THE SEC AND ACCOUNTING: A HISTORICAL PERSPECTIVE

Joel SELIGMAN *

Joel Seligman argues that in the absence of regulatory oversight, managerial incentives and notions of efficient markets and competitive positioning have proven to be insufficient in ensuring full disclosure of material financial data. The SEC, given express authority to regulate accounting practices, has, during the past fifty years, directly contributed to the standardization of financial statement disclosures. In establishing accounting standards, the SEC has exercised restraint, allowing private organizations such as the FASB to set standards subject to SEC oversight. Although the SEC could be more aggressive in initiating accounting standards (particularly with controversial practices such as pooling versus purchase treatment of acquisitions), as long as users have benefited from full disclosure requirements, the SEC can be perceived as having performed creditably in accounting standard-setting.

1. Introduction

Since 1934, the Securities and Exchange Commission (SEC) has been empowered to make rules and regulations governing registration statements and prospectuses as well as prescribe the form in which the required information shall be set forth, including the methods to be followed in the preparation of accounts [1]. This authority to promulgate generally accepted accounting principles has not been a power that the SEC has emphasized in its first fifty years. From the SEC's perspective, the regulation of accounting standards has been subordinated to the accomplishment of other statutorily defined tasks such as the regulation of the securities markets, the regulation of investment companies, the regulation of brokers and investment advisers, the restructuring of the public utility holding companies, the administration of mandatory disclosure programs, and the enforcement of the antifraud laws.

Indeed, without reference to any theory as erudite as the efficient market hypothesis, the SEC's predecessor long assumed that many standard-setting controversies could be adequately addressed by full disclosure of the accounting method employed [2]. Such a view reflects the cultural gap that has traditionally separated most SEC commissioners from the profession of

* Professor of Law. George Washington University National Law Center.
accounting. Many commissioners have shared the view of Joseph Kennedy, the SEC's first chairman, that accounting standard-setting was a technical, not particularly important, concern. As Kennedy put it in the spring of 1935, "I'd hate to go out of here thinking I had just made some changes in accounting practices" [3]. Four years later, Jerome Frank, also an SEC chairman, gave a notable address urging that "there can be such a thing as excessive emphasis on the importance of the accountant's task" [4]. Frank stated, in part:

Every man is likely to overemphasize and treat as fundamental those aspects of life which are his peculiar daily concern. To most dentists, you and I are, basically, but teeth surrounded by bodies. To most undertakers we are incipient corpses; to most actors, parts of a potential audience; to most policemen, possible criminals; to most taxi drivers, fares. "The Ethiopians," wrote Xenophon, "say that their gods are snub-nosed and black-skinned, and the Thracians that theirs are blue-eyed and red-haired. If only oxen and horses had hands and wanted to draw with their hands or to make the works of art that men make, then horses would draw the figures of gods like horses and oxen like oxen, and would make their bodies on models of their own." Spinoza suggested that if triangles had a god it would be a triangle. We make life in the image of our own activities [5].

Despite this institutional background I would like to suggest that the contribution of the SEC to corporate financial reporting has been important. In fact, the primary significance of the SEC's regulation of corporate accounting often tends to be underestimated. Without federal statutory law and the SEC, there would have been no mechanism to ensure the standardization of items in corporate financial reports. A quick comparison between present corporate financial reporting and that before 1934 or in exempt issues after 1934, makes it difficult to doubt the fundamental reform wrought by the federal securities laws and the SEC. In contrast, the role of the SEC in accounting standard-setting has been a less aggressive one. When this role, however, is evaluated with the aid of the efficient market hypothesis, I, again, would urge that the SEC's performance is creditable.

2. The standardization of items to be disclosed in corporate financial reports

The most fundamental contribution the SEC has made to corporate accounting is the standardization of both specific financial statements and textual items in filings with the SEC as well as in documents distributed to present and potential investors [6]. To appreciate the extent of this change, let me contrast financial disclosure practices in the period following the enactment of the securities laws with those existing previously and also with those existing in disclosure-exempt securities up to the present.

In the period immediately preceding the enactment of the 1933 and 1934 Securities Acts, the most controversial securities sold in this country were
foreign government bonds, particularly Latin American bonds. Between 1923 and 1930 American investors purchased close to $6.3 billion of foreign bonds [7], an amount equal to approximately ten percent of new securities sales in the United States during those years [8]. The collapse of the world economy in the late 1920s and early 1930s led to a substantial depreciation in most foreign bonds that had been sold in the United States. In March 1932, Senator Hiram Johnson, for example, calculated that the bonds of sixteen European nations were selling at fifty-seven percent of their par value [9]. The losses in Latin American bonds were far more severe. As of December 31, 1931, the aggregate market value of fourteen Latin American nations’ bonds was twenty-six percent of their par value; Peruvian bonds were selling at approximately seven percent of their par value [10].

Beginning in December 1931, the Senate Finance Committee held hearings on the sale of foreign bonds and securities in the United States [11]. These hearings, in part, focused on disclosure issues. At the request of the Committee, nine leading investment banks supplied record prospectuses or offering circulars employed in selling over 100 foreign government bond issues and approximately forty foreign corporate security issues during the 1920s [12].

Generally, the foreign bond prospectuses were extremely brief, many occupying less than a page in the printed hearings. Typically, they emphasized the selling points of the bond rather than investment risks. One case in point is the statement made in a 1923 Argentine bond issue sponsored by Kuhn, Loeb & Company, namely that “[i]n regard to climate and soil, the country presents the most nearly perfect area the world contains for the production of cereals and for cattle raising” [13].

The foreign bond prospectuses consistently omitted information that obviously would have been material to calculation of investment risk. Of the thirty-seven Latin American government bond prospectuses in the Senate Finance Committee record, none indicated the investment bankers’ gross spread, only four indicated or implied the due date of other loans, only six indicated or implied the annual interest or debt service on other debt, only four indicated whether the government issuing the bond had ever defaulted on a loan, only fifteen of the prospectuses disclosed both the issuing government’s total receipts and expenditures for any recent year, and in no case were receipt and expenditure figures broken down into specific items as they would be on a corporate income statement [14].

Corporate financial disclosure was little better. Passage of the 1933 Securities Act occurred after brief hearings in the House and Senate during the celebrated first hundred days period of Franklin D. Roosevelt’s presidency. Apparently, in reliance on the estimates of state blue sky officials, both the House and Senate reports asserted that investors had lost $25 billion during the previous decade because of what the Senate report termed “incomplete, careless or false representations” [15].
The official legislative history of the Securities Act, however, did not merely contain generalized estimates of investor securities fraud losses. Robert Healy, Chief Counsel of the Federal Trade Commission (FTC), testified before both the House and Senate hearings on the securities bill about specific accounting frauds that the FTC had documented during the first six years of its ongoing study of utility corporations. Healy emphasized that his testimony was meant to be illustrative, and in fact, his illustrations barely hinted at the extent of accounting fraud in the utility industry, which the Summary Report of the FTC's utility corporations study would document in 1935 [16]. Nonetheless, Healy did provide a well-documented example of material misrepresentations in a utility corporation offering circular [17]. He pointed out several instances where utility assets had been written up without a disclosure of their original cost or the basis for the write-up. Healy estimated that through 1933 the FTC investigation had found more than $1 billion of such write-ups and that asset write-ups had been employed by approximately seventy-five percent of the public utility firms studied by the Commission.

