

# Practice Problems of Accountants in Connection with Registration

## Statements

### *A Round Table*

LEADER:

Homer N. Sweet, *Lybrand, Ross Bros. & Montgomery*, Boston, Mass.

PARTICIPANTS:

William H. Bell, *Haskins & Sells*, New York, N.Y.

Carman G. Blough, chief accountant, *Securities and Exchange Commission*, Washington, D.C.

Samuel J. Broad, *Peat, Marwick, Mitchell & Co.*, New York, N.Y.

Walter A. Edwards, Jr., Norfolk, Va.

Edgerton Hazard, *Patterson, Teele & Dennis*, New York, N.Y.

Anson Herrick, *Lester Herrick & Herrick*, San Francisco, Calif.

David Himmelblau, *David Himmelblau & Company*, Chicago, Ill.

Marx P. Rosenthaler, *Rosenthaler, Shekell & Co.*, Detroit, Mich.

Frank E. Seidman, *Seidman & Seidman*, Grand Rapids, Mich.

Jacob S. Seidman, *Seidman & Seidman*, New York, N.Y.

Marshall M. Thomas, *Barrow, Wade, Guthrie & Co.*, New York, N.Y.

Carroll M. White, *Peat, Marwick, Mitchell & Co.*, Chicago, Ill.

*And others*

### TOPICS OF DISCUSSION

	PAGE		PAGE
Changes in registrant's business affecting future operations		Consent of accountant for use of name .....	327
Purchase and sales commitments.....	314	Income account, charges to .....	320
Sales Prospects.....	315	Income statements	
Changes subsequent to balance-sheet date		Amendment of prior years .....	319
Responsibility of accountant for reporting.....	331	For less than year .....	326
Responsibility of registrant for reporting.....	331	Of seasonal business .....	326
		Should be comparable .....	319
		Notes, explanatory.....	321
		Prediction, use of financial statement for .....	317

	PAGE		PAGE
Pro-forma balance-sheets		For summaries in advertisement .....	329
Certification of .....	329	For summaries in prospectus.....	328
Firm commitment.....	331	Robinson-Patman act	
Illinois requirement of.....	330	Responsibility of auditor for reporting	
Letter of transmittal accompanying .....	330	effect of .....	316
Prospectus		Securities and Exchange Commission,	
Certification in .....	326	attitude of	
Omission of schedules from.....	326	On accountant's consent .....	327
Reconciliation statement		On amendment of prior years'	
Certification of .....	325	statements .....	324
Use of .....	321	On responsibility of auditors.....	324
Responsibility of accountant		On responsibility of registrant.....	324
For reporting changes affecting future....	316	On surplus adjustments .....	324
For reporting changes subsequent to		Simplification of statements.....	327
balance-sheet date .....	331	Surplus adjustments .....	318

# Practice Problems of Accountants in Connection with Registration Statements

## *A Round Table*

THE meeting convened at 10:15 A.M. on October 20th at the Waldorf-Astoria, New York, with Mr. Homer N. Sweet, of Boston, presiding.

CHAIRMAN SWEET: We are here in this session to have an informal discussion on the subject of "Practice problems of accountants in connection with registration statements." An outline of the subject topics which we may discuss has been handed to each one.

The purpose is not so much to discuss the specific requirements of the Securities and Exchange Commission in the instruction books. You will notice that a number of the topics have to do with the question of what information shall be reported in order that the other parts of the statements may not be misleading.

Of course, there are extremes to be avoided. One extreme would be reporting so much information as part of the financial statements, or in notes thereto, as to encumber the financial statements as a whole with altogether too much information, and the result would be to make the statements confusing rather than enlightening to investors. The other extreme would be giving so little information in the financial statements that the registrant might be chargeable with having omitted something of vital concern to investors. We shall see if there is a middle ground which would avoid those two extremes.

### CHANGES IN REGISTRANT'S BUSINESS

The first topic suggested in the outline is "Changes in registrant's business, which may materially affect future sales or operating costs." Is there any one who has any ideas to propose on that topic?

MR. WILLIAM H. BELL (New York): Well, I suppose that we all understand that profit-and-loss statements, as presented in registration statements, are necessarily historical rather than a definite indication of what the profits, sales and results of operations generally are going to be for the future; but, of course, they are presented in the prospectus as practically the only information that the prospective investor has regarding the operations and, therefore,—I am speaking of the registration statements under the securities act of '33 now—we can't utterly disregard the effect of anything that may have happened or is likely to happen which affects the future.

In the case of a consolidated statement, if there is any change in the make-up of the group of companies during the period, such as one company's dropping out or another company's being taken in, i.e., included for only part of the period, it seems to me obvious that some information must be given as to the effect upon the statement as a whole of such dropping out or inclusion of a company. We frequently encounter that situation in cases of large groups of companies.

## CHANGES AFFECTING FUTURE OPERATIONS

Of course, I think we must be very careful as accountants about saying anything relating to the operating aspects of the business, unless it is quite pronounced. There might conceivably be a situation where the company is manufacturing and selling specialties protected by patents, and those patents are about to expire, or some competing device has been invented which is already encroaching upon the business of the registrant.

Or we may know, for example, that the product during the period has developed to be defective and that there are indications that there will be large returns. In connection with registration statements, we have always felt it necessary to bring out such a situation as that.

There may be questions of the effect of legislation upon the profit-and-loss statement of the company. The thing that occurs to me at the moment is the Robinson-Patman act which, especially in the case of chain stores, might have a definitely adverse effect upon the operations in the future if quantity discounts on purchases, which have been received, were to be discontinued. If, on the other hand, it is a company that has been giving discounts and which may be cited and get a cease-and-desist order from the Federal Trade Commission, the result might be quiet a difference in its business. I think we have got to be extremely careful in saying anything in footnotes to statements regarding the possible effect of such legislation. We mustn't do our clients an injury, and it is very easy to do so.

I know of one case recently where accountants became so excited about the possible effects of the Robinson-Patman act upon a chain store's business that they carefully took out all the discounts and advertising allowances in the expense accounts and in the cost of goods sold, and set them up separately and made such a footnote that it was a scarehead and scared off the bankers entirely. They abandoned the project, and I think injustice was done in that case.

