THE IMPORTANCE OF ACCOUNTING
IN THE WORK OF THE
SECURITIES AND EXCHANGE COMMISSION

Address

of

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Accounting plays an important part in the administration of most of the statutes which come within the purview of the Securities and Exchange Commission. Complying with the Securities Act of 1933 more than two companies file registration statements covering the sale of securities every business day. These registrations, which in the course of a year embrace practically every type of business enterprise, old and new, large and small, contain financial statements generally covering a period of three years together with comparative earnings summaries in most cases for ten years. And once a company has filed a registration statement in connection with the sale of securities it is required to file financial reports annually thereafter. Approximately 500 companies are now filing such annual reports.

There are presently listed on the various stock exchanges securities of more than 2000 companies which are required to file annual financial reports with the Commission pursuant to the Securities Exchange Act of 1934. The activities of more than 4000 security brokers and dealers are subject to the supervision of the Commission under this same Act and most of these broker-dealers also are required to file annual statements of their financial condition.

The Public Utility Holding Company Act of 1935 requires the registration of public utility holding companies and, among other things, the geographic integration and simplification of holding company systems, and the simplification of corporate and capital structures. Also recapitalizations, mergers, and consolidations of these companies and their subsidiaries are subject to approval by the Commission, as are, with certain exceptions, the issuance and sale of securities and the acquisition of securities and utility assets. All of these matters involve the submission of various types of financial statements.

Under the Investment Company Act of 1940 the activities of companies engaged primarily in the business of investing, reinvesting, and trading in securities are subjected to regulation by the Commission pursuant to which they are required to file financial statements under the circumstances commented upon previously in connection with the 1933 and 1934 Acts.

It is an important function of the accounting staff of the Commission to determine that these various financial statements are all that they purport to be – accurate, informative but concise, candid and uncolored – and to insure that they shall not be false or misleading with respect to any material fact or omit to state any material fact necessary to make them not misleading.

While we have promulgated certain rules and regulations governing the form and content of financial statements filed with the Commission and have prescribed classification of accounts with respect to utility holding companies and minimum audit procedures applicable to the accounts of broker-dealers, we have not attempted to lay down specific rules and regulations covering all phases of financial reporting. Instead we have depended in a large measure upon the accounting profession to establish and management to follow sound and generally accepted principles of accounting which, when consistently applied, will produce the type of financial statement necessary for the protection of investors. Likewise the establishment of standards which will insure adequate audit procedures has been left largely to the accounting profession. Thus most of the financial statements filed with the Commission must be certified by independent accountants.

Our certification requirements are contained in Regulation S-X (this is our basic accounting document and contains substantially all of our rules governing the form and content of financial statements), Rule 2-02 of which reads, in part, as follows:

> "(b) Representations as to the audit. – The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made

including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

"(c) Opinions to be expressed.—The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; and (iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

> "(d) Exceptions.—Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given."

Rule 3-07 referred to in (c) above requires that "If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

Most accountants' certificates which accompany financial statements filed with the Commission include the following or substantially similar wording:

> "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary
>
> "In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the _______ Company at _______, and the results of its operations for the year ____, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

Obviously the responsibilities of the accounting staff can not be fulfilled by the mere acceptance of financial statements certified by independent accountants; nor can we, in all cases, depend upon the profession to establish, or change where necessary, accounting principles and auditing standards expeditiously. The staff must not only satisfy itself that the statements are prepared in accordance with generally accepted accounting principles but must also determine to its satisfaction whether the principles followed have not become outmoded or are not applicable because of circumstances peculiar to the case in hand. To accomplish this the staff must keep abreast of accounting as well as economic developments.

The accounting profession has been striving for many years to establish a code of principles and practices which will result in financial statements that are meaningful, consistent with regard to the treatment of similar transactions, and which are not subject to misconstruction. Much has been accomplished in this direction, particularly during the last eight or ten years. The American Institute of Accountants has published thirty-one Accounting Research Bulletins and twenty-two Statements on Auditing Procedure which, while they may not always be followed religiously by the entire profession, have made the profession alive to its problems, and the Commission has been, I think, of considerable assistance in this program.

Usually when an accounting principle or practice, which may have been for many years the subject of debate among accountants, becomes generally accepted by the profession, it is included or reflected in our forms or regulations. There are, of course, exceptions to this procedure, principally in situations where, because of the requirements of the various statutes administered by the Commission, it is considered impracticable or contrary to the best interest of investors to adopt the profession's viewpoint. Such cases, however, are extremely rare.