While some of these reappraisals of utility property may have been fairly based on then current market or reproduction values, others clearly were not. For example, on several occasions, Electric Bond & Share, then the nation's largest public utility holding company, bought local operating companies, created a local holding company and recorded the value of the operating companies at a figure substantially above cost, without having taken any steps that could possibly have increased the value of the local operating companies [18].

Healy also offered several examples of utility firm fraud in preparing income statements. One illustration involved Insull Utilities Investments, which claimed $12 million income on the sale of certain stock subscription rights which it sold for that amount. The rights, however, had initially cost $16 million and Insull Investments had never recognized the $16 million cost as an expense. Consequently, as Healy testified, "instead of a profit of $12,000,000 there was a loss of $4,000,000" [19].

Much of this and similar evidence of management or investment bank concealment or misrepresentation of material investment information was anecdotal in nature. But independent private studies and well-informed persons in the investment community corroborated the evidence as typical and indicative of common problems in the financial community before 1934, thus underlining the need for a general mandatory corporate disclosure system. One such study was provided by Laurence Sloan, vice-president of Standard Statistics Company. On the basis of 1927 financial reports, he found it possible to compare the gross incomes and net profits of but 235 out of 545 leading industrial firms. In other words, Sloan found that forty-three percent of gross incomes were not reported by fifty-seven percent of these firms. For only 219 of the 545 firms was it possible to obtain data revealing the sums that were
charged to depreciation and depletion in the years 1926 and 1927 [20]. A subsequent study conducted by Sloan based on 1929 reports found that only 323 of 580 leading firms reported gross income; 257 or forty-four percent did not [21].

The Twentieth Century Fund’s much-cited study, *The Security Markets* [22], reached virtually the same conclusion in 1935. The Fund’s study was particularly critical of corporate periodic reports. While noting that the percentage of firms listed on the New York Stock Exchange and that made quarterly shareholder reports had increased substantially between 1923 and 1933 [23], the Fund concluded, “[t]he information contained in such reports is often so meager as to be almost useless to the stockholder. In numerous instances, indeed, instead of disclosing, the report succeeds in concealing the real conditions” [24]. Specifically, the Fund concurred with Sloan’s conclusions concerning corporate failure to publish gross income figures. It reported that “[s]ome corporations group depreciation charges with one or more other items of expense in such manner as to make it utterly impossible for the most experienced analyst to determine even approximately either the amount or the adequacy of such charges” [25]. Balance sheets often failed to distinguish “capital surplus” from “earned surplus,” failed to disclose the method employed in calculating inventory, and failed to itemize other current assets [26]. The Fund particularly condemned the practice of some parent corporations that neither included the records of subsidiary firms in consolidated financial statements nor published separate reports for these subsidiaries [27].

The preceding review of the evidence on which Congress relied in establishing initially the mandatory corporate disclosure system shows that before 1934 business corporations and foreign government bond issues often omitted or misrepresented material investment information. What is most striking in reviewing the historical evidence between 1934 and 1964 (when the number of firms subject to the SEC mandatory disclosure system was substantially increased) is that after 1934 the practices of firms not subject to the SEC’s mandatory disclosure system do not seem to improve.

The most comprehensive SEC investigation of omission of material information by firms exempt in whole or in part from the mandatory disclosure system was made in 1963 as part of the Commission’s *Special Study of Securities Markets* [28]. The *Special Study* surveyed the disclosure practices of 556 randomly selected over-the-counter industrial firms, examining in almost all instances financial statements for 1961 [29]. “Perhaps the most significant finding,” the study reported, “was that more than 25 percent of the issuers responding did not disseminate any financial information to shareholders at all” [30]. An additional thirty-three percent failed to include explanatory notes [31]. This meant that of the 556 over-the-counter firms examined, only about half provided shareholders with financial statements that included explanatory notes. Furthermore, the *Special Study’s* analysis of these firms’ 1961 proxy
materials found that in seventy-three percent of the instances in which proxies were solicited to elect directors, shareholders were not told the names of the nominees [32]. Also, “the remuneration of management was not given in 95 percent of the solicitations for election of directors” [33]. In fact,

[In over 50 percent of the solicitations that related to bylaw or charter amendments, the reasons for the amendment were not stated. Forty-eight involved modifications of securities; in two-thirds of such cases the effects of the modification on the rights of existing security holders were not given. Options, warrants, or rights to be authorized in 25 instances; ... in 21 of the 25, the provisions of the plans were not stated [34].

The most significant aspect of this pattern of non-disclosure to the SEC was its correlation with securities fraud. The Special Study surveyed every case of fraud under either the 1933 or 1934 securities acts that was reported in either a litigation or other SEC release during an eighteen-month period beginning in January 1961. Of 107 proceedings in which the name of the security was mentioned, ninety-nine (ninety-three percent) involved issuers that were not subject to the continuous reporting requirements of the 1934 Securities Exchange Act [35].

Similar deficiencies in disclosure of material information have been exhibited more recently by municipal securities issuers. In the wake of New York City’s near default in 1974–1975, a number of studies were made to determine whether the City’s much criticized accounting practices were exceptional [36]. Considerable evidence suggested that they were not. In 1976, the accounting firm of Coopers & Lybrand published a report entitled “Financial Disclosure Practices of the American Cities” [37]. Among other findings, the report found that eighty percent of the forty-six cities it studied did not disclose in their annual reports the value of their unfunded vested pension liabilities. The Coopers & Lybrand report estimated this liability to exceed $13 billion [38]. Moreover, actuarial studies were made on an annual basis for only fifty percent of the cities studied. In some cases, actuarial studies had never been made [39]. Almost half of the cities (forty-six percent) did not explain what methods of accounting were employed in their financial statements [40]. The report concluded, “our findings indicate a substantial lack of compliance with current generally accepted principles applicable to governmental bodies.” One measure of this lack of compliance cited by Coopers & Lybrand was the Certificates of Conformance awarded by the Municipal Finance Officers Association for compliance with generally accepted accounting principles.

[The organization issues fewer than 40 Certificates of Conformance each year. In fact, only about 400 such certificates have been issued over the last 30 years. Out of approximately 18,000 municipalities eligible to apply, only about 100 applications are even submitted annually for consideration. This points up the hopelessness of voluntary compliance [41].}
The most recent evidence concerning municipal disclosure practices was the publication in 1983 of a study conducted by Arthur Young & Company of the audited financial statements of 557 cities and counties [42]. The study found, among other things, that over one-quarter of all audited statements contained an inadequate accounting or use of an inappropriate basis of valuation of fixed assets [43]. Only in twenty-nine percent of the statements was there an analysis of debt service requirements [44], and some sixteen percent of the surveyed governments did not include a statement of revenues and expenditures [45]. Moreover, revenues and expenses were not uniformly categorized as operating or non-operating [46]. Only about twenty percent of the units surveyed described in footnotes long-term leases held by the government unit [47]. Similarly, only about half of the surveyed governments provided footnotes relating to pension and retirement plans [48]. In all, only fifty-four percent of the opinions rendered by financial auditors concerning these 557 cities and counties were qualified [49].

