment effected March 29, 1973, however, dissents are again permitted. It should be noted, however, that all pronouncements of the Financial Accounting Standards Board as of the date of this writing have issued with unanimous approval.

45. Copies of the Foundation's certificate of incorporation and bylaws, the Board's Rules of Procedure, and the Board's prior publications, as well as subscriptions to future such publications, may be obtained from the Financial Accounting Standards Board, Publications Division, High Ridge Park, Stamford, Connecticut 06905.

imposed restriction, the AICPA's accounting pronouncements can still be expected to be used for reference or as a safe harbor with respect to areas that the new Board, or the SEC, has not addressed.

The involvement of the AICPA in the development of generally accepted auditing standards can probably be traced to its assistance in the preparation of the Federal Reserve Bulletins⁴⁶ and the exchange of correspondence between the Institute and the Committee on Stock List of the New York Stock Exchange described above. An additional pamphlet, entitled "Examination of Financial Statements by Independent Public Accountants," was published under the Institute's auspices in 1936.⁴⁷

In 1939 a special committee of the AICPA was appointed "to examine into auditing procedures and other related questions in the light of recent public discussion,"⁴⁸ a statement relating to the investigation by the Securities and Exchange Commission of the notorious *McKesson & Robbins*⁴⁹ debacle. The special committee's report, entitled "Extensions of Auditing Procedure," which among other things adopted a requirement that auditors be present to observe the physical taking of their clients' inventories, was adopted and published by the AICPA Council. The Commission took note of these developments, and in its report refrained from attempting to establish auditing procedures independently of the AICPA. Availing itself of the opportunity afforded by the Commission, the AICPA in 1939 created a standing Committee on Auditing Procedure that continues to this day. Subsequently renamed the Auditing Standards Executive Committee, the Committee has promulgated a continuing series of Statements on Auditing Procedure, now called Statements on Auditing Standards and embodied in Statement on Auditing Standards No. 1,⁵⁰ a codification of all prior effective Statements, and Statement on Auditing Standards No. 2,⁵¹ dealing

46. 2 J. CAREY, *supra* note 28, at 20-41.

47. See 1 CCH AICPA PROF. STANDS. AU App. A. (1974).

48. *Id.*

49. For a summary of the Commission's report see *McKesson & Robbins, Inc.*, ASR No. 19 (Dec. 5, 1940), 4 CCH FED. SEC. L. REP. ¶ 72,020 (1974).

50. 1 CCH AICPA PROF. STANDS. AU §§ 100-710 (1974).

51. Reports on Audited Financial Statements, SAS No. 2 (October 1974). A principal reason for issuance of SAS No. 2 was to clarify expectations regarding auditors' responsibilities for uncertainties, the ultimate resolution of which, were it possible to resolve them as of the date of the auditor's report, could conceivably have material impact on the financial statements covered by the report. Auditors and other experts are of course unable to assess, except in unusual circumstances, the resolution of such matters as pending or threatened antitrust litigation, the possibility of expropriation of a foreign plant, possible materials shortages or the risk of a major customer's going out of business. They can only call attention to the existence of material uncertainties (if they are able to identify them) and see that some description of them is provided.

with reports on audited financial statements. The Committee's pronouncements have also included a recent Commentary⁵² advising auditors of their responsibilities in obtaining information from attorneys concerning possible contingent liabilities of their mutual clients.⁵³ Additionally, the Committee has assisted in the preparation of an extensive library of Industry Audit Guides⁵⁴ giving assistance to auditors with respect to various categories of clients.

The Committee functions pursuant to procedures similar to those of the former Accounting Principles Board. It is currently composed of twenty-one members, including nineteen practicing members of accounting firms, a professor of accountancy, and a senior official of the General Accounting Office. The Committee's strength, like that of the APB, is that its pronouncements reflecting the consensus of two-thirds or more of its members, not only carry the sponsorship of the AICPA, but also represent the considered view of the firms represented on the Committee.

AICPA members are required by recent amendment to the AICPA Code of Professional Ethics⁵⁵ to observe the pronouncements of the Financial Accounting Standards Board and its predecessors, the Accounting Principles Board and Committee on Accounting Procedure with regard to generally accepted accounting principles, and of the Auditing Standards Executive Committee with regard to generally accepted auditing standards.

