

**FINANCIAL STATEMENTS UNDER THE  
SECURITIES ACT  
AND THE  
SECURITIES EXCHANGE ACT**

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Report Submitted to the  
**SECURITIES AND EXCHANGE COMMISSION**  
by a Joint Committee representing

**The American Institute of Accountants**

AND

**The American Society of Certified  
Public Accountants**

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August 3, 1934

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JOSEPH P. KENNEDY, *Chairman*,  
ROBERT E. HEALY,  
JAMES M. LANDIS,  
GEORGE C. MATHEWS,  
FERDINAND PECORA.

SECURITIES AND EXCHANGE COMMISSION,  
WASHINGTON, D. C.

GENTLEMEN:

In accordance with your request at a meeting on July 19th, we, the undersigned, were appointed a committee representing the two national bodies of independent public accountants, the American Institute of Accountants and the American Society of Certified Public Accountants. This committee has given attention to those features of the Securities Exchange Act of 1934 and the Securities Act of 1933, as amended, which particularly affect the preparation and use of financial statements. We now have the honor to submit the report which accompanies this letter.

You requested that our report be presented to you as soon as possible after the meeting of July 19th; consequently the report is sent you without awaiting formal approval by the governing bodies of our profession. The suggestions are, therefore, those of this committee, based on the experience of its members with financial statements for registration under the Securities Act of 1933, for listing applications for various exchanges and for annual reports of corporations.

The purpose of the financial statements required by the Acts is to help the investor, and we believe that

this can best be accomplished by demanding only material information and permitting flexibility in the form and content of financial statements.

We see no reason why, with slight variations, the same type of financial reports should not serve for listing, for registration and prospectuses under the Securities Act and for annual reports. This would, however, be impossible if the Commission should ask for anything like the amount of information now required for registration under the Securities Act. It would be impracticable for corporations of large size to furnish such information promptly. Furthermore, if companies are compelled by regulation to force on an investor a mass of statistics which he can not understand we believe that the purposes of the Acts may be defeated.

We, therefore, strongly recommend that, so far as financial reports under the Securities Exchange Act are concerned, the instructions call only for balance-sheets and statements of income, of surplus and of reserves, prepared in the form and detail which the management and the independent accountants believe fairly present the financial condition and operating results of the corporation. These financial reports should be accompanied by a concise statement by the corporation as to the major accounting principles and practices followed during the period under review and any changes in such principles and practices since the preceding year.

We also recommend that similar requirements govern the preparation of financial information under the Securities Act and that at the same time the instructions already issued under that Act be modified accordingly.

Whether the policies adopted by the Commission shall be in accord with our recommendations or not, we trust that we shall have an opportunity to co-operate with you in drafting rules and regulations and in any other ways in which our profession can be of service.

We request that this report be received as merely the first step in the co-operative assistance we desire to render to the Commission in its administration of the Acts.

Respectfully submitted,

SAMUEL J. BROAD,  
JAMES F. HUGHES,  
JOSEPH J. KLEIN,  
PAUL K. KNIGHT,  
PHILIP N. MILLER,  
RODNEY F. STARKEY,  
ANDREW STEWART,  
HOMER N. SWEET,  
C. OLIVER WELLINGTON,  
*Chairman.*

**REPORT**  
of  
**COMMITTEE OF ACCOUNTANTS**

The Securities Exchange Act of 1934 requires that, for the protection of investors, each corporation desiring the privilege of listing on a national securities exchange shall furnish, at the outset, financial statements and other information regarding its affairs and that, thereafter, it shall file such annual and quarterly reports as the Commission may prescribe. In addition, should a corporation desire to offer a new issue of securities it is required under the Securities Act of 1933 (except for the exemptions under the Act) to file at that time financial statements and other information required by the Act.

In considering what recommendations we should make to the Commission to carry out the purposes of these Acts so far as financial statements are concerned, we have endeavored to keep in mind the rights of the investor, the duties of the issuer and the responsibilities of the Commission. This has involved consideration of the scope of the information that would be of value to an investor, as well as the practicability of furnishing such information. The results of these deliberations are condensed in the pages which follow, in

which, for convenience, the subject matter is classified under the following headings:

Scope of Information  
Uniformity of Accounting Practices and Forms  
Requirements for Financial Statements  
Education of Investors  
Quarterly Reports  
Natural Business Years  
Summary of Recommendations

**Scope of Information**

We recommend that financial statements required by the Acts, in order that they may be best adapted for presentation to investors,

- (1) Contain such information as is necessary fairly to present, in accordance with accepted accounting principles, the financial condition and operating results.
- (2) Exclude unnecessary matters and details which tend to obscure the important facts.