This evidence persuasively illustrates that without a federal law or government agency mandating minimum standard disclosure requirements, voluntary disclosure practices would be less uniform, more likely to omit information material to investors, and more often employed in securities fraud. This conclusion necessarily invites consideration of two related questions.

First and more important, why is the mandating of accounting and other information necessary? Why doesn't a voluntary disclosure system work as well, or nearly as well? In theory, it can be argued that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to disclose all or virtually all information material to investors voluntarily. These incentives are strongest with respect to new issues. Professor Kripke has written that

[a] disclosure will be supplied voluntarily by issuers interested in the capital markets when there is a consensus among suppliers of capital or other transactors in the capital markets that this information is necessary to them for lending and investment decision, since issuers will supply it because the alternative is to forego access to the capital markets [50].

Voluntary disclosure by issuers of new securities is also likely because of the competition among issuers for investors' funds [51], the likelihood that fuller disclosure will reduce a firm's cost of capital [52], and the ability of some investors to negotiate for information they consider material [53]. As for periodic reporting to shareholders, information from firms will also be forthcoming in theory because financial analysts will be generally more interested in firms that disclose as opposed to those that do not, and analyst interest should result in higher securities prices [54].

Management's reasons for seeking a high market price for their firm's common stock are obvious and presumably powerful. Not only do corporate
Managers frequently receive stock, stock options, or various forms of stock appreciation rights as part of their compensation, but when their shareholders are satisfied, managers are likely to enjoy larger salaries and fringe benefits and will be more secure in their tenure [55]. Also, both with respect to voluntary disclosure at the time of a new issue and period reporting to shareholders, management will additionally seek to disclose material information to avoid liability for securities fraud. Not only will their own self-interest in avoiding fraud liability theoretically prompt disclosure, but the self-interest of other persons who may also be liable (for example, underwriters, attorneys, and accountants) should do so as well [56].

In recent years, several financial theorists have amplified the view that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to disclose voluntarily material information to investors. A much-cited article by Jensen and Meckling [57], for example, argued that the separation of ownership and control characteristics of most large public corporations helped explain “why accounting reports would be provided voluntarily to creditors and stockholders, and why auditors would be engaged by management to testify to the accuracy and correctness of such reports” [58]. Their argument began with the premise that the smaller the fraction of a firm’s equity owned by its managers, the greater will be their temptation “to appropriate larger amounts of the corporate resources in the form of perquisites” [59]. The logical basis of their premise is simple enough. A manager who owned 100% of the firm would directly receive all of its benefits. A manager who owned any lesser percentage would have to share the direct benefits of the firm with other shareholders. There is an obvious temptation for an owner-manager with less than 100% ownership to seek the maximum perquisites or other non-pecuniary benefits. Such benefits, by definition, come at the expense of the direct benefit claims of the other owners.

Since the conflicting interests of corporate managers and outside shareholders are obvious in an equity market characterized by rational expectations, outside shareholders will assume that the value of shares in a firm owned both by insiders and outsiders will be less than the value of those shares had they been held by a single owner-manager. But, Jensen and Meckling argue that an analysis stopping at this point ignores

[the potential for controlling the behavior of the owner-manager through monitoring and other control activities. In practice it is usually possible by expending resources to alter the opportunity the owner-manager has for capturing non-pecuniary benefits. These methods include auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager's interests with those of the outside equity holders... [60].

Usually, both the outside shareholders and the corporate managers will have incentives to enter into a contract that restricts the manager’s consumption of

https://scholarship.law.upenn.edu/jil/vol7/iss3/4
perquisites. Such a contract should cause the value of the firm's shares to increase. Hence, the outside shareholders would find it in their interest to enter into it whenever the increase in the value of the firm exceeds the costs of the monitoring or incentive compensation systems.

Similarly, "[t]he manager finds it in his interest to incur these costs as long as the net increments in his wealth which they generate are more valuable than the perquisites given up" [61]. Since publication of material information would be necessary to ensure that managers are unable to trade for their own accounts at the expense of outside shareholders or exploit various other conflicts of interest, it follows that a standard feature of the monitoring contract between the manager and outside shareholders would be the publication of such data.

Employing signaling theory, Ross [62] has similarly concluded that "in a competitive market (with no mandated disclosure) the managers of firms will have a strong self-interest in disclosing relevant information..." [63]. Like Jensen and Meckling, Ross begins with the premise "that the separation of ownership and control is the central feature of the modern corporation" [64]. Such a separation in Ross's view means that

The economic fortunes of the management depend on those of the corporation. There are many reasons why this should be. The most obvious is that the performance of the company is affected by the actions of the management and serves as a measure of how well the members have performed. Compensation geared to firm performance, therefore, serves as an incentive for managerial performance. Managerial compensation does not have to be tied directly by some specified formula to the earnings or overall performance of the firm. The effect of managerial activities on firm performance will still link the fortunes of the managers with those of the firm: If the firm does poorly, management will be thought to bear some responsibility, and the demand for their services will be less. Conversely, if the firm prospers, management will share some of the credit, and the competitive market will drive their wages up [65].

The compensation of managers, however, will be limited "by the wage level they could receive in competitive jobs. No firm will hire a manager for $1 million a year when the going wage is $100,000" [66]. Thus, Ross, like Jensen and Meckling, assumes that voluntary contracts between managers and outside stockholders will preclude management abuse of material inside information.

Ross's incentive-signaling theory explains how such contracts might operate. Based on his premise, it would be in the interest of managers to disclose good
news. Disclosure will raise the value of the firm and, concomitantly, the manager’s compensation. “What of the [firms] whose news is bad or, alternatively, have no news at all? Just as the managers with good information have an incentive to signal the market to distinguish their firms from others, those with no information also have an incentive to signal” [68]. Firms whose earnings are stable will have incentives to signal “no news” by publishing honest financial reports and maintaining stable dividend levels to avoid being confused with firms with bad news. “Firms with bad news are then left with no recourse. They cannot match the guarantees of the ‘good news’ and the ‘no news’ firms; hence they will be evaluated as having received bad news” [69]. Will some firms then falsely publish good news reports? In Ross’s view, this is less likely than it might seem. To persuade a “wary public” that they are not falsely disseminating good news, managers with genuine “good news” will have to offer guarantees or warranties. For example, a manager might announce that he or she “will take a twenty percent pay reduction if earnings do not rise as ... predict[ed]” [70], or more prosaically, enter into a publicly-known performance-related contract or hire outside auditors. Managers of firms with less good news would be unable to match these guarantees or warranties. Thus, something like the opposite of Gresham’s Law would obtain in theory. As Ross puts it:

In general, there is a hierarchy of firms from best to worst, based on the relative change in their values that would occur if their inside information were made public. The incentive-signaling mechanism provides a structure that managers use to disclose their information in such a way that outsiders in the market believe it. Those with the best news distinguish their firms from those with the next best, and so on down the line. At the bottom of the hierarchy are those with the worst news, who would like to suppress it, but since it is not in their interest to offer the kinds of guarantees provided by those with better news, the worst news will also be effectively signaled [71].