Rule 203 concerns accounting principles. It provides as follows:

Rule 203—Accounting Principles. A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by [the AICPA] Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

An implementing resolution of the AICPA Council, effective May 7, 1973,⁵⁶ recognizes, for purposes of the Rule, Statements of Financial Accounting Standards issued by the Financial Accounting Standards Board and, subject to modification by the FASB, outstanding and effective Accounting Research Bulletins and Opinions

52. See note 12 *supra*.

53. *Id.*

54. See note 21 *supra*.

55. 2 CCH AICPA PROF. STANDS. ET §§ 202.01, 203.01 (1974).

56. *Id.* App. B.

of the Accounting Principles Board which were adopted by the APB on or before June 30, 1973. The AICPA Division of Professional Ethics had indicated⁵⁷ that in enforcing Rule 203 it will construe outstanding FASB statements, Accounting Research Bulletins and APB Opinions in the light of any interpretations thereof issued by the FASB.

The adoption of Rule 203 by the AICPA membership, and its implementation by the Council and the Division of Professional Ethics, represents a substantial tightening of standards by the accounting profession. Heretofore, observance of generally accepted accounting principles had been required by a resolution of the AICPA Council,⁵⁸ but generally accepted accounting principles merely had been defined as accounting principles having "substantial authoritative support." Thus, so long as AICPA members disclosed any departures from an Opinion of the Accounting Principles Board in their reports upon financial statements, they were permitted, notwithstanding such a departure, to report that financial statements were prepared in conformity with generally accepted accounting principles if the principles employed were elsewhere, whether in literature or practice, authoritatively supported.

While in some circumstances Rule 203 appears to permit an auditor to express an opinion to the effect that financial statements are presented in conformity with generally accepted accounting principles notwithstanding a departure from a pronouncement of the FASB or one of its predecessors, the exception is obviously intended to be read narrowly. It is confined by the Rule to situations in which the auditor "can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading." This construction is confirmed by a contemporaneous interpretation of the AICPA Division of Professional Ethics which indicates the exception will be inapplicable "in nearly all instances":

Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances which would not ordinarily be regarded as unusual in the context of Rule 203.⁵⁹

Thus, the exception might apply were the SEC to prescribe an accounting principle that conflicted with a pronouncement of the

57. *Id.* § 203.02.

58. AICPA, SPEC. BULL., DISCLOSURE OF DEPARTURES FROM OPINIONS OF ACCOUNTING PRINCIPLES BOARD (1964).

59. 2 CCH AICPA PROF. STANDS. ET § 203.02 (1974).

FASB, but it would not apply simply because an issuer and its auditors, no matter how strongly, happened to disagree with an FASB pronouncement.

Rule 202 of the AICPA Code of Professional Ethics similarly requires adherence by AICPA members, as a matter of professional ethics, to the ten generally accepted auditing standards adopted by the AICPA membership. It further provides that Statements on Auditing Procedure issued by the Committee on Auditing Procedure (now Statements on Auditing Standards issued by the Auditing Standards Executive Committee) are for purposes of the Rule "considered to be interpretations of the generally accepted auditing standards, and departures from such statements must be justified by those who do not follow them."

The AICPA Code of Professional Ethics serves as well as a model for state societies of certified public accountants and for the state boards of accountancy which supervise the licensing of certified public accountants.⁶⁰ From a legal standpoint, such ethical provisions, insofar as they require adherence to pronouncements of the Financial Accounting Standards Board and Auditing Standards Executive Committee, underscore the importance of those pronouncements as authority for the standards of practice binding upon certified public accountants.

The Accounting Principles Board, the Financial Accounting Standards Board, and the Auditing Standards Executive Committee have generally served the public well through their efforts. Their writ, for practical purposes, extends to enterprises not within the purview of the Securities and Exchange Commission, and but for their existence there would be large areas of practice left unregulated. Even within areas assigned to the Commission they serve an important function.

V. THE ROLE OF THE SEC

A. *Statutory Authority of the Securities and Exchange Commission with Regard to Accounting Principles and Auditing Standards*

The statutory authority that the Securities and Exchange Commission presently possesses with regard to accounting principles and auditing standards generally reflects the distinction between them. This distinction would be preserved as well by the pertinent provi-

60. Statutes regarding the establishment and operations of, and regulations issued by, state boards of accountancy are collected in 1 & 2 CCH ACCOUNTANCY L. REP.

sions of the proposed Federal Securities Code being prepared under the auspices of the American Law Institute.⁶¹ The Commission's authority is also sufficiently flexible to accommodate and make use of the contributions of the AICPA and the Financial Accounting Standards Board in establishing standards of practice.

