ADDRESS

of

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SECURITIES AND EXCHANGE COMMISSION

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The North Carolina Association

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I desire to express to the members of The Virginia Society and The North Carolina Association my appreciation of the compliment implied in the invitation to appear before you today.

When I was invited to talk to you upon some phase of the Securities Exchange Act of 1934, my decision to accept was made with considerable hesitation. First, because being extremely busy, I would have little time to prepare a paper, and, second, because I believe I am a better accountant than speaker.

However, I shall attempt to give you a brief sketch of certain phases of the requirements for the registration of securities under the Securities Exchange Act of 1934.

As you all are probably aware, one of the main objectives of the Exchange Act is to make available to the investor reliable information sufficiently complete to acquaint him with the condition of the company, the securities of which he desires to buy or sell. To accomplish this the Commission requires any person whose securities are listed, or are to be listed, on a National Securities Exchange to furnish a fairly comprehensive amount of information with respect to its affairs. It also requires certain information to be furnished by persons whose securities are listed, or are to be listed, on Exempt Exchanges, of which the Richmond Stock Exchange is one.

Registration of securities on an exchange may be accomplished by the filing of an application on the prescribed form, in triplicate, with the Commission and in the required number of copies with the Exchange on which registration is sought. If the Exchange authorities certify to the Commission that the security has been approved by the Exchange for listing and registration, the registration becomes effective thirty days after the receipt of such certification by the Commission, or within such shorter period of time as the Commission may determine.

Under the present rules and regulations of the Commission the continuance of registration upon an Exchange is conditioned upon the filing of interim reports covering material changes occurring from time to time, and the filing, within 120 days after the close of the fiscal year, of an annual report.

Since Form 10 is the form to be used by all corporations, with certain specified exceptions such as insurance companies, investment companies, banks, bank holding companies, railroads, foreign corporate bonds and the like, it can be regarded as the basic form. Therefore, I shall confine my remarks to the requirements of that form and the related annual report Form 10-K.

Form 10 calls for information of a non-financial nature, as well as financial data. A brief summary of these non-financial questions will illustrate the character of the material required to be furnished. First, a number of simple questions have to do with the organization of the registering corporation and of the system of which it may be an integral part. Next follow a series of questions which outline the capital structure of the registrant, calling for its authorized and outstanding funded debt; the debt structure of its subsidiaries; the authorized, issued, and outstanding capital stock of the registering corporation; the amount of securities of other corporations that it may have guaranteed; and its position with reference to outstanding warrants and rights. Then follow a series of questions directed toward getting an adequate description of the actual securities being registered, so that there may be a succinct statement of those matters relating to these securities of which any investor should be aware, such as conversion and redemption rights, interest or dividend rates, underlying collateral, substitution rights, and the like.

An effort has been made to confine these questions to elemental facts relating to the issue being registered. To afford those investors who seek more detailed and thorough knowledge of such matters, certain exhibits are required to be filed, such as underlying indentures or other constituent instruments defining the rights of the security holder. This is a desirable procedure, for it relieves the registrant of the difficult burden of summarizing the provisions of complex instruments, but at the same time it affords the investor such evidence as will best inform him as to the nature of his rights.

There follow a number of questions, one of which seeks information as to recent financing, a series of which relate to the control and management of the corporation, and finally, one question directed towards such stock options as may be outstanding and thus may materially affect the trading position of the securities on the Exchange.

The second portion of the form to which I shall now turn calls for financial data, in which I am sure you are more interested. Balance sheets as of the close of the most recent fiscal year and profit and loss statements, together with supporting schedules for the three years preceding the date of the balance sheet are required to be filed as a part of the application. The rules require that these statements shall contain, as a minimum requirement, the information specified in the instructions. While suggested forms for the presentation of these data are set forth, the rules permit the registrant to file the statements in such form, and order, and to use such generally accepted terminology as will best indicate their significance and character in the light of the instructions. This should not be interpreted to mean that any information called for by the form may be omitted, if present in the accounts, but only that certain variations in the presentation of the data are permitted. For example, the classification of assets and liabilities in the order of current to fixed may be reversed if such a change would best indicate their significance, but the proper classification of assets should always be given. Treasury stock may be shown as an asset, provided the reasons therefor are given, but as indicated, it is preferable to be shown as a deduction from capital stock or from either the capital stock and surplus, or from surplus, at either par or cost as circumstances require. The suggested form referred to is not an innovation, but represents sound principles in general use in the accounting profession.