At the very least, signaling theory assumes that managers of firms which have previously disclosed specific data or managers in industries where other firms disclose such data will know that failure to publish the data will be regarded by the market as a signal that the unpublished data are adverse. This would logically create a powerful incentive to disclose. Indeed, in theory, even firms with “bad news” might voluntarily disclose rather than suffer the market’s presumptions that their news was even worse.

These theories concerning management’s incentives to disclose information go a long way towards explaining why firms might voluntarily disclose information material to investors. But, as has been shown, such theories are not sufficiently consistent with available empirical evidence. Among other points, these theories fail to account for the incidence of securities fraud throughout this century or explain why the incidence of securities fraud seems to increase dramatically during certain periods. These theories do not ade-
quately explain why small firms, not subject to the SEC's mandatory corporate disclosure system, seem to have been responsible for a majority of the fraud cases brought by the Commission. Nor do these theories adequately explain why so many firms have employed practices such as "income smoothing" to obscure bad economic news.

Several of the assumptions underlying theories which explain management's incentives to engage in voluntary disclosure of material information seem unrealistic. These theories typically assume that corporate managers will make decisions concerning disclosure while employing a long-term temporal framework. But, as the SEC's 1977 Advisory Committee Report observed:

Very often there are significant motives for at least temporary concealment of adverse information on the part of corporate executives. Often a sizeable part of management's total compensation, such as benefits from stock options or stock bonus plans, depend upon the price level of the company's securities. Frequently, their direct compensation — salary and bonuses — will depend upon the earnings of the company, thereby providing strong motivation to enlarge artificially the company's earnings. In addition, there is often simply the hope that bad news will be temporary and thus need not be disclosed [72].

These theories also assume that corporate decisions concerning disclosure are made purely as a result of such financial considerations as stock market prices and the cost of capital. This assumption seems particularly unrealistic. The reluctance of many business corporations in the pre-1933 period to disclose what is considered today essential balance sheet and income statement data and the more recent reluctance of many firms to disclose line-of-business data or earnings projections has often been explained as fear of revealing useful data to competitors [73]. Such rationalizations highlight a key point. Many firms' disclosure practices, if not subject to mandatory rules, would be the product of both financial considerations and concerns about the firm's competitive position. Because of realistic or unrealistic concerns about the competitive market's response to dissemination of material financial information, some firms would prefer to suffer lower stock market prices or pay higher costs of capital rather than run the risk of inspiring additional or earlier entrants into their product markets. In short, there are fairly obvious theoretical reasons why corporations will not disclose some material information to investors unless compelled by law.

This conclusion effectively introduces a second question concerning a mandatory disclosure system: What data should be covered by the requirement of mandatory disclosure? For securities lawyers, the answer to this question is almost automatic: all material data. A fact is material according to the Supreme Court, "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" [74], or implicitly, in making investment decisions. One way the SEC gives meaning to the notion that all material data should be disclosed is through its detailed delineation of
items to be disclosed in Form 10-K annual reports or new securities issuances.

But the ultimate parameters of what the SEC considers material information are somewhat flexible. The SEC has balanced considerations of cost, ease of obtaining information, issuer exposure to fraud liability and other factors with investors' needs. In the past decade, some of the liveliest debates concerning the mandatory disclosure system have addressed issues such as whether corporate earnings projections should be mandatory or voluntary [75]; the degree of detail that should be required in a segmental or line-of-business disclosure [76]; and the executive compensation arrangements that need to be disclosed [77]. In each of these areas, the SEC made decisions that can be criticized for not going far enough to protect investors. It is important, however, to keep these debates in context. They focus on informational categories of an incremental significance. Disclosure of data in these categories would be in addition to that required by the detailed SEC information list. This list has contracted and expanded over time; it likely will continue to change in the future.

The basic point here is that the SEC does provide a list of the data that must be disclosed. The categorization of these data is consistent in a rough way with the common notion of materiality. Requiring the disclosure of this basic list of material data makes comparisons among financial reports possible. It also reduces the risk of fraud and the likelihood of unfairness to investors through conflicts of interest [78]. This is the SEC’s first and major contribution to the accounting profession.

3. Accounting principles standard-setting

In contrast, the SEC’s contributions to accounting principles standard-setting have been more equivocal. When the 1933 Securities Act was adopted, the then Harvard Law Professor Felix Frankfurter, who supervised its drafting, predicted that the power given to a federal agency to evolve uniform accounting standards would, more than any other part of the law, “have far-reaching beneficial effects on American corporate practices” [79]. Initially, Frankfurter must have been disappointed in the manner in which Joseph Kennedy and James Landis, the SEC’s first two chairmen, exercised this power. Neither one made any significant effort to have the Commission actively engage in accounting principles standard-setting.

Kennedy and Landis viewed accounting reform as subordinate in importance to capital flotation. Following the Commission's November 1934 Northern States Power [80] decision, the SEC permitted, in the words of a 1937 staff study, "financial statements reflecting improper accounting practices to remain unchanged provided such statements were footnoted to set forth the proper procedure which should have been followed together with a statement of the manner in which the accounts would have been altered had they been set up
properly.” Significantly, this somewhat minimalist policy came from a Commission that had been expected by many to promulgate uniform accounting principles.

Landis’s Commission further shackled the SEC’s reform of accounting standards by permitting the broadly worded requirements of Form A-2. Superficially, the Form A-2 stipulation that an accountant was required to certify his or her opinion of “the accounting principles and procedures” employed in a registration statement seemed like a practical limitation on corporate management’s ability to select self-serving accounting principles. However, as the SEC’s November 1937 staff study found, “[t]he Commission has not been disposed to make an issue of accounting practices which are deemed improper by the registration division but which are approved by the independent accountant in his certificate with the registration statement.” Only when “the accountant’s exceptions and the explanatory footnotes were so numerous that the statements were particularly confusing” would the Commission compel a corporation to redo its financial records along lines directed by the Commission [81].

During his term as the third SEC chairman, William Douglas disagreed with the Kennedy–Landis policy of leaving the promulgation of accounting principles almost entirely to the accounting profession. In 1936 and 1937, Douglas and fellow commissioner Robert Healy pressed the SEC to “take the lead in formulating accounting principles as it was empowered to do under the 1933 Act” [82]. Although Douglas directed the Registration Division and the Office of Chief Accountant to prepare studies of existing practices, he was never able to use these studies effectively.