Within the limits of its jurisdiction, the Securities and Exchange Commission apparently now possesses plenary authority over accounting principles. A registration statement for a public offering of securities filed with the Commission under the Securities Act of 1933⁶² (hereinafter the 1933 Act) is required by Section 7⁶³ thereof to contain information, including financial statements audited by independent public accountants, specified by Items 25-27 of Schedule A;⁶⁴ these items authorize the Commission to prescribe the detail and form of the financial statements so included. The Commission is granted additional authority, pursuant to Section 19(a),⁶⁵ to prescribe "accounting, technical and trade terms" used in the 1933 Act and to prescribe the "methods" of accounting to be followed in preparing such financial statements.

The Commission is granted similar authority by Section 3(b) of the Securities Exchange Act of 1934 (hereinafter the 1934 Act) to define "technical, trade and accounting terms used in [the 1934 Act] . . . insofar as such definitions are not inconsistent with the provisions of [the 1934 Act]"⁶⁶ With regard to issuers of securities registered on a national exchange, or corporations having assets exceeding 1 million dollars and 500 or more shareholders of record, the Commission may require that a registration statement

61. The proposed new Federal Securities Code is being prepared under the auspices of the American Law Institute by Professor Louis Loss. The Code generally would require registration and periodic reporting in a manner comparable to the scheme of the Securities Exchange Act of 1934, with updating and circulation of an offering circular when securities are publicly offered, and would provide some sensible and long overdue coherency to securities regulation. Much of the Code has been completed and tentatively approved by the members of the ALI: Tent. Draft No. 1 (1972), Tent. Draft No. 2 (1973) and Tent. Draft No. 3 (1974). A subsequent edition of the Code has recently been published (and received a day or so prior to this writing), ALI, Federal Securities Code, Reporter's Revision of Text of Tent. Drafts Nos. 1-3 (Oct. 1, 1974), from which derive the sections of the Code cited in this article. Although the "Reporter's Revision" does not yet bear the imprimatur of ALI membership approval it must be taken as the current working text. Reference is still required to Tent. Drafts Nos. 1-3, however, for the Reporter's comments.

62. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970).

63. 15 U.S.C. § 77g (1970).

64. 15 U.S.C. § 77aa, Sched. A., (25)-(27) (1970).

65. 15 U.S.C. § 77s(a) (1970). The Commission has of course exercised this authority extensively. *E.g.*, SEC Reg. S-X, 17 C.F.R. § 210 (1974).

66. 15 U.S.C. § 78c(b) (1970).

be filed containing balance sheets and profit and loss statements for not more than the three years preceding registration and such further financial statements as it may deem necessary for the protection of investors.⁶⁷ These registrants, as well as issuers of securities that have seen a 1933 Act registration statement through to effectiveness and continue to have 300 or more shareholders of record⁶⁸ may be required to file annual reports, certified by independent public accountants if required by the regulations of the Commission, and quarterly reports which the Commission apparently cannot require to be so certified.⁶⁹ With regard to all reports made pursuant to the 1934 Act, the Commission is authorized to prescribe the form or forms in which the information is to be set forth, items or details to be shown in the balance sheet and earnings statement, and methods to be followed in their preparation.⁷⁰ The Commission is further authorized to prescribe additional record keeping and accounting requirements for registered exchanges, associations, members thereof, and brokers and dealers.⁷¹

67. 15 U.S.C. §§ 78l(b)(1)(J)-(L), 78l(g)(1) (1970).

68. 15 U.S.C. § 78o(d)(1) (1970).

69. 15 U.S.C. § 78m(a)(2) (1970). Section 13(a) reads in pertinent part as follows:

Sec. 13 (a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.

(2) *Such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.*

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange. (Emphasis added.)

The legislative history of the 1934 Act indicates that the text of Section 13(a)(2) was revised to deny the Securities and Exchange Commission authority to require registrants to file audited financial statements on other than an annual basis. The reasons for this limitation on the Commission's authority appear to have involved, first, businessmen's concern regarding the expense of quarterly audits and, second, auditors' concern that their report would lend undue authority to quarterly reports (which by their nature are inherently imprecise) and that their examination would unduly delay issuance of such reports.

See, e.g., Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 893-96 (1934); Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 7175-77 (1934) (Statement of George O. May); id. at 7208 (Memorandum submitted by American Institute of Accountants dated March 6, 1934).

70. 15 U.S.C. § 78m(b) (1970).