In this connection the Commission, in 1937, announced a program "for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions." Pursuant to this program there have been published sixty-three Accounting Series releases, some of which indicate the Commission's views on accounting matters but most of which constitute an expression of opinion by the Chief Accountant concerning accounting and auditing principles and practices. Many of these opinions expressed by the Chief Accountant have their counterpart in the Institute releases referred to previously. There still remain, however, many points upon which the profession is not in agreement and in respect of which optional treatment is found reflected in financial statements; and new problems are arising almost daily.

One of these releases, No. 4, issued April 25, 1938, expresses a basic administrative policy of the Commission as to financial statements. It deals with the large area where specific rules and regulations as to methods and procedures of accounting to be followed are neither practicable nor desirable and where chief reliance of the Commission for the protection of investors is found in accounting principles and practices which have been recognized as sound by professional accountants generally. The release reads as follows:

> "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."

The application of Release No. 4 is well illustrated by Accounting Series Release No. 53. In that release the Commission dealt with a practice – tolerated by some accountants and sincerely advocated by others – pursuant to which the current income account was charged, under the heading of income taxes or charges in lieu of income taxes, not only with the actual amount of income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year. This additional charge against income was, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The principal conclusions announced in the opinion were that:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws;
2. The use of the caption “charges or provisions in lieu of taxes” is not acceptable; and
3. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off.

In the many cases considered by the Commission which led to the adoption of the release there seldom was any question as to the adequacy of the factual or technical disclosure furnished in footnotes. It was the Commission’s opinion that these disclosures, however extensive they might be, did not overcome the fundamental misrepresentation inherent in the resulting statement presentation. The Commission therefore reached the conclusion that amendments would be required pursuant to Release No. 4.

The other releases in the Accounting Series deal with such matters as losses resulting from revaluations of assets, investments in subsidiaries in consolidated statements, dividends on corporation’s own stock held in sinking fund, excess of proceeds from sale of treasury stock over cost thereof, balance sheet presentation of stock having preferences in involuntary liquidation in excess of par or stated value, unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from sale of capital stock, consolidation of foreign subsidiaries of domestic corporations, quasi-reorganizations, disclosure to be given certain types of provisions and conditions that limit the availability of surplus for dividend purposes, postwar refunds of Federal excess profits taxes, premiums paid upon the redemption of preferred stock, impropriety of writing down goodwill by means of charges to capital surplus, use of public accountants' names in connection with summary earnings tables, and independence of accountants. Additional releases will be published as and when the desirability thereof is indicated.

At present we are confronted with two problems which threaten to produce, and in fact are producing, income statements which, in my opinion, are more misleading than enlightening. One is the provision in current corporation reports to stockholders for additional or extraordinary depreciation allegedly necessary because of the unprecedented price levels; the other is the direct charging and crediting of items to earned surplus. Neither of these problems is new. Interest in the accounting for fixed assets follows closely the trend in the business cycle. The 1920's were a period in which the upward appraisal of fixed assets was popular and the importance of higher replacement costs and presence of values in excess of the book figures was stressed in financial, legal and regulatory circles. The 1930's saw a reversal of this situation and extensive writedowns or properties were the vogue, sometimes to the extreme of reduction to nominal amounts and the practical elimination of depreciation charges. Footnote explanations of the situation were a necessity if proper comparison of results for a series of years was to be made.

A little over a year ago the Commission considered a registration statement of a manufacturing company in which the footnotes revealed that fixed assets were carried at appraisal values. The independent accountants' certificate was in standard form and unqualified. Inquiry developed that the company followed the policy of recording reappraisals of its physical properties from time to time “to the end that the book value of the corporation’s assets and of its stock might approximate as nearly as possible to current replacement values.” We took the position that this procedure was contrary to sound and generally accepted accounting principles and required a revision of the financial statements to a cost basis despite the contention by the certifying accountants that the use of appraisal values for the purposes of reporting fixed asset values is sufficiently widespread to constitute the use of accepted accounting principles and practices. Accounting Research Bulletin No. 5 published in April 1940 was cited in support of our position. That bulletin states that “Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values in both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations.” No dissents to this bulletin by any members of the Accounting Procedure committee were noted. The cost basis for tangible fixed assets was reaffirmed in Bulletin No. 24 published in December 1944.