To accomplish these objectives, flexibility in the form and content of the statements must be permitted. The substance, not the form, is important. Rigid regulations which attempt to cover all cases tend to stress the form and sacrifice substance and inevitably result in an excess of detail. The liabilities under the Acts and the powers of the Commission, rather than elaborate regulations, should be the means of procuring adequate disclosure. We believe that it is possible to

formulate simple regulations which will meet the specific requirements of the Acts and will not impose an unreasonable burden upon reporting companies.

Historical information, a great deal of which is required under the present instructions for administration of the Securities Act, is extremely burdensome to prepare and in the majority of cases is of no value to investors. We urge that the extent to which historical information shall be included be left to the discretion of the management and the independent accountants.

Apart from the volume of the information required, it is of importance that the financial statements be presented in simple form. So far as possible, in all significant matters they should be complete in themselves without reference to supplemental schedules.

#### **Uniformity of Accounting Practices and Forms**

The members of the Commission asked our opinion on the desirability and practicability of bringing about uniformity in accounting practices, either for industry as a whole or for particular branches of industry. We feel that the importance of uniformity has been greatly over-emphasized. It may be more misleading than informative.

Any attempt at uniformity should be limited to a few general principles so broadly stated that they will permit wide variations in application to meet different conditions. Certain general principles of accounting are now commonly accepted, but such principles are flexible and must frequently be modified in practice. The management and the independent accountants

should be free to apply principles in the manner best adapted to the conditions prevailing, so that the statements shall not be misleading. We recommend that the Commission postpone formulation of any principles until it shall have had opportunity to study the financial statements and accompanying declarations of accounting principles and practices which we are recommending be filed by reporting corporations.

On the other hand, the application of consistent practice to the accounts of a corporation in successive years is of prime importance. We recommend that the practice of each corporation be disclosed and any change in practice from preceding years be clearly stated. This is most important in the case of income statements, because investors generally estimate the value of an investment by using a multiple of the earnings. In making such estimate, they should be informed as to the earnings and charges which are of an extraordinary nature. A proper classification of earnings and a similar classification in successive years are, therefore, necessary.

We recommend that the Commission do not attempt to adopt any standardized forms of financial statements. Such forms will force corporations to fit their statements into a prescribed mould, although the presentation of their statements in this manner may not be truly informative. Rigidity of form may well defeat its own purpose by placing undue stress on items which may be immaterial for a particular company, while minimizing other items which, in the peculiar circumstances, may be relatively important.

### **Requirements for Financial Statements**

We recommend that the financial statements required should consist of (a) a balance-sheet in comparative form; (b) an income statement in comparative form; (c) a surplus statement; (d) a statement of changes in reserves; (e) a concise statement by the corporation as to the major accounting principles and practices followed during the period under review and any changes in such principles and practices since the preceding year; (f) similar statements for subsidiaries or consolidated statements, whichever will more clearly set forth the essential facts.

As previously stated, we recommend that no set forms be prescribed but that statements be accepted in the form and detail which, in the opinion of the management and the independent accountants, fairly present the financial condition and operating results of the corporation. We further recommend that neither rigid instructions nor questionnaires be issued, but that the Commission adopt general regulations as guiding principles for the preparation of financial statements. We recommend that such general regulations be substantially as follows:

- (a) That the balance-sheets be prepared to present as clearly as practicable:
  1. The basis on which the principal assets on the balance-sheet are stated.
  2. A reasonable classification and adequate description of the substantial items of the balance-sheet, so as to display significant facts.

- (b) That the income statement show a reasonable classification of the source of income and the nature of expenses; that operating income be distinguished from non-operating income; and that substantial extraordinary income or charges, whether of a recurring or non-recurring nature, be disclosed and described.
- (c) That the surplus statement and the analysis of changes in reserves show suitable segregation according to the classes of the surplus or reserves and the character of the respective charges and credits, not including either analysis or segregation of surplus or reserves prior to the period covered by the financial statements.

The regulations under the Securities Act of 1933 should be modified so that the requirements may be the same as those outlined, with the addition of such other information as is specifically required by Schedule A of the Act.

### **Education of Investors**

We believe that, by adding force and authority to efforts already made by accountants, the Commission can render valuable service to the public by helping investors to understand the significance of financial statements.