71. 15 U.S.C. § 78q(a) (1970). The Commission still has additional authority with regard to special categories of registrants which are not considered in this article. *See, e.g., Public Utility Holding Company Act of 1935 §§ 5(b)(2), 15, 20(a); 15 U.S.C. §§ 79e(b)(2), 79a, 79t(a) (1970); Trust Indenture Act of 1939 § 319(a), 15 U.S.C. §§ 77sss (1970); Investment Company Act of 1940 §§ 30, 31, 15 U.S.C. §§ 80a-29, 80a-30 (1970); Investment Adviser's Act of 1940 §§ 204, 211(a), 15 U.S.C. 80b-4, 80b-11(a) (1970).*

Items 25 and 26 of the 1933 Act require balance sheets and profit and loss statements "certified by an independent public or certified accountant."⁷² No auditing standards are prescribed, nor is authority expressly conferred upon the Commission to prescribe them. An accountant whose report is included in a 1933 Act Registration statement pursuant to those items, however, is subject to suit pursuant to Section 11(b).⁷³ Should the plaintiff in such an action establish a material misrepresentation in either the audited financial statements or the auditor's report, the auditor is afforded the defense, among others, of establishing that

he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part [the audited financial statements and his report] of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading⁷⁴

The standard of reasonableness prescribed is "that required of a prudent man in the management of his own property."⁷⁵ The need for generally accepted auditing standards, for purposes of the 1933 Act, derives substantially from these provisions.⁷⁶

Under the 1934 Act, the Commission is authorized to require that financial statements included in registration statements filed pursuant to Sections 12(b) and (g),⁷⁷ and in annual (but not quarterly) reports filed pursuant to Section 13(a)(2) be "certified . . . by independent public accountants."⁷⁸ Again, the 1934 Act does not expressly authorize the Commission to prescribe the standards by which an independent public accountant is to conduct the examination underlying his report. With regard to audited financial statements and their reports, auditors, however, are also subject to civil liability under the 1934 Act, principally pursuant to Section 10(b)⁷⁹

72. 15 U.S.C. § 77aa, Sched. A, (25)-(26) (1970).

73. 15 U.S.C. § 77k(b) (1970).

74. 15 U.S.C. § 77k(b)(3)(B)(i) (1970).

75. 15 U.S.C. § 77k(c) (1970).

76. Exposure to civil litigation implies that the triers of fact will evolve and apply standards for decision. Auditors are practically and professionally compelled to develop those standards in advance of such proceedings. The bar may be coming to the same conclusion with respect to lawyers' professional performance. See American Bar Association Committee on Ethics and Professional Responsibility, Formal Opinion 335 (Feb. 2, 1974) (lawyers' responsibility for matters of fact in opinions permitting transfer of securities), an attempt to provide some gloss for *SEC v. Spectrum Ltd.*, 489 F.2d 535 (2d Cir. 1973) (negligent failure to uncover factual error is ground for injunction against attorney) which reads very much like an AICPA Statement on Auditing Standards.

77. 15 U.S.C. § 78l(b), (g) (1970).

78. See note 69 *supra*.

79. 15 U.S.C. § 78j(b) (1970).

and Rule 10b-5.⁸⁰ Thus, as is the case pursuant to the 1933 Act, auditors are required to exercise good faith and, for certain plaintiffs, the requisite due diligence in their examination.⁸¹ It is in this sense that the 1934 Act requires auditors to observe generally accepted auditing standards.⁸²

Since both the 1933 and 1934 acts require that certain financial statements be "certified by independent public or certified accountant[s],"⁸³ or "certified . . . by independent public accountants,"⁸⁴ the Commission legitimately claims implicit authority to determine whether a person or firm purporting to certify or to report upon financial statements is, in fact, a public or certified accountant, or a firm of such accountants, whether that person or firm is independent of the issuer of the financial statements, and whether the representations contained in the report sufficiently fulfill their statutory function.

The Commission's powers with regard to auditing are considerable, even though it lacks the express authority to prescribe auditing standards and procedures that it has in the case of accounting principles. The Commission has prescribed elaborate standards regarding auditors' independence⁸⁵ and the representation required in the auditor's report.⁸⁶

In order to make the auditor's report acceptable for filing by a registrant, any representations of the auditor required by the Commission must be supported in some fashion by work which the auditor has performed. The Commission thus has, for practical purposes, a considerable, albeit indirect, capacity to influence the evolution of auditing standards and procedures. For example, Rule 2-05 of Regulation S-X specifically requires that the auditor's report "state whether the audit was made in accordance with generally accepted auditing standards."⁸⁷ Moreover, the Commission's interpretive pronouncements, chiefly in the form of releases, including the opinions of its Chief Accountant issued as Accounting Series Releases, are likely to be found persuasive by the courts in litigation

80. 17 C.F.R. § 240.10b-5 (1974).