Douglas’s accounting policy was announced in April 1938. In the seven preceding months, his attention had been focused almost entirely on the political implications of the 1937 recession, his struggle with the New York Stock Exchange, the Whitney scandal, lobbying for the Maloney trust indenture and bankruptcy bills, and debates within the Roosevelt Administration on the problems of small business, government-sponsored regional banks, deficit spending, and the Temporary National Economic Committee. By necessity, Douglas could do little more in pursuing accounting reform than associate himself with the approach to accounting principle-setting espoused by Judge Healy.

Douglas recalled in his autobiography that in late December 1937, Healy, an enthusiast for the common law’s method of incremental case-by-case development, spoke also for Douglas when he described “the next step in accounting”:

The staff as the result of instructions has for some time been studying the proposal to issue some rules dealing with accounting and appraisals. We are not thinking of a mass of rules or innovations in accounting. We are trying to express a few standards as to principles
which we believe are accepted by a majority of good accountants, especially those who do not assume the role of special pleaders for their more lucrative clients [83].

This approach proved inadequate. The ideal of comparable corporate financial statements, as distinguished from the common law's ideal of individualized justice, can be effective only if pursued within a comprehensive accounting framework. But SEC Chief Accountant Blough had convinced a majority of the Commission earlier in December that his office lacked sufficient time and staff to do "the extensive research necessary to formulate the correct accounting principles," even in individual accounting controversies [84].

The limited Healy–Douglas policy was never fully effected. A majority of the SEC commissioners (Mathews, Frank, Hanes) opposed Commission formulation of accounting principles. Mathews, long the conservative stalwart of the Commission, later explained, "[o]ne need only recognize that the principles of the science of accounting are in a state of flux and rapid development to be hesitant in wresting guardianship from the hands of the profession" [85].

A compromise was engineered among the five SEC commissioners in late March by which the chief accountant was authorized periodically to issue accounting releases expressing interpretations of accounting standards on major accounting questions "for the purpose of contributing to the development of uniform standards" [86]. One month later, the Commission, with Mathews dissenting, modestly tightened the looseness of the Kennedy–Landis footnote policy with the adoption of Accounting Series Release No. 4, which stated in its entirety:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is not substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant [87].

The ultimate consequence of the Douglas SEC's decision not to attempt the promulgation of uniform accounting principles was to place the burdene on the accounting profession to develop standard-setting institutions. This decision was not inevitable. But it paralleled SEC regulation of the organized stock markets and the over-the-counter stock market. In each of those cases, rule-making was made by private organizations subject to SEC review. The important historical question became: How successfully did the SEC perform this review function?
The most important test of the Commission's accounting review function came during the 1960s conglomerate merger wave. "In absolute terms," an FTC staff report concluded in 1972, "there is no argument [that] the wave of merger activity during the 1960s was the largest in American history." Between 1962 and 1969, twenty-two percent of the companies included on the Fortune 500 list of largest manufacturing corporations were acquired. In 1968 alone, twenty-six of the largest 500 manufacturing firms were absorbed by other firms. In that one year nearly ten percent of all independent manufacturing corporations with $10 million or more in assets ceased to exist independently [88].

Under the then prevailing generally accepted accounting principles, when one firm acquired another, the transaction either could be treated as a purchase or as a pooling transaction. Since it was widely believed that the pooling method might artificially stimulate merger activity, encourage corporations to issue excessive debt or preferred stock securities, or mislead investors, the propriety of employing pooling was the leading accounting controversy of the 1960s. Pooling first became popular in the post-World War II period. In September 1950, the Committee on Accounting Procedure of the American Institute of Accountants, then the industry's accounting principle setting body, felt compelled to limit sharply the use of pooling. Accounting Research Bulletin (ARB) No. 40 emphasized as an attribute of a pooling transaction that "all or substantially all of the equity interests in predecessor corporations continue." Three other factors also were to be considered: similar size of the merging corporations, continuity of management, and similar complementary business activities. ARB No. 40 suggested that pooling was most clearly permissible when similar-sized firms, in the same or related industries, consolidated while generally continuing the equity interests of both firms' common shareholders and the managerial functions of both firms' executives.

Seven years later the American Institute of Accountants' Committee on Accounting Procedures relaxed the limitations imposed by ARB No. 40. In ARB No. 48, the Committee no longer indicated that "the presumption that a pooling of interests is involved would be strengthened if the activities of the businesses to be combined are either similar or complementary" [89]. Nor did ARB No. 48 consider the relative size of the constituent firms to be determinative. Only when one firm was ten or twenty times the size of the other was there a "presumption that the transaction is a purchase rather than a pooling of interests."

Accounting Research Bulletin No. 40 stated that "all or substantially all of the equity interests in predecessor corporations continue." Contrary to this tight standard, ARB No. 48 stated that substantial proportionality of equity interest was a factor to be considered, but "any one factor might have varying degrees of significance in different cases." Similarly, the elimination of one of the constituent firms' management became a not "necessarily determinative" factor of "varying degrees of significance in different cases" [90].
By the early 1960s, it was widely recognized that ARB No. 48 did not impose effective limitations on the use of pooling. The Accounting Research Division of the American Institute of Certified Public Accountants (AICPA) was sufficiently concerned that in March 1960 it hired University of Illinois professor Arthur Wyatt to study the matter. Wyatt's report, *A Critical Study of Accounting for Business Combinations*, published in 1963, concluded that ARB No. 48 had resulted in "the distinctions between those combinations deemed to be purchases and those deemed to be poolings [becoming] less clear than in previous periods." Since Wyatt believed it inappropriate for "the effect on earnings per share which will flow from the accounting for business combinations [to] influence the accounting for business combinations," he recommended the abolition of pooling whenever a business combination involved an exchange of assets or equities between independent parties [91].

The AICPA did not concur. Maurice Moonitz, the institute's director of accounting research, agreed with Wyatt that "the general conclusion is unavoidable that accounting for business combinations has deteriorated in recent years so that a variety of practices can be described as 'accepted.'" But, speaking for a committee of the AICPA's new standard setting body, the Accounting Principles Board, Moonitz reported disagreement with Wyatt's view that pooling should be discontinued: "[T]he Committee feels that the distinction between poolings and purchases should be continued, but with such modifications as are necessary in the criteria relating to the two forms of business combinations to make the distinction rest on differences of substance and not of form" [92]. The APB, however, did not initially make these modifications. The next official word on the subject came in 1966 when the APB gave its opinion on how financial statements should be restated when pooling occurred. It mentioned in a footnote that Wyatt's *Critical Study of Accounting for Business Combinations* has been published, and another research study on accounting for goodwill is in process. The Board plans to reconsider the entire subject of accounting for business combinations after the latter study is published" [93].