I notice that Mr. Sweet in his outline of topics has one respecting seasonal aspects of business, so I won't discuss that. Mr. Chairman, that is all I have in mind.

CHAIRMAN SWEET: Does any one else have any thoughts on this topic No. 1?

MR. BELL: There is another thing that just occurred to me, Mr. Sweet, that we ought to consider—the effect of forward contracts, whether a company is committed under purchase contracts when the replacement cost itself has declined, or possibly under sales contracts when it sells at a lower price than competitors can sell for. It may be very important, in connection with this question of registration statements, whether a company is tied up to long contracts, especially adversely.

MR. M.P. ROSENTHALER (Detroit): I have one question to ask. In cases of registration statements, where the manufacturer is supplying perhaps 20 or 25 per cent of his entire production to one chain group, the question has been raised with me as to whether it is important or unimportant—generally felt by the attorneys to be important—to disclose the fact that there is one large source of demand which may or may not disappear.

As against that, we always have the problem of objections to publishing the annual sales, which might automatically show in the statement what is going to this particular outlet. I wonder if anybody has had any actual experience with the commission which would indicate where the line will be drawn. What is a serious amount?

## SALES PROSPECTS

CHAIRMAN SWEET: I think that is a very important question. Of course, the question could arise, not merely because there is one customer who has been taking 20 per cent of the output, but because certain of the lines of products, which may in the past have been sold to a number of customers, may be of such a nature that their future sales possibilities are somewhat dubious.

Does any one have the solution to the question that has just been raised?

Personally, I wouldn't think that necessarily, because 20 per cent of the output has gone to one customer, any mention had to be made of that. I think there are other circumstances to be considered, namely, the whole relationship between the registrant and the customer.

MR. ROSENTHALER: That only applies, of course, in a highly competitive field where business is taken each year for a particular output and it might make a material difference upon future operations; if a company loses that particular output—unless, of course, in the ordinary course of events substitution was made.

CHAIRMAN SWEET: Well, is it a specialized product, or is it a product that would be salable to other customers?

MR. ROSENTHALER: For example, you could take the garment industry, with the substantial proportion of the garment sales to organizations such as the Penney Company. Concerns in the industry depend to a great extent upon the demands of buyers for that particular group. Where you have your larger chains picking up a substantial amount of their demand from certain sources of supply, an outlet lost is difficult to replace.

CHAIRMAN SWEET: Does any one have a thought on the question that has just been raised?

MR. EDGERTON HAZARD (New York): There are some indirect examples of what might happen to the prosperous company under those circumstances. A client of ours was in just exactly that position, having about three-quarters of its business among big chain stores. It was making a tremendous amount of money, doing a nice business, when suddenly the contract was lost. The firm was bankrupt in about three months after they had lost their one customer or, rather, their one big customer.

I think that, if there had been a registration statement in this case, the possibility of such a development would have been very important—it practically ruined a very prosperous business and put it in bankruptcy in almost no time.

CHAIRMAN SWEET: Did you say that three-fourths, in your example, of the sales were to a single customer?

MR. HAZARD: To a single organization.

CHAIRMAN SWEET: I think that is quite different from the 20 per cent case.

## RESPONSIBILITY OF AUDITOR

MR. BELL: Mr. Sweet, I would like to raise a point. I think there are a lot of things that may affect adversely or favorably the prospects of a company that are the primary concern of the registrant and its attorneys, that the accountants don't need to worry about so much.

I think that the accountants should concern themselves in a general way. I think they fall short of their duty to their clients if they don't advise them, perhaps, on some of these things, but

we are not so much concerned from the standpoint of liability or responsibility, I think, unless it directly affects the historical aspect of the business.

CHAIRMAN SWEET: In this case where 75 per cent of sales are to a single customer, I assume that the information would be reported in the history of the registrant's business in the registration statement and in the prospectus; so the question is whether similar information ought to be reported also as a part of the profit-and-loss statement, either by segregation of sales in the body of the statement or by an explanatory footnote.

What do you think should be the accountant's attitude, Mr. Bell, in this case of the 75 per cent sales to a single customer?

MR. BELL: Well, in an exaggerated case like that, I should feel happier if there were something said about it as a footnote in the profit-and-loss statement.

CHAIRMAN SWEET: So should I. But what about the 20 per cent case?

MR. BELL: I wouldn't go that far, I think.

CHAIRMAN SWEET: That is my feeling, I wouldn't think necessarily that, because 20 per cent of sales are to a single customer, it has to be reported, unless it has already become probable that that source of income is likely to be cut off.

MR. FRANK E. SEIDMAN (Grand Rapids): Mr. Chairman, I am wondering to what extent the accountant is justified in going into matters of the kind that Mr. Bell has mentioned in so far as future prospects of earnings are concerned. Aren't we opening up a field that leads to almost immeasurable possibilities?

For instance, suppose there were a drastic change in manufacturing methods in a given industry. As soon as we assume responsibility in one form or another for pointing out possible drastic future changes in the earning power of the company, without pointing out other things which may be just as drastic but which may not come to the knowledge of the accountant, aren't we getting into the situation of being a prognosticating body and not a fact-finding and reporting body?

MR. ANSON HERRICK (San Francisco): Mr. Sweet, in the 20 per cent case, would it not depend upon whether the nature of the business was such that an elimination of 20 per cent of the gross would have a more important effect upon the net? In many businesses a reduction of 20 per cent of the gross might be controlled through cost of expenses, with the consequence that the net would be reduced only by 20 per cent; whereas in other cases, there might be a difficulty of control, with the result that a decline of 20 per cent would wipe out the net.

Now, the existence of those circumstances should be within the knowledge of the accountant, and it seems to me that, even where as little as 20 per cent goes to one customer, if there was any possibility of a loss of that business, combined with a control situation which might result in a loss to net, that should be considered a very material factor.

CHAIRMAN SWEET: I didn't understand that Mr. Bell was advocating that any prognostications affecting future earning possibilities should be reported in the financial statements, but I suppose that your point, sir, is that, in going as far as Mr. Bell did propose, you would be afraid of the implications of that policy and of the chance of encroaching upon representations that are pretty close to forecasting the future.