81. See, e.g., *Hochfelder v. Ernst & Ernst*, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,781, at 96,582 (7th Cir. Aug. 30, 1974).

82. See *id.*

83. 1933 Act, Sched. A, Items 25-26, 15 U.S.C. § 77aa, Sched. A, (25)-(26).

84. 1934 Act, §§ 12(b)(1)(J)-(K), 13(a)(2), 15 U.S.C. §§ 78l(b)(1)(J)-(K), 78m(a)(2).

85. SEC Reg. S-X, 17 C.F.R. § 210.2-01 (1974); Accounting Series Releases Nos. 2, 22, 37, 44, 47, 81, 112, 126, 4 CCH FED. SEC. L. REP. ¶ 72,000 (1974).

86. SEC Reg. S-X, 17 C.F.R. §§ 210.2-02, -05 (1974); see also Accounting Series Releases Nos. 13, 21, 61, 62, 90, 115, 4 CCH FED. SEC. L. REP. ¶ 72,000 (1974).

87. SEC Reg. S-X, 17 C.F.R. § 210.2-02(a) (1974).

involving accountants. In a sense, therefore, the Commission has not only such prescriptive power as may be granted by statute with regard to accounting principles and implicitly conferred power as to the form and content of the auditor's report, but also has persuasive authority to make known its views regarding both accounting principles and auditing standards to certified public accountants and to the courts in areas where the SEC may lack prescriptive authority. For practical purposes this authority is shared with the AICPA and the Financial Accounting Standards Board.

With few exceptions, the proposed Federal Securities Code,⁸⁸ now in the course of preparation under the auspices of the American Law Institute, would continue the Commission's present authority as to accounting principles and auditing standards. In Section 1503 the Code collects all provisions having to do with such authority. The text of widest applicability is Section 1503(a) which reads in pertinent part as follows:

For purposes of this Code . . . 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 the independent public accountant's report.⁸⁹

88. See note 61 *supra*.

89. ALL FEDERAL SECURITIES CODE § 1503(a) (Reporter's Revision of Tent. Drafts Nos. 1-3, Oct. 1, 1974) [hereinafter cited as Reporter's Revision]. See note 61 *supra*. The full text of Section 1503 is as follows:

Sec. 1503 [*Accounting and records*.] (a) [*Rule-making 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 the independence for public accountant's insofar as they practice before it, and (5) prescribe the form and content of the independent public accountant's report.

(b) [*Required records*] (1) The following persons shall make and keep for prescribed periods whatever records the Commission prescribes by rule:

(A) a national securities exchange or a member thereof, a registered securities association, or a registered broker, dealer, or investment adviser;

(B) a registered investment company, a depositor, or a principal underwriter for a registered investment company other than a closed-end company;

(C) (i) a registered holding company, a subsidiary thereof, or a mutual service company, (ii) an affiliate of any such company or of a utility company to the extent of records relating to a transaction that is subject to this Code, or (iii) a utility contractor to the same extent.

(2) For purposes of this Code, the Commission, by rule, may require an independent public accountant to keep reports, work sheets and records relating to a person designated in section 1503(b)(1) for one or more prescribed periods.

(c) [Accountants for investment companies.] (1) It is unlawful for a registered management company (other than a common law trust of the character described in [Inv. Co. Act § 16(b)]) or registered face-amount certificate company to file a financial statement on which an independent public accountant has reported unless

(A) the accountant was selected at a meeting, held not earlier than thirty days before or later than ninety days after the beginning of the fiscal year and called by a notice specifying the selection as a purpose of the meeting, by the vote (cast in person) of a majority of those members of the board of directors who were not interested persons of the company;

(B) the selection (except as otherwise provided in section 1503(c)(2)) was submitted for ratification or rejection at the annual meeting of stockholders during the fiscal year if there was such a meeting;

(C) the employment of the accountant was conditioned on the right of the company, by vote of a majority of the outstanding voting securities (considered as a single class) at a meeting called for the purpose, to terminate the employment forthwith without any penalty;

(D) the accountant was sent or given copies of all communications sent or given by the company to holders of its voting securities during the period of his employment, and he was invited to attend all meetings and was given a right to be heard and to answer stockholders' questions with respect to any part of the business of the meetings that concerned him in his professional capacity; and

(E) the report of the accountant was addressed to both the board of directors and the security holders.