To discuss at length the individual items set out in the form is beyond the scope of this paper, but for reasons to which I shall refer later, I feel that I should cite a few of the general features required by the form:

(1) The total of current assets and liabilities shall be stated and designated as such;

(2) Reserves provided against current assets shall be separately shown in the balance sheet, and shall be deducted from the specific asset to which they apply;

(3) Notes and accounts receivable known to be uncollectable shall be excluded from the asset as well as from the reserve account;

(4) In the registrant's balance sheet investments in securities of affiliates, indebtedness of affiliates, not current, and indebtedness to affiliates, not current, which in the respective consolidated balance sheets are consolidated, are required to be stated separately from those not consolidated;

(5) Serial bonds, notes and mortgage installments due within one year, and funded debt, if treated as a current liability, shall be shown separately;

(6) Under certain circumstances funded debt falling due within one year may be treated as a non-current item;

(7) For each class of capital stock the number of shares (a) authorized, (b) outstanding: par value per share; if no par value, the stated or assigned value per share, if any, and the capital stock liability thereof shall be shown in the balance sheet;

(8) Where the company has differentiated in its accounting for surplus, it is required that it be segregated into (a) paid-in surplus and/or (b) other capital surplus; and (c) earned surplus;

(9) The instructions do not clearly indicate how a surplus deficit shall be shown in the balance sheet, but we insist that it be shown on the liability side as a deduction;

(10) Footnotes are required to be appended to the balance sheet setting out (a) contingent liabilities, (b) the method used in amortizing debt discount and expense, (c) the provisions made for writing off discount and commissions on capital stock, and others of a similar nature;

(11) Sales, Cost of Sales, Selling, General and Administrative Expense, provision for federal income and excess profit taxes, and other items are required to be separately stated in the profit and loss statement.

The supporting schedules required were designed to give the analytical stockholder additional information regarding the major accounts. The balance at the beginning of the period, as per accounts, the additions, the deductions with a description of the accounts to which charged and the balances at the end of the period, are called for except in the funded debt, capital stock, and the two schedules supporting the profit and loss statement.

In view of the fact that the instructions to a number of these schedules permit the accountant to accept the balance at the beginning of the period as per accounts, the registrant is required to furnish under Item 34 a survey of certain past accounting transactions which may have occurred during the period since January 1, 1925, and which in all probability are still reflected in present financial data. Thus, substantial revaluations that may have been made in such specific assets accounts as the investment account, the property account, and the intangible asset account, are required to be stated, together with the contra-entries that will indicate the disposition of the amount added or deducted by such write-ups or write-downs. Again, any amount that may have been released from the capital stock account, either by the device of paid-in surplus or by restatement of capital stock is to be accounted for. Also, there is disclosed the too frequent practice of writing off debt discount and expense rather than amortizing it over the period of the debt to which it relates, a practice which distorts the earning statements.

I might add that the responses to Item 34 indicate that previous financial statements of some of the companies must not have been prepared in accordance with accepted accounting principles.

Item 34 may be certified by either (a) the board of directors through its authorized agent, or (b) the chief accounting officer of the registrant, or (c) independent public accountants. This optional certification is not, however, extended to the financial statements. They are required to be accompanied by a certificate of an independent public or independent certified public accountant. It must be dated, must be reasonably comprehensive as to the scope of the audit made, and must state the opinion of the accountant in respect of the financial statements of, and the accounting principles and procedures followed by the registrant and its subsidiaries.

Since this requirement places upon the certifying accountants the responsibility for preparing financial statements in accordance with accepted accounting principles, and since the instructions for the Form clearly indicate the data required to be furnished, the question may well be asked, “Why the statements submitted need be examined except to determine that all material called for is filed”. I regret to state that such a question is only too readily answered. No one can examine a large number of the statements, mind you not all of them, without being impressed with the apparent disregard of the instructions and the lack of general acceptance of well established principles in respects where it would seem that fundamentals of accounting are involved.

I can illustrate this best by citing some of the deficiencies found in the applications and annual reports. I shall first take up the accountants’ certificate.

Very often accountants’ certificates merely recite that “we have audited” or “we have made an examination”, without stating, in general terms, the nature and extent of such examination. It seems highly important from the investors’ point of view to know the nature and extent of the examination upon which the accountant is expressing his opinion. It likewise seems highly important from the accountants’ point of view to clearly state the extent and limitations of his examination, since the average investor is apt to take such an unqualified statement as meaning that a complete examination of the books and accounts of the registrant has been made.

The certificates usually give a fairly complete expression of opinion as to financial statements, but they very often do not clearly express an opinion, or omit an opinion altogether, as to the accounting principles and the accounting procedures followed by the registrant.

When qualifying their certificates in respect of the financial statements or the accounting principles and procedures followed, accountants seem to be even more reluctant to clearly express their opinion. Such qualifications usually state the facts in general terms and leave the reader to his own interpretation. The accountant then contents himself by saying "Subject to the foregoing", or "on the basis indicated", and gives what otherwise appears to be an unqualified certificate. In these instances we usually request the accountant to clearly express his opinion as to the qualifications, or, if no qualification was intended, to delete the phrase "subject to the foregoing".