MR. SEIDMAN: Exactly.

## FINANCIAL STATEMENTS THOSE OF CLIENT

MR. BELL: In the first place, the financial statements are the representations of the registrant and not of the accountant, and I don't think the accountant is necessarily assuming any responsibility for, let us say, a partial statement of one factor which may possibly affect the future adversely, by reason of a footnote that such and such is the case, so that the prospective investor can bear it in mind.

We all think that the registrant ought to lean over backward in presenting anything that might reasonably come up and then be held against him as not having been told to the prospective investor. I don't think there is any question of the accountant's responsibility in this except for things that affect the financial condition at the date of the balance-sheet which may develop later, up to the date of the effective date of the registration, and come to the notice of the accountant, or things affecting the profit-and-loss statement existing at the time which anybody ought to know about in judging the profit-and-loss statement.

These are no new principles at all. We have all recognized them within the last thirty years. I don't think there is any question of accounting responsibility, Mr. Seidman.

MR. SEIDMAN: Mr. Chairman, I didn't raise the question from the point of view of saving our hides. I raised it from the point of view of where the accountant's responsibility starts and stops. I feel that when an accountant attempts to analyze a statement, not from the point of view of the history of the company and its earnings, but from the point of view of that history in so far as it may relate to future earnings, he enters a field which goes beyond accounting.

CHAIRMAN SWEET: Will some one help us to resolve this apparent difference of viewpoint?

MR. S.J. BROAD (New York): I agree with Mr. Bell that the accountant is not a prognosticator. However, I think that the securities act and the way these statements have been used have encouraged investors to look upon a financial statement, and particularly earning statements, as an indication of what a company may do in the future. I don't think we ought to encourage that more than we have to, but I think we ought to acknowledge that the condition exists.

Now, in these matters that have been discussed, the 75 per cent and the 20 per cent cases, those are to my mind not prognostications; those are statements of fact as to the past. Let the investor make his own prognostications.

We show sales of a million dollars and we say nothing about it. Well, that is a nice business. But suppose we show sales of \$750,000 to one customer and \$250,000 to the rest of the world, and that is a very different business. That, however, is history; it is not the future. We let the investor make his own prognostications, if he wants to, and take that gamble if he wants to. But I think if we did not state the situation, we would be omitting a material factor that might make the statement misleading.

I think, in relation to the future, the accountant has to be very careful as to what he says. In the history of the business, usually written by the attorneys or by the engineers—not by the accountant—there is plenty of room to bring out any possibilities as to the future. If there is in the history of the past some indications as to dangerous possibilities for the future, we should state the facts, put them in red ink if you will, and let everybody see it. But I don't think we ought to deal with every possibility that may happen, and unless there is some relation to the past I do not think the accountant has that responsibility.

MR. SEIDMAN: I agree with that statement completely. I think that a segregation of sales and other factors of the past, indicating what the company has accomplished, is a material factor; but when it comes to prognostications, I think those are things of the future and not in the province of accountants.

CHAIRMAN SWEET: As I understood Mr. Bell, it was not his proposal to estimate what would be the effect on business of the Robinson-Patman act or any other legislation; I understood him to say that the fact of the existence of the Robinson-Patman act would be a possible subject for a footnote, and any other legislation that might have an impact upon the business of the registrant.

#### SURPLUS ADJUSTMENTS

Shall we consider the second topic? "Should surplus adjustments related to prior year income or expense be included in the income statements reported in A-2 for any of those years?"

For example, suppose that 10-K has been filed under the exchange act for the year 1936 with surplus adjustments reported in that year which have to do with income and expense for the preceding year, 1935; and suppose that during 1937, perhaps I had better say 1938 now—suppose during 1938 the company files an A-2 registration statement under the securities act. Should those surplus adjustments, which have been reported on 10-K in 1936, be allocated to the profit-and-loss statements for the years affected in the registration statement form A-2? Or should surplus for 1936 in A-2 be reported in the same manner as it was in 10-K for the year 1936? What are your ideas on that question?

#### AMENDMENT OF PRIOR YEARS' STATEMENTS

MR. WALTER A. EDWARDS, JR. (Norfolk): I do not believe that we should amend a prior year's income accounts. Take, for example, a royalty amount paid in the subsequent year which applied to three or four years preceding. Now, if we should deduct the royalty, which could easily be computed, as applicable to each year, we would then reduce the net profit, of course, for each year; but perhaps that would not be the case if we were aware of a patent infringement, and perhaps our sales price could have been increased during those years if we had been aware of this additional expense.

Then, too, perhaps during those years under the revenue act of 1936 we may have had an undistributed-profits tax. This expense was in controversy, let us say, and was not deductible until the case had been finally settled. We would not have had an undistributed-profits tax if we had been accruing those expenses right along; yet we cannot take the undistributed-profits tax out of the years incurred under the revenue act, because we didn't have those deductions in computing the tax.

CHAIRMAN SWEET: Was it evident, when the accounts were closed for the prior year, that the company was obligated for some expense in connection with the patents?

MR. EDWARDS: No, sir. One I have seen ran for several years before the matter ever came up, and then it was a matter of controversy which was carried to the Supreme Court.

CHAIRMAN SWEET: Well, if we assume that no obligation for expense had arisen in the preceding years, then I don't suppose that there would be any ground for prorating the payment later made for the prior year.

## NEED FOR COMPARABLE STATEMENTS

MR. DAVID HIMMELBLAU (Chicago): Mr. Chairman, I think the statement made should be an exception rather than the rule. In other words, we all agree that it is absolutely fundamental that, if we are going to turn out three-year statements, we can't do that work unless we take all our surplus adjustments back to the year to which they belong. Otherwise, we have definitely failed to accomplish the first object of A-2, that is, to have a three-year statement that is comparable as between those years. I fail to see any merit to the idea that accounts once reported on 10-K become closed forever and should never be recast for a different purpose. You may have exceptional cases where you can't prorate, you can't adjust, but they are very few, so far as I have observed.