(2) If the selection of an accountant is rejected pursuant to section 1503(c)(1)(B) or his employment is terminated pursuant to section 1503(c)(1)(C), the vacancy so occurring shall be filled by vote of a majority of the outstanding voting securities (considered as a single class), either at the meeting at which the rejection or termination occurred or at a subsequent meeting called for the purpose. A vacancy occurring between annual meetings of stockholders by reason of death or retirement shall be filled as provided in section 1503(c)(1)(A) with its time periods disregarded.

(3) The employment of an independent public accountant for a common law trust of the character described in [Inv. Co. Act § 16(b)] may be terminated by action of the holders of record of a majority (within the meaning of section 299.15(c)) of the outstanding shares of beneficial interest in the trust in the same manner as is provided in [Inv. Co. Act § 16(b)] in respect of the removal of a trustee, and the provisions of that section as to the calling of a meeting are applicable. The vacancy so occurring may be filled by action of the holders of record of such a majority of the shares of beneficial interest (A) at the meeting, if any, at which the termination occurs, (B) through instruments in writing filed with the custodian, or (C), if it is not so filled within a reasonable time, at a subsequent meeting called by the trustees for the purpose.

(4) It is unlawful for a company within section 1503 (c)(1) to file a financial statement in whose preparation its controller or other principal accounting officer (or any other employee with similar responsibilities) participated unless he was selected either by vote of the holders of the company's voting securities at their last annual meeting or by the board of directors.

(d) [Accountants for registrants generally.] In the case of a registrant other than a company within section 1503(c)(1), the Commission may prescribe comparable requirements by rule, except that it may not prescribe the qualifications of *directors*.

(e) [Holding companies, etc.] With respect to the persons specified in section 1503(b)(1)(C), the Commission

(1), by rule, may prescribe uniform systems for keeping their required accounts; and

(2), by order, may prescribe accounts in which particular outlays, receipts, and other transactions shall be entered, charged, or credited, and the manner in which the entries, charges, or credits shall be made, and may require an entry to be modified or supplemented so as properly to show the cost of any asset or any other cost.

Under the 1934 Act, as has been indicated, the Commission is authorized to require an examination and report by independent auditors only for annual financial statements. Although Section 1503(a)(3) of the ALI Code would appear to permit the Commission to require an audit of financial statements other than annual financial statements, the Code contains a similar limitation in Section 601⁹⁰ that provides for the filing, submission to shareholders, publishing and retention of "annual reports (with financial statements), quarterly reports, and other reports" The inherent limitations of quarterly financial statements, and the possibility that investors will place undue reliance upon such statements if they are accompanied by an auditor's report are discussed elsewhere.⁹¹ The Reporter for the Code has taken a sensible position in neither requiring, nor leaving room for a requirement that auditors report upon quarterly financial statements. There is, of course, no prohibition in either the ALI Code or the 1934 Act against attestation by auditors to quarterly or any other financial statements on a permissive basis where the circumstances warrant, or against advice or assistance by public accounting firms in connection with an issuer's preparation of such financial statements.

The Commission's authority with regard to auditors' independence of their clients is presently derived from the statutory requirements pertaining to reports upon financial statements by "independent" auditors, and thus is limited to the context of an auditor's report. Section 1503(a)(4) of the ALI Code, however, would authorize the Commission to "establish standards of independence for public accountants insofar as they practice before it." This formulation conceivably could permit the Commission to prescribe standards affecting auditors' independence in a broader context than reporting—for example, in appearances before the Commission or its staff to argue the merits of a particular method of accounting.

Section 1503 usefully clarifies the Commission's authority to require the examination of and report on financial statements by

See also [Holding Co. Act § 13(c)].

(f) [*Trust indentures.*] See [Trust Ind. Act § 314 (c)(3)].

(g) [*Persons subject to other accounting rules.*] With respect to the reports and accounts of a person whose methods of accounting are prescribed under another law of the United States or a State, the rules and orders under this section may impose additional requirements; but those requirements may not be inconsistent except (1) as provided in section 1602(b) or (2) to the extent that a rule or order recites that it applies despite an inconsistency.

(h) [*Cross-references.*] See also sections — [Trust Ind. Act § 314(c)(3)], 1502(a)(5), and 1703 (d)(3)(C).