Before leaving the subject of accountants' certificates, I wish to point out that the Commission will not recognize as independent any certified accountant or public accountant who is not in fact independent. Quite often it is found that the certifying accountant is a director of, or owns a substantial amount of stock of the registrant, which, of course, destroys his independence with respect to that particular registrant.

Some of the more common deficiencies found in the balance sheet are:

(1) The failure to segregate inventories by major classes and to state the basis of determining the amounts shown in the balance sheet.

(2) The failure to give a proper explanation where what appear to be non-current items are included under current assets in accordance with an accepted trade practice.

(3) The failure to show reserves on the face of the balance sheet as a deduction from the assets to which they apply.

(4) The failure to segregate current and non-current assets and liabilities and to show the total thereof.

(5) The failure to show the number of shares of stock authorized, the par or stated value thereof, and in a few cases, the capital stock liability by class of stock is omitted.

(6) The failure to show either, or both, the amount per share and total or dividends in arrears on preferred stock.

(7) The failure to segregate and classify the various surplus balances as carried in the accounts.

(8) The failure to segregate and state separately the amount of minority interest in capital stock and surplus.

(9) The failure to state the amount and method of dealing with the difference between the registrant's investment in, and its equity in the net assets of its consolidated subsidiaries. The importance of this requirement can readily be appreciated when

it is considered that this difference may be composed of several items which may be either debits or credits. The disclosure of the nature of these amounts and their disposition in consolidating the accounts, therefore, is essential to a proper understanding of the financial condition of the consolidated group, and to ascertaining whether correct principles of consolidation have been followed in consolidating the accounts.

Turning to the profit and loss statement we find that some of the common deficiencies in that statement are:

(1) The inclusion of Selling, General and Administrative and Other Operating Expenses in Cost of Goods Sold.

(2) The failure to state the basis of determining the amount at which the inventories are stated, where inventories are used in the computation of Cost of Goods Sold.

(3) The failure to indicate the reason for the discrepancy between the closing inventories on the profit and loss statement and the amount shown on the balance sheet.

(4) The failure to show in a footnote or otherwise the effects on the profit and loss statement of major changes in accounting principle or practice, such as the change in the depreciation rates or taking less than normal depreciation because of subnormal operations; the write-down of fixed assets or the write-off of bond discount and expense before the expiration of the life of the bond issue.

(5) The taking up in profit and loss of dividends declared out of surplus at date of acquisition of subsidiaries.

As to the Schedules, the most common deficiency in connection therewith is the failure to furnish all of the schedules and to indicate the reasons for the omission of schedules which are not applicable under the circumstances.

I will not attempt to discuss each schedule in support of the financial statements, but will cover a few of the more serious deficiencies in connection with some of them.

Schedules III and V - A large number of the accountants completely ignore the requirement of a statement of the policies of the companies in connection with the provisions for depreciation of fixed assets and the amortization of intangibles.

Schedule VII "Surplus" - In view of the many problems that have arisen in connection with this schedule, it would be futile for me to attempt to discuss Surplus here. But I will say that some accountants are very lax in their opinions as to what constitutes proper capital surplus and earned surplus charges and credits.

Schedule IX – "Income from dividends" is often found deficient in that the registrant's equity in subsidiaries' net profit and loss for the fiscal year is omitted. This is considered a major deficiency for the reason that it is only information furnished from which the investor may determine the profit and loss of each subsidiary included in the consolidated profit and loss statement.

Let me now cite a few other problems which have arisen in connection with financial statements submitted in applications and annual reports.

In several cases registrants charged to surplus and credited to income, dividends on their own stock held in their treasuries. By this procedure a company with a substantial amount of treasury stock could, on the basis of an earned surplus at the beginning of a series of years during which no profits whatever were made, show net income in the profit and loss statement and pay dividends therefrom during such years.

In another case a registrant carried in its own balance sheet Investment in Subsidiaries at cost which was greatly in excess of the par value of subsidiaries' stock. However, the accountant, in preparing the consolidated statements, eliminated only the par value of the subsidiaries' securities, notwithstanding that the subsidiaries' book value at date of acquisition, was in excess of par. The surplus at date of acquisition, of course, as well as the par value of the subsidiaries' stock should have been eliminated against the investment account.

In a number of cases, fixed assets were written down by a charge to capital surplus rather than to earned surplus. As a result of this, the Commission published a letter by the Chief Accountant, which I would like to read to you.

There are other cases which I might mention, but I believe the few I have submitted are sufficient to emphasize some of the respects in which it has seemed to us that some accounting statements have failed to present a proper picture of the business.

Up to this point I have purposely omitted making any mention of the many excellent statements which have been filed, the cooperation displayed by the accountants as a whole, and the progress made towards attaining the higher standards of the profession in general.

My remarks have been made with the view of brining to your attention some of the problems to be worked out, and the failure of some accountants to recognize their responsibility to the investing public.

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