MR. HAZARD: I think it depends somewhat on the manner in which surplus accounts are kept by the companies involved. I have seen some registration statements where the surplus account with its adjustments was practically a duplicate profit-and-loss statement for prior years; if you don't throw them back in a three-year statement, you have only a half-picture of the results as of those years.

I have seen them almost two or three pages long, with adjustments of taxes and production cost and of everything under the sun; in that case the profit-and-loss statement is almost meaningless unless you go back to those surplus adjustments.

Where the surplus adjustments are small, if your current accountant makes a profit-and-loss statement, then there is no point to going back and throwing them in.

## CHARGES TO INCOME IN CURRENT YEAR

MR. BELL: I think that one answer to this is fundamental. Accountants as a rule countenance too much crediting and charging off of items directly to surplus which ought to go to income. We ought to make as good an effort as we can to determine a net income for every year, having regard to the various contingencies—set up reserves for them if you like—and not go wild with respect to the equalization of profits over a number of years or anything of that sort. If, however, we are faced with patent litigation, so that there is even a reasonable possibility that we are going to have to pay additional royalties, let us provide for them out of income. If we have additional taxes for prior years, soak them into the income for this year, unless the thing is so enormous that it is definitely going to distort the income results—and that is seldom going to happen. I like to see a surplus account that is clean and that has but one credit, net income, and charges for dividends.

If we adopt that policy, we can credit things to income which might seem to be a little extraneous to the ordinary operating income for the year, do it quite properly and have the current income for the year stand all these charges.

Now, I think that there are two arguments definitely on this question of throwing back things that are credited and charged to income. As a rule, I agree with Mr. Himmelblau, but there are, I think, certain things that you can't dismiss lightly with respect to large corporations, particularly the objection to starting net income differently for two different purposes. Whatever you do, I think you have to say what you have done. If you have thrown back surplus adjustments from 1938 to '36 and '35, and so forth, you have to say so; and if there are things in the surplus accounts charged in '36 which, if they had come up, would have been recognized as charges in the '34 income, I think you have to say so.

MR. HAZARD: The new utilities commission rules have followed out Mr. Bell's idea. The new classified accounts of public utilities just issued for next year have followed Mr. Bell's theory, and they require that current year's adjustments of prior years' expense items are to be thrown into the current year's expenses and revenues if they don't materially distort the picture from year to year, which will probably have a clarifying effect upon some of the surplus accounts of utilities in this state.

MR. BROAD: I think we might quote something even more authoritative than the public utility regulations; that is, our bulletin, *Examination of Financial Statements by Independent Public Accountants*, which is put out by the Institute and presumably has some authority as far as accountants are concerned. The same suggestion is made there.

CHAIRMAN SWEET: Was the suggestion that the items be taken up in the current year?

MR. BROAD: Yes, unless they are materially significant. But in the normal run of things, we know that we can't close the books finally on a particular date. There are bound to be overlaps from one period to another.

CHAIRMAN SWEET: And if it would distort the showing of net income for the year materially, then the adjustments would go directly to surplus?

MR. BROAD: I was quoting the bulletin. That point is not covered there.

#### USE OF EXPLANATORY NOTES

CHAIRMAN SWEET: But I suppose under your proposal, Mr. Bell, that in any situation, if any single adjustment, or if the adjustments falling into one year taken together, had a substantial effect upon the net income, you would make explanatory notes?

MR. BELL: By all means. I would say, if you decided not to make any retroactive adjustments—if you had to charge in '36 what would, if it had been recognized at the time, have come up in '34—and you decided that all things considered it is a good thing to leave it as a surplus charge, there should be in a note something to the effect that the net income for '34 would be affected by a surplus charge of 1936 shown in schedule VII.

Of course, there is another objection to not throwing these things back. You have the surplus charge in '38, which you know affects '36, but you don't know what is coming up in '40 or '41 that is going to affect '37 and '35, and so forth. I think that you have to take every case on its merits, and not adopt any absolutely ironclad rule on these things.

MR. BROAD: Mr. Sweet, I have sat at Mr. Bell's feet so long and have learned so much from him that I hesitate to disagree with him, but I would like to take issue with him on one point. He made a suggestion that if you had an item of surplus that should have been reflected in '34, a note should be made to that effect and indicating that after this adjustment had been made the result would be so and so. That doesn't seem right to me. When we put out a statement it is presumed to be right, but we put in a footnote and say it is wrong. Stating that an item is wrong doesn't make it right. I think we ought to correct it instead. If we want to, we can put in a reconciliation, when reporting something different from what has been reported before, but I think it is desirable to make the change and explain that it has been done.

MR. BELL: Mind you, I stated as a generalization that I am in favor of throwing these things back, but I think there are cases where it is not desirable. If some things come up in '36 that evidence carelessness, or anything but the most careful effort to determine net income in '34, then by all means throw it back.

But you know very well that there are things coming up in '36, '37 and '38 that could not possibly have been foreseen in '34, and I think that in some of those cases it is a decided injustice to reduce the net income for the year 1934 accordingly.

MR. HIMMELBLAU: There seems to me to be a question involved that relates to the point I was trying to bring out. I felt that with our hindsight we should recast the accounts, using the reconciliation statement to show what we have done. Otherwise, I fail to see how we are going to have a comparable statement. If we can get a comparable statement without it, I am interested.

MR. BROAD: There was something in the regulations or the act, I don't recall where, but I believe it was in the regulation, regarding the accountant's certificate that first came out, requiring that he state that he believed the statement to be true at the date thereof. There is another clause somewhere about a statement being false or misleading in the light of the circumstances under which it is made. I would like to stress that, "in the light of the circumstances under which it is made."

Assume that in '34 we didn't have certain information; we didn't have that knowledge. In '38 we do have the information, and "at the date thereof," i.e., at the date of our later report, I think we still require to believe the statement is true. Now, if we have the benefit of hind-sight, I doubt whether it is harmful to admit there has been some mistake. I don't think the accountant is doing any harm to himself, or that the client is doing any harm to himself, if he makes a new presentation with the benefit of hind-sight. We have found something new, we have corrected it, and here is what the correction amounts to.