The term depreciation as used in accounting has been considered by the profession for many years and has been the subject of reports by the Committee on Terminology of the American Institute of Accountants. Two of these reports have been published in the Accounting Research Bulletin series, Nos. 16 and 20. The latter in November 1943 defined depreciation accounting as “a system of accounting which aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.” I had believed that this concept and that of the cost basis for recording tangible fixed assets had attained practically complete acceptance in accounting circles in this country. However, the high price levels since the close of the war have resulted in some evidence of a resurrection in business circles of the attitude of mind which prevailed in the 1920’s with respect to plant and equipment values and the accounting therefor. Recent public discussion in financial journals has revived the theory that depreciation accounting is directly related to replacement of fixed assets and that currently reported profits in most cases are overstated by the failure to recognize this alleged fact. Application of this idea in financial statements in a diversity of forms has come to our attention recently.

The Crane Co. in its annual report for 1946 discloses an item of $500,000 under reserves in its balance sheet labeled “Appreciation toward excess of future replacement cost of machinery and equipment over original cost.” The profit and loss statement shows a caption “Net profit for the year” from which the $500,000 appropriation is deducted and the final caption is described as “Amount of profit transferred to earned surplus.” The complete footnote explanation is “Pursuant to action by the Board of Directors, the Company made an initial appropriation of $500,000 out of 1946 earnings toward the excess of anticipated replacement cost over original cost of its older and less efficient machinery and equipment. This does not represent the total of such additional cost that would be experienced if the Company were faced with immediately replacing all of its machinery and equipment and does not take into account such possible costs in regard to land and buildings.”

While I can see no objection to this treatment of what is, in effect, a surplus reserve, I fear that the last figure on the profit and loss statement rather than the “Net profit for the year” before the deduction of the appropriation will be considered the net profit. An appropriation debit I the earned surplus account instead of in the profit and loss account would avoid the possibility of confusion.

A second approach to the problem of the effect of the high level of prices on fixed asset costs is found in a proposal which we were asked to consider to segregate by some formula the excess costs incurred in new construction and to amortize the sum so determined over an estimated limited period of excess earnings – the basic element to be subject to normal depreciation. This procedure carries over the principle of the treatment of war time emergency facilities to peace time operations. The idea seems to be subject to certain defects in conforming to the concept of allocation of cost over estimated useful life in a systematic and rational manner in that the period of excess earnings and extent of the excess cost appear to be difficult to determine.

A third treatment of the problem is that reflected in the United States Steel Corporation Quarterly Earnings Report to its stockholders for the quarter ended June 30, 1947. This report shows under the caption “Wear and exhaustion of facilities” two items – an amount based on original cost followed by an amount “Added to cover current cost,” $6,700,000 in the second quarter, $12,500,000 for the half year. No indication was given in the first quarter’s report that this innovation in accounting procedure had been adopted. The explanation in the second quarter’s report warrants quotation in full:

> “The reported income for the second quarter of 1947 reflects an increase of $6,700,000 in the amount deducted as a cost covering wear and exhaustion of facilities over that based upon the original cost of such facilities. The present-day cost of new facilities to replace those worn out through use in production is substantially more than the original cost of the facilities so replaced. If the charge for wear and exhaustion of facilities installed in earlier years is continued on the old basis of their original cost, the resultant reserve will be inadequate to cover the cost of the replacements which will be necessary when these earlier facilities have served their useful life.
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> “In the first quarter of 1947 the problem was dealt with tentatively by including a provision for a part of the cost of current construction in the charge for goods and services purchased.
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> “In the present statement the amount so charged and a corresponding amount for the second quarter are shown as additions to the charge for wear and exhaustion of facilities as ordinarily computed in the past. The principle involved is analogous to that applied by U. S. Steel since 1941 in the use of the ‘last-in, first-out’ method of determining the cost of products and services sold in respect

of inventories. However, the added amount for wear and exhaustion is not presently deductible for income tax purposes.

"The additional charges are equivalent to thirty per cent of the charges for depreciation as ordinarily computed in the past. This is materially less than the percentage of increase in cost of new plant construction over pre-war cost but it is deemed appropriate at the moment pending further study."

Note particularly that this explanation indicates that the charge of $5,800,000 to cover depreciation on excess replacement cost of facilities was included in the item "Products and services bought."