Two years later, the AICPA's study of goodwill "reached," in the words of its authors, George Catlett and Norman Olson of Arthur Andersen and Company, "the same conclusion [as Wyatt's]: pooling should not be permitted in most business combinations [94]. By then, the purchase versus pooling controversy had become a cause célébre in the accounting and financial literature [95]. Academic and practitioner fulminations against "dirty pooling" or "pooling-fooling," as the accounting gadfly Abraham Briloff memorably dubbed it [96], had become so widespread that even news magazines like *Time* and *Newsweek* joined the denunciations of "Profits without Honor" [97]. In 1969, an FTC staff report on corporate mergers branded pooling a "tool of deception" and made the recommendation that "the Securities and Exchange Commission immediately require pooling of interests
to be eliminated as the normal mode of accounting for acquisitions involving
the exchange of stock" [98]. In an article surveying accounting developments
during the 1960s, corporate attorney A.A. Sommer, soon to be named an SEC
commissioner by President Nixon, castigated the Accounting Principles Board
for five years of foot-dragging on the pooling versus purchase controversy after
the publication of Wyatt's study. "During that five-year period," Sommer
noted, "billions of dollars of economic activity was accounted for in a manner
that almost literally everyone knew was an inadequate and sometimes down-
right misleading method of dealing with the transactions" [99].

Throughout the entire two-decade period during which the pooling versus
purchase controversy divided the accounting profession, the SEC could have
resolved the controversy at any time by issuing a rule prohibiting or limiting
the use of pooling. A review of the relevant memoranda on file with the SEC's
Office of Chief Accountant makes plain that this option was never seriously
considered by the Commission.

The SEC's Chief Accountant, Andrew Barr, preferred to leave the
promulgation of accounting standards to the accounting profession, usually
limiting the SEC's role in the setting of accounting standards to that of making
recommendations to the Accounting Principles Board (APB). Even when Barr
disagreed with an action of the Board, he generally did not urge the SEC to
employ its statutory powers to reverse the APB [100].

Within the SEC, Barr defended this deferential approach as necessary to
avoid another incident like that occasioned by APB Opinion No. 2. In
December 1962, the APB issued, without prior consultation with the SEC, an
opinion dealing with the "investment credit," which had been enacted into law
in October of that year. Four of the "Big Eight" accounting firms favored
recognizing the credit in the year eligible assets had been acquired, the
so-called flow-through method. The other four "Big Eight" firms favored
recognizing the credit over the life of the asset, the so-called deferral method.
By a two-thirds vote, the APB issued an opinion calling for the deferral
method. Barr later wrote, "I supported the Board position, believing it to be
sound and that this was an opportunity to support one solution to a new
accounting problem." After being importuned by the Treasury Department,
business firms and accountants opposed to the APB opinion, the SEC reversed
the APB in January 1963 with an Accounting Series Release (ASR) that
permitted use of either the flow-through or deferral method of accounting for
the investment credit [101]. In the view of AICPA vice president (and house
historian) John Carey, "[t]he prestige and authority of the Accounting Princi-
pies Board had been badly damaged in its first effort to advance the cause of
comparability." Still, throughout the pooling versus purchase controversy, Barr
frequently characterized his role as helping to "effect a compromise that would
be acceptable to all interested parties" and thus eliminate the need for SEC
intervention [102].
Barr was deeply influenced by a second consideration during the pooling controversy. Through 1970, few accounting concepts had been more fervently championed by the SEC than its opposition to the writing-up of assets above their original costs. Unjustified asset write-ups had been the most conspicuous accounting abuse of the public utility holding companies. Preventing similar write-ups had been historically among the paramount considerations in SEC accounting policy. In many circumstances, Andrew Barr favored the pooling method of merger accounting for cases where one firm used stock to acquire a second firm because pooling avoided the writing-up of assets that might occur if the purchase method were employed [103].

At the same time, Barr was well aware that the case-by-case application of ARB No. 48 had led to a "serious erosion" of standards. As early as January 1962, Barr delivered an address illustrating that the presumption in Accounting Research Bulletin No. 48, namely, that a merger should be accounted for as a purchase rather than a pooling transaction whenever one firm was more than ten or twenty times the size of the other had already been "nickled and dimed away," as his successor John Burton would subsequently state [104]. After studying 153 recent mergers recorded as pooling transactions, Barr found that the owners of the acquired unit in sixty-three cases (forty-one percent) held less than five percent of the voting stock after the combination. In 102 of the 153 mergers (sixty-seven percent), the owners held less than ten percent. Yet the SEC's first direct public response [105] to the principle-setting controversy did not come until June 1968, when the Commission issued Securities Act Release (SAR) No. 4910 [106]. It warned that when merged firms employed the pooling method but compared the pooled earnings of the consolidated firms with the unpooled results of earlier years, the publication of "substantial percentage increases in sales, net income, and earnings per share obtained by such comparisons are misleading ... comparisons in such cases should be made with financial data for the prior period restated on a combined [pooled] basis" [107].

The SEC's June 1968 release was recognized within the Commission as a small first step toward resolving the pooling versus purchase controversy. Later in 1968, Barr wrote a latter to the APB outlining what the SEC suggested were "acceptable criteria for pooling-of-interest accounting":

The acquiring company should issue only unissued common shares or convertible preferred stock which is a common stock equivalent at issuance and has voting rights equal to those of the common stock into which it is convertible in exchange for the common shares or net assets of the company being acquired. Other types of securities, such as convertible debt and warrants, should not be used in a pooling transaction.

The combination should be between viable corporate businesses and there should be a plan for continued operation of the businesses. The combination should be a tax-free reorganization.
As a practical matter, there should be a substantial size test with a minimum disparity of two to one between the combining enterprises [108].

Even with an SEC Chairman characterizing the pooling versus purchase controversy as "urgent" [109] and the SEC's Chief Accountant being able to describe a rule that would have resolved the controversy, the SEC did not act effectively. This was, in part, the consequence of the replacement of Manuel Cohen, the then SEC Chairman, with Nixon's first appointee, Hamer Budge, early in 1969. In testimony prepared for Cohen to deliver in February 1969, he had intended to state that if the APB did not "promptly" solve the pooling problem, "the urgency of the situation may dictate rule-making by the Commission." But before Cohen could deliver this testimony, President Nixon accepted his resignation. Hamer Budge delivered the statement prepared for Cohen, but did not act on it [110].

Approximately one year later, Budge testified to the Senate's Subcommittee on Antitrust and Monopoly that the APB would soon circulate a proposed draft of an opinion on business combinations. The opinion would include "very severe restrictions" encouraged by the SEC [111]. Budge described some of these "restrictions" which bore a marked resemblance to Barr's suggestions to the APB in the fall of 1968. Notably, pooling was to be permitted only if the size ratio of the combining companies would be at least three to one [112]. Within three months, however, Budge made plain that the SEC had no intention of imposing such "very severe restrictions" on the APB. Responding to the lobbying efforts being waged by the Financial Executives Institute and others in opposition to the APB draft opinion, which the SEC had helped design, Budge informed the House Antitrust Subcommittee on May 14, 1970:

We are aware that there are strong objections to parts of this proposed opinion and that there is not unanimity of opinion on the proper recording of business combinations. The principal objections have been forcefully presented to the business world in releases of the Financial Executives Institute. This organization at first supported a 9-to-1 size test instead of the 3-to-1 test in the APB proposal but later reconsidered and it now takes the position that no size test should be imposed. The FEI also opposes mandatory amortization of intangibles. These views and those of all other interested parties must be considered. All concerned, I am sure, believe this to be one of the most important accounting problems today demanding a prompt solution, but it will be difficult to reach agreement on a definitive opinion [113].