MR. WOODS: I really want to emphasize what Mr. Himmelblau said. I want to emphasize that I think we must, where we are giving three-year income accounts, use our best judgment with all the knowledge we have up to the date of making those income accounts and statements and state them as clearly as we can.

CHAIRMAN SWEET: Mr. Himmelblau, may I ask you a question? Suppose the situation is that you made the best estimate you could at the time when certifying the income for the year, but that later developments show that the amount is materially different. Now, suppose that to prorate that back would mean an adjustment in income tax and surtax, assuming the company still had the right to file amended returns. Might that not also have affected the dividend declarations by the directors, had they had that later information at the time? Do you place any limits on the policy of readjustment of the prior years?

MR. HIMMELBLAU: It seems to me that if we don't go the whole route as you have outlined it, the A-2 statement is meaningless. In other words, if it is merely going to be a copy of the last three statements, why not say that is what it is?

Unfortunately, the A-2 statement is used for a certain purpose, whether we want to use it for that purpose or not. The people who get those statements actually do use them for the purpose of disclosing a trend. There is no way you can stop them from doing it.

Now, if we have information at this date indicating that the last three 10-K's do not properly indicate the trend, we know that our statements will be misused when we put them together in three copies. Under those circumstances, I fail to see that we can close our eyes to the situation and say that we should merely copy three 10-K's.

It goes back to what Mr. Bell said. For a long period of years, even before the registration statements, if we have had new information on depreciation experience or any other important factors, we restated them for the period under review in order to develop a set of

earnings which would most clearly represent the actual results for those years, as we later knew the facts.

If the A-2 is to serve any major purpose and if we are really going to avoid some liability, I think we have the responsibility of seeing to it that, when the A-2 is signed, it covers all the information available up to that date.

I never did believe in surplus adjustments; I still don't. I think they are the convenient device of many managements to prevent showing the full facts.

#### THE RESPONSIBILITY OF MANAGEMENT

MR. GIBSON: Assuming that these statements that we are discussing are, after all, the client's representations and not the accountant's, this occurs to me. Here we have a report to the stockholders put out by the president of the company and his directors. We have a form 10-K for the years '34 and '35, which is a sworn statement of the company's officers. It seems to me that the company itself would have a very large part in the decision as to what an A-2 statement covering three years would disclose and the form of its disclosure, and I don't think it can be a matter where the accountant has the full responsibility for a decision.

It seems to me that, at most, it should be the result of a joint discussion. There may be very important reasons in the minds of company officers why it was inadvisable to have three different statements to be sworn to and submitted.

I was anxious to ask Mr. Himmelblau a few minutes ago if we would in all cases amend the outstanding 10-K's for apportionments of surplus entries to respective years.

There is just one more point. Isn't it true that we are placing more emphasis than is perhaps necessary on the difference between surplus charges and income charges? Several writers have laid down that bogey-man.

An intelligent reader of a statement invariably looks at income in the income statement with due regard to the accompanying surplus statement. I am saying an intelligent reader of a financial statement. The difficulty with putting out income statements with surplus charges, it seems to a number of us, is that the newspapers pick up a single figure regarded as income, forgetting any item which may be handled directly through surplus, either as a charge or a credit.

MR. CARMAN G. BLOUGH (Securities and Exchange Commission): My opinion has been so strong on that score that we have been accepting reconciliations filed as amendments to 10-K which reconciled, in the 10-K reports, the differences between information originally filed in the 10-K and the information which has been filed in a subsequent A-2. My own personal opinion is that that is the desirable thing.

Form 10-K is a running series of annual reports prepared in the best manner possible in the light of facts existing at the time of the filing of the 10-K.

I also wish to express complete agreement, as far as my own personal reaction is concerned, with the sentiments expressed by Professor Himmelblau.

#### NEW FORM OF STATEMENT PLANNED

With respect to Mr. Bell's recommendation, I would like to tell him that it has borne fruit to the extent that there is a recommendation before the commission at the present time—in the tentative draft of the amended form of statement—which gives surplus an equal place with the balance-sheet and profit-and-loss statement.

Now, we are not unmindful, however, of the fact that there is a very strong tendency—and probably a great deal of merit in that tendency—in the direction of carrying all the adjustments through profit-and-loss statements. But even though you were carrying all adjustments for prior years to the profit-and-loss statement for the year in which adjustments had been made, if those adjustments are significant, it seems to me that, in recasting the statements for A-2, there are very good reasons for throwing those adjustments back into the year to which they belong.

The investor, be he ever so intelligent, is not in nearly so good a position to allocate those charges and credits to surplus or to the income account of the year to which they belong, as is the accountant or the registrant, and it seems to me that the advisable thing is to put them in the year in which they belong in the light of knowledge that you have at the time the statement is filed. Then the person who picks up the prospectus and for the first time familiarizes himself with the affairs of this company, has in consecutive order the statements of the three years prepared in the best light of the information available at the time those statements were prepared.

The fact that there may be adjustments in the future affecting the last year doesn't alter the fact that you have done the thing to the best of your ability.

With respect to whether these are statements of the registrant or the accountant— unquestionably they are the statements of the registrant and the accountant is responsible for expressing his opinion with regard to them.

On the other hand, none of you are so naïve in accounting matters that you don't realize that in 99 cases out of 100 those statements of the registrant are prepared by the accountant, and the accountant is the one who keeps himself in touch with the securities act and with all of the other legal aspects and trends in accounting which should guide the registrant in the preparation of his statement.

I don't think accountants should be bashful about preparing in the way in which they think they ought to be prepared, statements that the registrant is to present as his own. If the registrant refuses to file them in that form, that is a different story; there is no reason why the accountant in that case shouldn't express his opinion that the statements for those years do not reflect the facts as they are now known and let the commission decide whether or not it will force the registrant to adjust the statements.

#### ATTITUDE OF THE S.E.C.

So far, we have not absolutely required that adjustments be made for prior years, but we have a definite feeling that they should have been applied to prior years. Now, there has been a good deal of thought and disturbance about the complications that arise if you certify to one set of statements when you file a 10-K and then three years later certify to a statement that is different.