90. Reporter's Revision § 601.

91. See note 69, and text accompanying notes 3 & 4 *supra*.

independent auditors, by expressly limiting that authority to reports upon financial statements; in contrast, Section 13(a)(2) of the 1934 Act somewhat ambiguously calls for auditors' attestation to annual reports. The clarification is probably not of substantial importance, however, because attestation by auditors traditionally has been limited to financial statements rather than to the annual report in its entirety.

Section 1503(b) of the Code would authorize the Commission to require such registrants as exchanges and their members, securities associations, brokers, dealers, investment advisors, investment companies, the principal underwriters for open-end investment companies, depositories, holding companies, and the like, to make and retain records in accordance with the Commission's rules. Furthermore, it would authorize the Commission to require that independent auditors maintain work papers, records and reports pertinent to such registrants for such time as the Commission might require. Presently, such requirements for auditors are limited to records pertaining to investment companies.⁹²

Section 1503(c) reiterates the largely formal trappings of corporate democracy presently embodied in Sections 32(a)(1)-(4) of the Investment Company Act of 1940, and requires that the independent auditor of an investment company be elected by disinterested directors, and that his employment be ratified and subject to termination by the shareholders. The Section also imports a provision of English law⁹³ to the effect that the auditor receives all communications to the shareholders of the investment company, and has the right to attend and respond to questions at shareholders' meetings. These provisions are probably of more formal than substantive significance insofar as their practical effect is concerned. Their scope would be substantially extended beyond present law, however, because for registrants other than investment companies, Section 1503(d) would authorize the Commission to impose similar requirements with regard to auditors' approval by shareholders and attendance at shareholders' meetings.⁹⁴

B. *The SEC's Exercise of Authority*

The SEC's role in the establishment of accounting principles and auditing standards reflects as a matter of course its different authority with respect to each. It indicates, as well, a sensible

92. Investment Company Act of 1940 § 32 (c), 15 U.S.C. § 80a-31(c) (1970).

93. Eng. Companies Act 1967, c.81, § 14(7).

94. Reporter's Revision § 1503(d).

awareness of the benefits which accrue both to the Commission and to the public from the proprietary involvement of the accounting profession and the Financial Accounting Standards Board in the formulation of such standards and principles.

Among the foremost of the benefits is the substantial commitment of talent and resources that is commanded by the AICPA Auditing and Accounting Standards Divisions and the FASB. The Auditing Standards Executive Committee and the FASB provide focal centers for substantial participation by the organizations and individuals who must apply and observe the pronouncements of these bodies. Many of these participants prefer that accounting principles and auditing standards be defined by the FASB and the AICPA, with their substantial practical insight and experience, rather than by governmental authority. Their interest in seeing the FASB and AICPA continue in this function provides substantial motivation for support and acceptance of FASB and AICPA pronouncements, going beyond a routine effort to stay on the right side of the law as prescribed by governmental authority. The AICPA and FASB could be preempted by public authority in their prescription of auditing standards and accounting principles only at substantial public cost. Even if the requisite budgetary resources were committed, it is doubtful that a public agency could attract the talent and resources that are now committed to the work of the AICPA and FASB. The FASB and AICPA free large resources of the SEC for direction elsewhere.

The substantial involvement of the organized accounting profession in the establishment of auditing standards and its support and cooperation with the FASB in the latter's establishment of accounting principles have added significantly to the stature and professionalism of the practice of public accountancy. The auditors' ability to serve the public interest in examining and reporting upon financial statements is greatly enhanced by client's perception that the standards and expertise that the auditors bring to their work are largely the auditors' proprietary knowledge, rather than pronouncements of a public agency whose meaning and significance would be relatively more open to debate between auditor and client. Moreover, the auditors' self-perception as guardians, creators and custodians of the body of knowledge underlying their practice contributes importantly to the maintenance of the attitude of independence and professionalism that they bring to their work.

It is for such reasons that the Securities and Exchange Commission historically has supported the efforts of the organized account-

ing profession in the establishment and observation of generally accepted accounting principles.⁹⁵ Thus, during the time that the organized profession had secured the consensus of its members that financial statements were not to be regarded as having been prepared in conformity with generally accepted accounting principles unless the principles employed enjoyed substantial authoritative support,⁹⁶ the Commission adopted a similar administrative policy.⁹⁷ When the AICPA moved to adopt an ethical requirement of observance of pronouncements of the Financial Accounting Standards Board,⁹⁸ the Commission, in Accounting Series Release No. 150,⁹⁹ reaffirmed and elaborated upon its earlier position by providing that

principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.