The following month, Budge repeated these remarks in an address to the American Society of Corporation Secretaries, adding that "some revisions may be made" [114]. With the SEC thus refusing to impose the standards its own Chief Accountant had earlier suggested were appropriate, including the pivotal size test, the way was clear for the internally divided APB, in August 1970, to release Opinion No. 16 [115], eliminating any size test and merely requiring that the combining companies be autonomous, employ voting common stock to effect the transaction, and for two years after the merger not plan to dispose
of a significant part of the assets of the new combined firm. Although the SEC did secure from the Board, in an accompanying APB Opinion No. 17 [116] on intangible assets, a rule requiring that goodwill be written off over a period not exceeding forty years, there seems to be no plausible basis for believing that a Commission less reluctant to deal with accounting standards could not have issued at least as restrictive a rule several years earlier.

In retrospect, there are two general types of reaction one can have to the SEC's performance during the pooling versus purchase transaction controversy. On the one hand, aided by the efficient market hypothesis, it is possible to conclude that the controversy was far less significant than it appeared to many at the time. Two subsequently published economic studies concluded that investors, in fact, were not deceived by the pooling accounting technique. While these studies do suggest that the “rhetoric” of those who opposed pooling was overheated, they do not fully resolve the pooling controversy. It is difficult to believe that pooling did not contribute to artificial price run-ups in at least some instances. It also is difficult to believe that the rapid price run-ups and declines of LTV, Litton, and other corporations did not persuade some investors to quit the market. These investors might have remained in a market characterized by less extreme price oscillations. Finally, it is difficult to believe that the opportunity to engage in pooling accounting did not motivate some business executives to engage in excessive debt leveraging. Nonetheless, these studies do persuasively suggest that the risks to investors of alternative accounting principles are reduced when the method of accounting is clearly disclosed [117].

On the other hand, if one attributes any significance to the controversy, it is difficult to avoid the conclusion that the SEC was unduly passive in responding to the difficulties the accounting profession had in promulgating new standards. This was the primary SEC reaction to the controversy. Formally, the SEC fully supported the accounting profession’s establishment of the Financial Accounting Standards Board (FASB), never even suggesting that the Commission should directly promulgate accounting standards [118]. At the same time, the SEC took steps to improve its supervision of the Board’s standard-setting. More than any earlier SEC Chairman, William Casey emphasized the importance of accounting principles standard-setting [119].

Casey's most significant step toward improving SEC oversight of private accounting principles standard-setting was to hire Columbia Business School professor John Burton as the SEC's Chief Accountant following Andrew Barr’s retirement in 1972. Burton believed the SEC should be a “creative irritant” in the accounting principles standard-setting process, like “the sand in the oyster.” In retrospect, Burton would state: “In the financial reporting environment as it exists today, substantial change will not occur in the absence of SEC stimulation. If there is to be innovation, the Securities and Exchange Commission must be a principal source” [120].

https://scholarship.law.upenn.edu/jil/vol7/iss3/4
It now is clear that Burton's tenure as SEC Chief Accountant was the period during which the SEC most self-consciously attempted to perform an innovative role in accounting standard-setting. I do not believe it has performed this role with the same spirit since Burton left the Commission. I also believe that when one reviews the performance of the FASB in developing an adequate conceptual framework for accounting standard setting, there are disturbing parallels to the APB's earlier indecision on the same matter. Arguably, the SEC should perform a more aggressive and, perhaps, more public role in helping the accounting profession perform its standard-setting chores in an expeditious manner.

It is noteworthy, however, that several of the most important innovations of the Burton period, including supplemental replacement cost disclosure, approached standard-setting by employing the SEC's traditional technique of full disclosure. This technique, obviously, is consistent with the efficient market hypothesis. Primarily for the institutional reasons earlier emphasized, I am skeptical that the SEC can often be an effective court of last resort in standard-setting controversies. Still, a defensible second-best approach to standard-setting controversies is one which insists on disclosure of data that enables users of financial statements to effectively compare reports which employ different alternative accounting principles. To the extent that the SEC has performed an important role in making available, in notes to accounting statements and elsewhere, data that so aid the users of financial statements, I would argue that the Commission has recently performed a creditable role in accounting standard-setting.

Notes

[2] See, e.g., Securities Act: Hearings on S.875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 215-20 (1933) (testimony by R. Healy) [hereinafter cited as 1933 Senate Hearings]. Healy believed that assets should always be carried on balance sheets at cost, id. at 218, a position that is open to reasonable dispute. The basic point of the Healy testimony on the securities bill, however, was somewhat different. He testified before the Senate Hearings that "I have demonstrated, and if I have not I can, that a mere balance sheet without supporting statements is useless." Id. at 220. What made the write-ups of the utility corporations objectionable was not merely that assets were written up above cost, but that the utility firms consistently failed to disclose original cost or the basis of the write-up in the notes accompanying their financial statements.

[5] Id., at 295–96. Frank was fond of a quotation by Elbert Hubbard characterizing "the typical accountant" as:

A man past middle age, spare, wrinkled, intelligent, cold, passive, non-committal, with eyes like a codfish, polite in contact, but at the same time unresponsive, cold, calm and
damnably composed as a concrete post or a plaster of paris cast; a human petrification with a heart of feldspar and without charm of the friendly, minus bowels, passion or a sense of humor. Happily they never reproduce and all of them finally go to hell.


[10] Id. at 6057.


[12] The nine firms were: Kühn, Loeb & Company (whose prospectuses and circulars appear in Foreign Bond Hearings, supra note 11, at 184–89, 294–98); National City Company (whose prospectuses and circulars appear in id. at 163–83); Dillon, Read & Company (id. at 463–64, 480–89); Speyer and Company (id. at 1140–56); J&W Seligman & Co. (id. at 1327–55); Lee, Higginson & Co. (id. at 1503–53); and Chase National Bank (id. at 2039–43). Several of the Kühn, Loeb prospectuses were co-managed by J.P. Morgan & Co. Other prospectuses were placed in the hearings record, id. at 527–604 by Chemical Foundation, a trade association critical of financing foreign chemical production.

[13] Id. at 226.