I don't see that there is any problem involved in that at all. In 1936 you certified to a 1935 statement in the light of what you knew at that time. If you have made the provisions as you should have made them, provisions that are foreseeable at that time, and made the proper statements on the basis of the facts known at that time, and then, subsequently, with additional facts, prepare another statement which shows a different result because things took place after the first statement was filed, I don't think you have involved yourself in any liability or any criticism. But in order to clarify yourself on that, I think the recast statement should carry with it a reconciliation between the statements now filed and those previously filed, so that the person

who reads them may know that there have been subsequent adjustments that were not known at the time the original statement was cast.

That will also take care of the point raised here, that the 1937 statements may have adjustments made in 1940 or '41. The fellow who reads the statement for '35 and the reconciliation showing that there had to be adjustments to that in subsequent years, will realize, when he comes to '37, that there may be and will be some adjustments that will have to be made for the year and he can take that into consideration in his analysis.

CHAIRMAN SWEET: Mr. Blough, I hope that you are not expecting too much of accountants as to their competency in comprehending the legal aspects of which you spoke.

MR. BLOUGH: By legal aspects, I had in mind the requirements of the various acts that affect accounting statements and the rules and regulations of the various governmental bodies that affect accounting statements which have in themselves the force of law.

#### CERTIFICATION OF RECONCILIATIONS

CHAIRMAN SWEET: Mr. Blough, I would like to know, with regard to the reconciliation statement that you spoke of, whether that statement is required by the S.E.C. to be certified by the accountant or not?

MR. BLOUGH: As I indicated when I first mentioned that point, we haven't really gotten down to the very foundation. I think at the present time reconciliations are being accepted when filed by the company without certification, though what the provisions will be when there is a definite regulation with respect to that proceeding, I can't now say.

CHAIRMAN SWEET: I am not sure that I am ready to accept fully, Mr. Blough, the idea that there is no difficulty in recasting the profit-and-loss statement in form A-2 with respect to years already reported.

On form 10-K, it seems to me, we might have special cases where the recasting would amount to a violent assumption; that is, the directors may very well have acted, probably did act, in certain ways fully in reliance on the profits that were reported in the prior year and before any different figure could have been known. Now, we may have cases, I say, where it is impossible to make adjustments all along the line, because you can't undo actions which may have been taken by the directors in reliance upon the figure. So it seems to me that the purpose of A-2 is not merely to report earnings in the light of the present knowledge, but also to report the financial statements as a whole for the historical record on the basis on which the business of the company was managed.

Suppose that we now consider question No. 3, which is "Statements of income for period of less than a year, especially if business is seasonal." Mr. Bell, was there something that you wished to say on that?

MR. BELL: That sort of dovetails into topic No. 1 that I discussed. If a business is seasonal, and possibly whether or not it is seasonal, I think it is generally desirable to have a footnote on the profit-and-loss statement to the general effect that the results of operations for this five months, or whatever it may be, should not be relied upon as necessarily indicative of the results of operations for the full year. That certainly would apply, I should think, if the business were markedly seasonal.

CHAIRMAN SWEET: I think we should have in mind that the income and expense for the fractional part of the year are required to be shown in a comparative statement alongside of the figures for the full years in form A-2.

## OMISSIONS FROM PROSPECTUS

Is there any other comment on this question? If not, we can proceed to No. 4, "Accountant's reliance on the rule permitting certain schedules in registration statement to be omitted from the prospectus." Do we invariably omit from the prospectus all of the schedules permitted by the instruction to be omitted, or are there exceptions where we feel that, in order to give our certificate for purposes of the prospectus, some of those schedules, despite the rule, ought to be included in the prospectus? What have you to say on that question?

MR. SEIDMAN: Mr. Chairman, we have had recently an A-1 case which involved that very situation. The detail required by the various A-1 schedules tied in to such an extent with the historic background of the profit-and-loss statements and balance-sheets that, notwithstanding the fact that we know the attitude of the S.E.C. is to reduce the explanations and qualifications to as short a space as possible, we insisted that all the schedules, all the details in the various A-1 schedules, be part of our certificate; and in the various exhibits and schedules which we submitted, we took the precaution of indicating that none of the schedules should be omitted in connection with our certificate.

MR. BROAD: Perhaps, Mr. Sweet, I am a little old-fashioned, but I still feel that the balance-sheet, the profit-and-loss statement, and surplus account are three statements through the medium of which we should be able to give a fair picture of the financial position and earnings of a company.

Now, I can see situations where a schedule VI, the summary of reserves, might bring out some facts that might be very material. For example, if there were \$100,000 of bad debts, and in accordance with its usual method the company had set up a normal reserve for the year of \$10,000, but had had this large loss in the particular year, I think that is material. I think that should be noted on the profit and loss.

I think the accountant has a certain moral responsibility to get the data into such form that the average person who is not used to reading profit and loss can get from those three statements the information that he will require.

I think we should be able, within reasonable scope, to get material matters into the statements—I don't like the thought that we are going towards further expansion of statements. I would like to see our statements more contracted. Let us hit the material points, stress those, and not bury them under a lot of data which to most people is useless.

CHAIRMAN SWEET: I read recently that the commission was at work on the task of simplification of the registration statement forms and of the contents of the prospectus. It seems to me that the suggestion just made by Mr. Broad is a most excellent one to be considered in working out the details of simplification.

## USE OF ACCOUNTANT'S NAME WITH SUMMARIES

Suppose we pass to No. 5, which is "Consent to use of the accountant's name in connection with condensed summaries of earnings and pro forma balance sheets."

I am thinking of the prospectuses which in the forepart give a much condensed summary of earnings for the three-years' period. Suppose that condensed summary is introduced by the statement that it is taken from the financial statements certified by so-and-so.

I would like to ask Mr. Blough, does the S.E.C. require the accountant's consent to the use of his name in that connection?

MR. BLOUGH: I am not at all sure that I can answer that question.

MR. BELL: I can answer it. They do.

CHAIRMAN SWEET: And suppose that the accountant is not named, but that the introduction is to the effect that the statements have been prepared from the full statements in the prospectus—does the S.E.C., Mr. Bell, still require consent?