The Commission, of course, has not abandoned the field to either the accounting profession or the FASB. The requirements for the form and content of financial statements manifested in Regulation S-X,¹⁰⁰ its various registration and reporting forms, and in the Commission's Accounting Series Releases indicate a substantial involvement in the establishment of accounting principles. The Commission's tradition of cooperation with the AICPA, and now with the FASB, also does not amount in any respect to a delegation of the Commission's regulatory power to a private body.¹⁰¹ The Commission is authorized to establish accounting principles when it deems the establishment to be in the public interest. It is not required to do so when accounting principles have otherwise been established and are being observed. Any party who perceives himself to be aggrieved by existing accounting practice, whatever its source, can petition the Commission to modify that practice.¹⁰² Indeed, such a party is in a sense benefited by the opportunity to petition not only the Commission but the FASB as well.

95. See Pines, *The Securities and Exchange Commission and Accounting Principles*, 30 LAW & CONTEMP. PROB. 727 (1965).

96. AICPA, SPEC. BULL., DISCLOSURE OF DEPARTURE FROM OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD (1964).

97. SEC Accounting Series Release No. 4 (May 10, 1938).

98. See text at notes 55-60 *supra*.

99. SEC Accounting Series Release No. 150 (Dec. 20, 1973).

100. 17 C.F.R. Pt. 210 (1974).

101. For a suggestion to the contrary see Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970). For a response see the Wheat Study, *supra* note 42 at 51-52.

102. 5 U.S.C. § 553(e) (1970).

Since issuance of Accounting Series Release No. 150, the Commission has not stood idly by while waiting for the FASB to act. Indeed, in the next Accounting Series Release,¹⁰³ the Commission made known its views regarding disclosure of inventory profits attributable to inflation. Further, it soon modified Regulation S-X with regard to the financial statements of life insurance companies,¹⁰⁴ and, pending adoption of a pronouncement by the FASB, it promulgated interim requirements for consolidated and combined financial statements.¹⁰⁵ In its latest Accounting Series Release, the Commission has revised Regulation S-X further to take account of a recent pronouncement of the FASB concerning recognition of research and development costs.¹⁰⁶

VI. CONCLUSION

The involvement of the accounting profession in the establishment of professional standards has been of substantial public benefit not only by virtue of the standards thus developed and improved, but also by serving as a focal point for the organization, recognition and development of the accounting profession itself. To a substantial extent, the rise of the accounting profession has been grounded on that involvement. A profession actively involved in the development of its standards will do a better job in their application. By their efforts, the American Institute of Certified Public Accountants, and the independent Financial Accounting Standards Board, have provided a reasonably coherent framework for accounting and auditing practice in areas that otherwise would have been subjected to fragmented or conflicting regulation.

Despite the benefits deriving from their efforts, these private agencies, by their nature, must remain vulnerable to the risk of conflicting or competing decrees and regulations, which could deprive them of their general acceptance and vitality. Their role and importance could be diminished should the Securities and Exchange Commission preempt or fail to support them. Similarly, these private agencies run certain risks if their contributions to the advancement and improvement of accounting and auditing are not understood and applied by governmental agencies, the Congress and the courts. At present, there is no indication that either the AICPA and its Auditing Standards Executive Committee or the

103. SEC Accounting Series Release No. 151 (Jan. 3, 1974).

104. SEC Accounting Series Release No. 152 (Feb. 14, 1974).

105. SEC Accounting Series Release No. 154 (April 19, 1974).

106. SEC Accounting Series Release No. 164 (Nov. 21, 1974).

FASB face any substantial risk of preemption or lack of support; there is evidence instead that they continue to have the support they require. The process works more than reasonably well.

Author's postscript: On December 19, 1974, subsequent to the preparation of this article, the SEC, with the apparent objective of requiring review by independent public accountants of quarterly financial information, proposed that such information be prescribed in a footnote to annual audited financial statements filed with the SEC. SEC Rel. No. 33-5549, CCH FED. SEC. L. REP. ¶ 80030. The proposal would preclude the accountant from indicating that the information is unaudited, thus illustrating the warnings of this article. See text following note 27. As a practical matter, an issuer faced with the prospect of year end review by its auditors will be forced to have them review it on a quarterly basis. Thus, with regard to quarterly information the proposal would accomplish indirectly what for good reason section 13(a)(2) of the 1934 Act directly precludes. See note 69 *supra*.