Investors relying upon financial statements should know that such statements reflect a combination of personal judgments, accounting conventions and recorded facts. Judgments and conventions have an

important effect on the construction and presentation of financial statements. The soundness of the judgments necessarily depends on the competence and integrity of those who make them. One of the important accounting conventions is that the balance-sheet of a going concern shall be prepared on the assumption that the concern will continue in business. Plant assets, permanent investments and intangibles are usually stated at cost or on some other historical basis without regard to realizable or replacement value. Assets such as inventories and accounts receivable are commonly stated at their estimated value in the ordinary course of the continuing business, which is usually greater than the realizable value in forced liquidation. Cash and readily marketable securities are customarily stated at values which do not depend upon continuance of the business. In sharp contrast are the nominal assets, such as unamortized discount and other deferred charges, the value of which would almost entirely disappear if the concern were to go out of business.

The investor should also understand that reports of earnings of industrial enterprises for a single year or shorter periods are of limited significance because they may be disproportionately affected by transitory influences. Fair conclusions as to past earning power can not be drawn without comparison of the profits over a period of years.

Finally, the investor when considering the record of earnings and the latest balance-sheet should remember that the future value of his investment depends in large measure on factors which can not be shown in financial

statements. Among these factors are the ability of the management and the effect of changes in technical processes, shifting markets, tariffs and taxation on the plant, product and sales of the corporation. Any one of these human or physical or economic factors may throw the concern into difficulties or materially alter its financial condition and earning capacity.

#### **Quarterly Reports**

As requested at the meeting of July 19th, we submit the following comments on the subject of quarterly reports:

In some cases, quarterly statements may be helpful; in others, such statements, if unaccompanied by detailed explanations, may be more apt to mislead. In most industries quarterly reports are, at best, estimates of progress for the period. Generally earnings do not accrue evenly throughout the fiscal year, because of such factors as large orders or seasonal variations, and it is impracticable for the management, in reporting the quarterly earnings, to determine with reasonable accuracy the effect of such factors. In many cases inventories, reserves, valuations and other essential facts are not finally determined until the end of the fiscal year.

If the Commission should decide to require quarterly financial reports, these reports should be limited to income statements; they should be in condensed and comparative form and should be made available with reasonable promptness. Estimates should be allowed, and, if they have been used, that fact should be stated. The corporation should be given the option of preparing

the quarterly report to cover the individual quarter or the twelve months terminating at the end of the quarter or the period from the beginning of the current fiscal year to the end of the current quarter. Corporations which employ the thirteen-period year should be permitted to render such comparable reports as are obtainable from their records.

#### **Natural Business Years.**

Most corporations have fiscal years coincident with the calendar year. This has the effect of concentrating the preparation and issuance of annual reports within a relatively short period. Adherence to the calendar year is largely a matter of custom, and there are positive advantages in the adoption of the natural business year as the fiscal year. Reports based on the natural fiscal year permit a more accurate determination of earnings; they show more clearly the trend of operating results, and they are, therefore, more informative to investors. Such reports are frequently more economical for the corporation, because, at the end of the natural business year, the cost of taking inventory is lower and the business of the corporation normally is less active. Such reports spread over the year the work of accounting firms and credit and statistical organizations and they will also simplify the administrative problems of the Commission.

In many cases comparisons between corporations engaged in the same industry would be more valuable to investors if the annual reports of such corporations were based on the natural business year of the industry.

We therefore recommend that the Commission encourage all corporations to adopt their natural business years as fiscal years.

#### **Summary of Recommendations.**

The recommendations contained in this report may be summarized as follows:

1. The financial information required should be limited to that which will be of substantial value to investors.
2. Uniformity of major accounting principles in a particular industry is desirable as an ultimate objective, though uniformity in their application may be undesirable. For the present, corporations should be required merely to indicate the principles which are followed.
3. No standardized forms of financial statements should be prescribed. Statements in the form and detail best adapted to the particular conditions should be accepted.
4. There should be co-ordination of the requirements relative to financial statements for:
  - (a) Listing on a national securities exchange;
  - (b) Registration statements and prospectuses under the Securities Act of 1933;
  - (c) Annual reports.

This would entail substantial modification of the present regulations under the Securities Act.

5. The Commission should endeavor to advise investors as to limitations of financial statements as guides to the value of investments.
6. If the Commission should decide to require quarterly reports, these reports should consist only of income statements; they should be issued promptly; they should be in condensed and comparative form; and they may be based on estimates if necessary.
7. The Commission should encourage corporations to adopt their natural business years as fiscal years.