MR. BELL: Only when the accountant's name is given.

CHAIRMAN SWEET: All right! Well, then, in cases where the underwriters desire to name the accountant in the sentence introducing the condensed summary—what is your practice in reviewing the condensed summaries and deciding whether, under the circumstances, you are willing to give your consent? That is the question. What have you to say on that?

MR. BELL: I don't see any reason why we shouldn't give our consent, providing, of course, that the figures are correct and providing it is a reasonable condensation which brings out the material facts, and providing also there is a reference to any important footnotes or any important qualifications by the accountant in his certificate.

CHAIRMAN SWEET: Does any one have a different thought?

MR. BROAD: I would like to say a word on that point. Mr. Bell said, for one thing, that the S.E.C. had not required consent where the accountant was not named. A case came up recently where my firm was not named in the earnings paragraph. Reference was made to the more detailed financial statements and the accountant's report and we were asked to consent, but we didn't know what there was to consent to and we did not consent. I don't know whether that indicates a trend toward asking the accountants to assume further responsibility.

#### RESPONSIBILITY FOR SUMMARIES

I think the test of our responsibility under the securities act is that the statement must be a fair summary. The accountant does not assume legal responsibility unless he consents, but I think he has a certain moral responsibility to his client or to the bankers to see that it is a fair summary. I think, on the other hand, that where we are going to consent we ought to take more initiative in telling our clients what should be stated in that paragraph.

We have, perhaps, a certain duty in the selection of footnotes. In one recent case the attorneys stated that they would not put any footnotes in. They weren't going to select footnotes, and it was to be either all the footnotes or none. In that case it turned out to be none, and the accountants did not consent.

I think that, if we are going to consent and take the legal responsibility, it is our duty and our right to say what should be said in the earnings paragraph, and I think we should insist.

CHAIRMAN SWEET: Is there any other remarks on this point?

MR. JACOB S. SEIDMAN (New York): May I ask Mr. Bell or Mr. Blough whether a reference in the advertisement of the type that I think is the most generally used—that is, to the effect that the following is a condensation of the earnings of the company as certified by John Jones and as qualified or explained in the footnotes contained in the registration statement, and so forth—is regarded as perfectly all right and a fair summary of the qualifications and exceptions that may be related to the hearings set forth in the registration statement?

CHAIRMAN SWEET: You are speaking now of a newspaper advertisement?

MR. SEIDMAN: Yes, where there is a condensation of the earnings statement and it is said that these are the earnings as certified by John Jones and Company, together with or as further explained by notations or comments made in that certificate in the registration statement; I ask whether that is considered all right.

CHAIRMAN SWEET: However that question is to be answered, you do have equal moral responsibility, in passing upon the fairness of the summary.

MR. SEIDMAN: I didn't know from the nature of the comments that had been made—and with which I am in complete agreement—that in any condensation, if it is fair, the accountant ought to have no hesitancy in giving his consent even if the condensation occurs in a newspaper advertisement with the mere general reference that these are the earning figures, but as more fully explained and perhaps even qualified in the registration statement.

#### SUMMARIES IN ADVERTISEMENTS

CHAIRMAN SWEET: Well, I suppose what Mr. Broad had said would apply also to the newspaper prospectus.

MR. BROAD: I would say yes—a fair summary. For instance, let us assume that in the last year the company changed its method of figuring inventory with the result that there was a profit shown where there should have been a loss. The inconsistency is mentioned in a note on the profit-and-loss statement with a statement perhaps that if the change had not been made then their earnings reported would be several thousand dollars less. Now there is a statement in the summary showing the bare figures and incorporating the notes by reference. It may be that the investor does not read the notes but he does read the wrong figures and is misled as to the earnings. The courts have ruled somewhere that means of information and information are not the same thing.

MR. SEIDMAN: It may be that I have not made the point clear. The specific part to which I had reference—and I think it is more or less the practice in these newspaper advertisements—merely says that the following are earnings as certified by John Jones and Company and as further explained or qualified in their certificate set forth in the registration statement, and I was wondering whether that is something to which accountants give their consent.

CHAIRMAN SWEET: I think that is a common method of setting it out in the newspaper prospectus.

MR. BELL: Well, it depends upon what the qualifications are.

MR. SEIDMAN: Is it to be assumed, then, that where the statement does appear in the newspaper advertisements, the qualifications are not of such a drastic character as perhaps to place the figures alone in a light that might lead to misunderstanding?

CHAIRMAN SWEET: I think that is a legal question.

MEMBER: Doesn't the advertisement usually state that a copy of the prospectus can be obtained from the underwriters?

CHAIRMAN SWEET: Yes, I think so.

#### PRO FORMA BALANCE-SHEETS

Is there any other remark on that? Shall we consider pro forma statements, which is the latter part of the topic?

I have heard it said by a good many that a shortcoming of the present form of prospectus usually given out is that it lacks a pro forma balance-sheet and, therefore, the investor finds it difficult to visualize the financial position of the company as it will be after consummation of the financing.

Now and then a pro forma balance-sheet is given in the prospectus and the accountant is asked on behalf of the underwriters to give a special certificate for the pro forma balance-sheet.

Have any of you had experience with a case of that sort? And is it your practice to give a certificate for a pro forma balance-sheet?

MR. ROBINSON: I don't suppose that any of us would be in a position to give the so-called certificate or an opinion with respect to a balance-sheet which purports to present a financial condition which has not existed.

Is not the pro forma balance-sheet merely a compilation of figures based upon statements with respect to which we have given our opinion, plus assumptions of certain transactions to be consummated?

I think that it is generally the practice for the accountant to give a letter to the underwriter or to his client merely stating that, based upon certain transactions and no others (set forth specifically in the head of the pro forma statement) and from certain statements (properly referred to) and with respect to the opinion given, a pro forma statement has been prepared and is submitted herewith.

CHAIRMAN SWEET: As I understand, you would not consent to the publication of your letter and your certificate in the prospectus?

MR. ROBINSON: I see no objection to the publication, but I should think there would be an objection to referring to it as a certificate, because it is a letter of explanation as to what has been done. You have taken certain figures and put them together and you must refer back to the balance-sheet and the opinion on such balance-sheet.