[14] The findings in the text were based on the examination of three Argentine prospectuses, id. at 225–30, 1151–52; seven Brazilian prospectuses, id. at 463–64, 649–51, 655–56, 686–87, 704–06, 720–22, 1328–29; seven Chilean prospectuses, id. at 231–43, 1142–47; seven Colombian prospectuses, id. at 1018–24, 1147–55, 1511–16, 1533–34, 1537–40; one Costa Rican prospectus, id. at 1519–23 (the identical prospectus also appears id. at 1534–36); five Cuban prospectuses, id. at 279, 280–84, 2039–43; one Dominican Republican prospectus, id. at 716–20; four Peruvian prospectuses, id. at 1523–26, 1529–32, 1545–53; and two Uruguayan prospectuses, id. at 1140–41, 1155–57. Twenty-seven of these prospectuses were issued by foreign states and twelve by cities or departments of foreign states. Two of the twelve securities issues by cities or departments were guaranteed by a foreign state. See id. at 1531, 1328. In those two instances, the computations in the text were based on disclosure of data either by the locality or by the state. Thus, if either the locality or the state disclosed receipts and expenditures for any year, that would be tabulated as a finding of disclosure. Ten cities or departments issued securities not guaranteed by foreign states. In these instances, tabulations were based on disclosures by the issuing locality.


[17] 1933 Senate Hearings, supra note 2, at 211–12.

[18] Id. at 215–20.

[19] Id. at 220–21. Healy’s testimony was considerably amplified by the FTC Summary Report on Utility Corporations, supra note 16. See, e.g., id. at 282–304 and 845–48 (detailed discussion of write-ups).

The report also documented other utility corporation fraudulent practices, such as holding companies recording as income the undistributed earnings of subsidiaries, id., at 468–73, and an industry-wide pattern of misleading practices in recording depreciation. Id. at 496–512.


[29] To select this sample, the Study Group examined the January 1962 National Quotations Bureau monthly summary of over-the-counter firms. At that time, this summary was considered the most comprehensive list of firms traded in the over-the-counter market. The January 1962 summary listed 13,335 issuers in whose securities the broker-dealer community had shown interest during the last three months of 1961. The Special Study then selected every fifth issuer or a group of 2,667 issuers. Of this total, 427 domestic listed, and 275 foreign securities were then withdrawn for unexplained reasons. The Special Study then distributed questionnaires to the remaining 1,965 issuers. Id. at 18–19, pt. 3. Half of these 1,965 issuers were asked to submit copies of all financial reports submitted to shareholders in the year 1961. Id. at 11. In all, 771 issuers responded with a completed questionnaire and either submitted the requested financial report or indicated that they had sent no material to shareholders.

[30] Id. at 11.

[31] Id. at 12.

[32] Id. at 13.

[33] Id. at 14.

[34] Id.

[35] Id. at 10.

[36] See generally Staff of House Comm. on Banking, Finance, and Urban Affairs, Subcomm. on Economic Stabilization, 95th Cong., 1st Sess., Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (Comm. Print 1977). In 1974–75, it was highly unlikely that New York City would have been able to sell $4 billion of debt securities with the same interest rate and terms that it had not materially distorted its financial position. Id. at 112–39, ch. 3; 36–39, 74, ch. 4; and 2–6, ch. 7. Systematically, the City overstated its revenue. For example, in October 1976, it was estimated that $963 million of the City's $5.078 billion deficit was attributable to accrued federal and state aid that was not collectable. Ch. 2, 18–26. Another $358
million in City taxes was recognized as income although not received in cash and subsequently written-off as uncollectable. *Id.* at 9–17, ch. 2. Similarly, it was estimated that over eighty percent of $502 million in real estate taxes listed by the City as receivable were not collectable. *Id.* at 27–34, ch. 2. At the same time, New York City systematically understated its expenses and liabilities. One major misrepresentation involved the failure to recognize municipal employee pension expense for a period of two years after the expense was incurred. This two-year lag alone was responsible for understating the City's 1975 cumulative deficit by some $2.167 billion. *Id.* at 37, 49–61, ch. 2. The City also delayed recognizing expenses which, by June 30, 1975, totalled $365 million by employing, among other contrivances, the charging of June payroll expenses for June, the last month of the City's fiscal year, to July, the first month of the next fiscal year, and employment of a 364 day year. *Id.* at 37, 40–45, ch. 2. In addition, the City charged to its capital budget, used to fund projects such as streets, parks, bridges, tunnels, and other property of a long-term nature, some $722 million in expenses in 1975, and a total of $2.434 billion for the 11 years, 1965–75. *Id.* at 66–70, ch. 2.

[38] *Id.* at 26–7.
[40] *Id.* at 33.
[41] *Id.* at 37. Other studies of Municipal Accounting made at that time reached similar results. See Peterson, Doty, Forbes & Bourque, *Searching For Standards: Disclosure in the Municipal Securities Markets*, 1976 Duke L.J. 1177; *Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 84th Cong., 2d Sess. 1–2 (1976) (testimony of Mr. Lennox Moak, Vice President of the Municipal Finance Officers Association); Note, *Federal Regulation of Municipal Securities; Disclosure Requirements and Dual Sovereignty*, 86 Yale L.J. 919, 925–26, n. 25 (1975 Arthur Andersen report); N.Y. Times, June 4, 1979, at D9 (studies by Ernst & Ernst and Touche, Ross & Company).
[43] *Id.* at 17.
[44] *Id.* at 29.
[45] *Id.* at 52–55.
[46] *Id.* at 67.
[47] *Id.* at 154.
[48] *Id.*
[49] *Id.* at 142. The reasons for qualifications varied. See *id.* at 145.
[58] *Id.* at 306.
[59] *Id.* at 313.
[60] *Id.* at 323.
[61] Id. at 326.
[63] Id. at 184–85.
[64] Id. at 183.
[65] Id. at 183–84.
[66] Id. at 184.
[67] Id.
[68] Id. at 186.
[69] Id. at 187.
[70] Id. at 185.
[71] Id. at 187.
[73] Id. at xxi; Foster, Externalities and Financial Reporting, 35 J. Fin. 521 (1980).
[76] Id. at 432–37.
[78] See discussion in Seligman, supra note 6.
[79] Transformation, supra note 3, at 71 (quoting Frankfurter). Much of the material in section 3 of this article is derived from Transformation, supra note 3, at 197–201, 416–30 and 551–7.
[80] See Transformation, id. at 117.
[84] See Douglas, supra note 82, at 275.
[91] Wyatt, supra note 90.
[92] Id. at xi–xxx (Moonitz preface).
[94] Catlett & Olson, Accounting for Goodwill 105 (1968).
[105] In 1966 and again in 1969, the SEC encouraged the APB to adopt Opinions Nos. 9 and 15, requiring that certain convertible securities substantially equivalent to common stock be taken into account in calculating earnings per share. These opinions dealt with a tangential aspect of the pooling versus purchase controversy.
[107] Id.
[112] Id.
[114] Address of Hamer Budge (June 12, 1970) (on file with the SEC).
[117] Lorie & Halpern, Conglomerates: The Rhetoric and the Evidence, 13 J. Law & Econ. 149 (1970); see also Hong, Kaplan & Mandelker, Pooling vs. Purchase; the Effects of Accounting for Mergers on Stock Prices, 53 Acct. Rev. 31 (1978).