This procedure is clearly contrary to any concept of depreciation accounting which would distribute the <u>cost</u> of the assets over their estimated useful lives in a systematic and rational manner, and results in a direct understatement of profit as determined on the cost basis.

A fourth variant on the treatment of high construction costs appears in the case of DuPont. This company's semi-annual statement, as of June 30, 1947, to its stockholders includes under "Reserves" in the balance sheet an item "Excessive Construction Costs - $10,500,000," and a charge in the statement of Consolidated Income of a similar amount, of which $5,300,000 was for the first quarter. The charge is shown as a deduction immediately following the caption "Net Operating and Other Income" before arriving at "Net Income for the Period" and is captioned "Provision for Excessive Construction Costs." The amounts involved are approximately one-sixth of the resulting net income for each quarter. The note relating to the items reads as follows:

"Current construction costs are believed to be excessive. Therefore, effective January 1, 1947, the Company elected to anticipate accelerated depreciation in the early years of operation of newly constructed plants by setting aside out of Net Operating and Other Income a reserve for excessive construction costs in the year incurred. It is the present intention that, when the plants come into operation, depreciation will be provided at normal rates on the gross amount of plant cost."

As I read the quoted footnotes applicable to the DuPont and Steel statement it appears that these companies have determined that extraordinary depreciation charges are necessary for the current year on opposite grounds – one on the theory that current costs of construction are temporarily excessive and should be absorbed immediately; the other on the theory that present prices are here to stay, or at least for some time to come, and that replacement of current facilities will be at higher price levels which should be provided for now. I can find no basis for reconciling the procedure followed by either Steel or DuPont in their current quarterly reports to stockholders with any generally accepted treatment of depreciation or with the principle of matching costs with revenues. And, in my opinion, abandonment of the cost basis of accounting in favor of any of the plans so far revealed in current reports is unjustified unless and until reconsideration of every aspect of the problem indicates the propriety of such course. This position has been taken also by the American Institute of Accountants in a release to the press on September 25, 1947.

The other problem – the determination of whether and under what circumstances any charges or credits, other than dividend distributions and transfer of net income, may be made direct to earned surplus – is one of long standing. It involves two conflicting concepts of income statement presentation – the historical or "all inclusive" statement versus the earning power or "current operating performance" statement.

A bulletin now under consideration by the Committee on Accounting Procedure of the American Institute of Accountants dealing with Income and Earned Surplus recognizes the conflicting opinions on the subject and in effect supports the "current operating performance" concept since certain specified extraordinary items are required to be excluded from the determination of net income for the year if their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom, and these may be carried direct to earned surplus or shown separately after the determination of Net Income.

On the contrary the American Accounting Association has indicated its intention to not change the position taken on this subject in its statement of Accounting Principles Underlying Corporate Financial Statements. The Association's statement of the historical concept as applied to the income account was expressed in 1941 as follows:

> "Income is measured by matching revenues realized against costs consumed or expired, in accordance with the cost principle. All such revenues and costs should be reflected in the income statement. Only in this manner can the income statements of a corporation express completely its entire income history for a period of years. For any one year the income statement should reflect all realized revenues, and all costs and losses written off during that year, whether or not they have resulted from ordinary operations."

This apparently irreconcilable divergence of views between this spokesmen for the American Accounting Association and the American Institute of Accountants on a question of accounting of such fundamental importance is most disturbing to me; for it is to such bodies of professional accountants that the Commission looks for the authoritative statement of accounting principles which may be regarded as generally accepted.

While the accounting staff of the Commission has been, for many years, fully in accord with the views of the Association as quoted above and has lent its support to their general adoption, in view of the widespread disagreement on the subject among practicing public accountants and the convincing arguments advanced in support of both sides of this question we have not felt it desirable to freeze our views by recommending to the Commission the adoption of a rule on the subject. Instead it seems desirable to observe the effects of the Institute's proposed bulletin (if it is issued in its current form) in practice for a reasonable period, but continuing, of course, our practice of insisting upon income statements which in our opinion are not misleading. It may be that, as some of the proponents of the proposed bulletin intimate, supportable entries direct to surplus will be so rare under the provisions of the bulletin that the results will be acceptable. If this proves to be the case, it will be a long step forward in the development of meaningful and comparable profit and loss statements.

In closing I should like to impress upon those of you who may hesitate to choose accounting as your profession because you may think it is cut and dried and nothing remains to be done, that not a day passes which does not present either a completely new problem or an old one which requires reconsideration.