CHAIRMAN SWEET: And you would be willing then to give written consent to the use of your letter in the prospectus?

MR. ROBINSON: Well, with respect to that, our practice is to include in the consent the use of our name in the prospectus, always of course being sure that you see the prospectus before signing.

CHAIRMAN SWEET: Is there any other discussion on this?

#### ILLINOIS BLUE-SKY LAW

MR. CARROLL M. WHITE (Chicago): I think you will find that in Illinois registrations under the Illinois Commission require that a pro forma balance-sheet be given.

CHAIRMAN SWEET: Is that required to be certified under the Illinois blue-sky requirement?

MR. WHITE: It is.

CHAIRMAN SWEET: How does that work out in practice? Does it mean that if you have a registration under the securities act and some of the distribution is to be in Illinois, investors in other states than Illinois would receive the same prospectus as investors in the state of Illinois? Is that the practice?

MR. WHITE: I believe it is.

CHAIRMAN SWEET: So that you would have pro forma statements certified by the accountant in the prospectus filed with the S.E.C.?

MR. WHITE: I wouldn't say it was certified, but you will have to give a letter saying that the pro forma balance-sheet has been prepared giving effect to certain transactions.

CHAIRMAN SWEET: The Illinois law does not go any further than to require a letter signed by an accountant?

MR. BELL: I was going to say that we have written any number of letters in which we say we can't express an opinion as to the correctness of a pro forma, but we do so and so.

MR. BLOUGH: I would like to ask Mr. White a question for my own information. In the state of Illinois, if you have an offering there that you also register with the S.E.C., are you required to file a pro forma statement where there is not a firm commitment?

MR. WHITE: I couldn't answer that.

MR. HIMMELBLAU: You file it with the state, even if there is no firm commitment.

CHAIRMAN SWEET: Is that a part of the final prospectus that is distributed to investors?

MR. HIMMELBLAU: Filed with the state of Illinois.

CHAIRMAN SWEET: That was what I wanted to get at: whether it would become a part of the prospectus. As I understand it, it does not have to be in the prospectus.

MR. F.E. SEIDMAN: No, the Federal prospectus would have nothing to do with the requirements of Illinois details; in fact, in some respects Illinois requires many more details than the Federal prospectus does.

CHAIRMAN SWEET: Does that answer your question, Mr. Blough?

MR. BLOUGH: Yes, it does.

#### CHANGES SUBSEQUENT TO BALANCE-SHEET DATE

CHAIRMAN SWEET: We will consider No. 6, which is "Changes subsequent to date of balance-sheet prior to the effective date of the registration statement."

What is the responsibility of the registrant and of the accountant in reporting certain classes of events which have taken place subsequently to the date of the balance-sheet and prior to the effective date? What has been your experience in that? Is it your practice, let me ask, to make further examination of the registrant's books and inquiry of the officers and employees with regard to transactions that may have taken place out of the ordinary subsequent to the date of the balance-sheet and prior to the effective date?

MR. SEIDMAN: In the ordinary course, where there are transactions subsequent to the date of the balance-sheet but prior to the effective date, wouldn't anything material be properly included right in the certificate or comments, if any, so as to limit the problem to transactions that develop subsequent to the date of the certificate and prior to the effectiveness of the registration?

CHAIRMAN SWEET: Well, we have discovered in one of the remarks made here that the date of a certificate might be a very early date, and if the company is filing under the six-months' rule, it might be quite a long interval between the date of the balance-sheet and the effective date of the registration statement.

MR. WOODS: Mr. Sweet, it seems to me that the accountant can't have any responsibility for what happens after the date of his certificate and before the registration statement becomes effective—in many cases, because he may only be making annual audits and not be in a position to learn anything since the date of the certificate. Now, I should think the registrant, on the other hand, does have a responsibility of calling to the attention of the S.E.C. and filing with the

registration either explanations or an amended balance-sheet, if in the light of subsequent information the balance-sheet as already filed is obviously misleading.

MR. M.M. THOMAS (New York): Consider contracts signed between the date of the balance-sheet and the date of the certificate, when they were brought out in the registration statement. I am thinking of leases to be described under schedule 8. A lease signed a month after the date of the balance-sheet, but in effect and a binding contract upon the company as of the date of the certificate, must be given consideration.

CHAIRMAN SWEET: Mr. Woods, I am not giving a legal opinion, but doesn't the act itself say something about the liability of the expert as of the effective date of the registration statement

MR. WOODS: Well, I don't see how the accountant could possibly have access to reliable information after the date of his certificate if he isn't called in for any purpose after that date.

MR. BROAD: Suppose there should be a major flood in that particular section?

CHAIRMAN SWEET: Suppose a major flood destroys some considerable part of the plant, or at least puts it out of operation, and that the expense of restoration would be considerable—is that the kind of fact that should be mentioned as a note to the balance-sheet?

MR. WOODS: After the date of certificate the accountant should be kept in touch with flood conditions and general economic conditions. I think that really comes under Mr. Bell's exception. I am not sure whether it was Mr. Bell or Mr. Broad, but I think it was something they both agreed upon.

MR. SEIDMAN: Mr. Chairman, we received a deficiency letter on that specific point; a recapitalization or special dividend, I don't remember which, took place after the date of our certificate and we received a deficiency from the commission insisting that we give the facts and recast our statements, or give footnotes explaining it.

CHAIRMAN SWEET: Well, it is quite a different question from the effects of a flood.

MR. SEIDMAN: Well, I am wondering—is it just flood, or any material fact?

CHAIRMAN SWEET: Where do you draw the line? That is the question.

Can any one suggest the line of demarcation on this question?

MR. WOODS: I think, Mr. Sweet, that the recapitalization point is another question. There the S.E.C. says in effect: There are later developments regarding which the accountant should certify; kindly have your accounts certified with regard to this matter. That is very different from general responsibility of accountants to keep in touch with what might be happening after the date of the certificate in a case where he does not have daily access to the operations of a corporation.

CHAIRMAN SWEET: I regret to say that our time is up and that we will have to adjourn.