

PROVIDING FUNDS FOR OUR ENTERPRISES BY THE ISSUE OF SECURITIES

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The subject of my remarks was announced, I believe, as “Providing Funds for Our Enterprises by the Issue of Securities”. I didn’t think up those ringing words. That was obviously the work of a mind which controls a tongue more eloquent than mine. I can’t think of a topic, however, which gives me a wider freedom of choice and, hence, I shall use the title which was handed to me.

The economic history of this nation is a history of response by forces of incalculable magnitude – growth of large aggregations of economic power, the availability, indeed the rush, of surplus wealth for investment, the struggle of the great powers, the responsibility of world power, the development of weapons of mass destruction. Let us try to classify, if we may, the techniques by which such forces are handled. At the risk of over-simplification we can say that two methods have been employed – sometimes alternatively, sometimes concurrently – the development of counter forces or the imposition of legal controls.

Let me illustrate what I mean. Take the development of large aggregations of economic power represented in our giant corporations. Counter forces operating to control that power are competition of rival businesses and the collective bargaining power of labor unions. The legal controls operating to control the power are the anti-trust laws, the labor management relation laws, and the securities laws. Sometimes there have been attempts at voluntary self-imposed controls such as the cartels of Europe or the old NRA codes under the short-lived and unconstitutional National Industrial Recovery Act.

Take another example – the struggle of the great powers. On the one hand, we set up counter forces, rearmament, EDC, the winning of the atom race. On the other hand, we attempt controls, the League of Nations, the Naval Disarmament Treaty of 1922, the United Nations.

The wisdom with which we select a method or combination of methods of responding to these great challenges of our time determines the strength of our nation and may determine our survival.

Let me illustrate again. In some European nations private business has met the pressure of competition by a system of privately imposed controls – cartels with price fixing, allocation of markets, resistance to efficient methods of production, low wages, feeble attempts to develop mass markets. The result? A dangerous lack of popular support for private enterprise.

Now let me get a little closer to the announced subject of my remarks. This country has generated surplus wealth – savings if you will – available for investment. Corporations have been developed as a legal vehicle to bring together the savings of millions. There are some 7,000,000 stockholders in this country. One corporation has of over a million stockholders. If you consider the indirect investment represented by ownership of insurance policies and interest in pension funds, the savings of many more millions are invested in the American industrial economy. The result of this is a peculiarly American and Canadian phenomenon, a literal pressure of money saved by the general public to find a place for investment in business and industry.

What do we do with these forces? The corporations call for capital. The members of the public press forward to invest their savings. We might depend entirely on an automatic system of self-adjustment. Investors could learn by bitter experience; the buyer could beware; businesses which forfeited public confidence would fail; the strong would survive; there would be no restriction in gathering capital into enterprise. Any such concept involves an inexcusably naive confidence that good will always triumph over evil.

It is inherent in the nature of things that there must be some legal controls imposed on one man who gathers together and administers capital furnished by others. That is true of trust funds. It is true of bank deposits and in its own way it must be true of corporate capital. Corporations are artificial entities, creatures of the state. They are empowered to do only what the law says they may do. Their directors have duties both as to good faith and prudence. Their property must be handled with due regard to the rights of creditors and stockholders. These general concepts are incontrovertible, but an effective system of legal controls involves the development of detailed rules and effective techniques to insure compliance.

When we look at the function of the modern corporation in gathering and administering capital, what ends do we desire? What abuses do we seek to prevent?

- (1) We want to encourage investment – money in the mattress, jewelry in a vault are static wealth
- (2) We want no foolish, meaningless obstacles to the accumulation of capital.
- (3) We want opportunity for initiative and imagination to develop the full economic potential of an enterprise.

I don't need to tell you that there are a number of other things that we want also:

- (1) The investor should know what he is getting into when he buys securities.
- (2) The public owners of an enterprise are entitled to current information.

- (3) Financial information should be presented to investors with reasonable completeness and in accordance with generally accepted accounting principles.
- (4) The investor should have a remedy against someone who deceived him by misrepresentation or concealment.
- (5) A public stockholder should have a chance to vote intelligently at corporate meetings – not blindly.
- (6) The markets for securities should be free of manipulation.
- (7) People with inside information should not be allowed to make use of such inside information to the disadvantage of their fellow security holders, and transactions between such persons and the corporation should be subjected to careful scrutiny.
- (8) People engaged in businesses involving recommendation of investments, sale of securities, handling of other people's money and securities, should be registered and should be required to file publicly available information about themselves.
- (9) Trustees for corporate bond and debenture issues should be sufficiently independent to assure conscientious performance of the duties of such a trustee and the trustee should be required to perform its obligations with prudence.
- (10) In cases of reorganization of corporations in which there is a large interest of public creditors or public investors, there should be some assurance of administration by an independent trustee, a vigorous inquiry into the true financial status, and a sound, feasible, fair and equitable reorganization plan.

I am not going to go into detail as to how the several Acts administered by the Securities and Exchange Commission in the aggregate contribute to the attainment of these general objectives. This audience is acquainted with the statutory pattern of disclosure and regulation.

The effectiveness of both the disclosure provisions and the regulatory provisions of the statutes administered by the Securities and Exchange Commission is based in great measure on the reliability of financial information and the presentation of that information in accordance with sound accounting principles.

Generally speaking, the information most determinative of the value of a security and the progress of its issuer is the financial condition of a business and the financial results of its operations.

Many of you remember the comment made in 1926 in William Z. Ripley's book "Main Street and Wall Street":

"The advocacy of really informative publicity as a corrective for certain of our present corporate ills must be placed in its proper relation to the whole matter of democratization of control. A prime argument which raises its head at the outset of all discussion of share-holders' participation in direction is that the shareholder – the owner, in other words – is hopelessly indifferent to the whole business. His inertia as respects the exercise of voting power, and almost everything else, is an acknowledged fact. But no one expects it to be otherwise. No one believes that a great enterprise can be operated by town meeting. It never has been done successfully; nor will it ever be. The ordinary run of folks are too busy, even were they competent enough. Nor is it true that the primary purpose of publicity, the sharing of full information with owners, is to enable these shareholders to obtrude themselves obsequiously upon their own managements. But such information, if rendered, will at all events serve as fair warning in case of impending danger. And this danger will be revealed, not because each shareholder, male or female, old or young, will bother to remove the wrapping from the annual report in the post, but because specialists, analysts, bankers, and others will promptly disseminate the information, translating it into terms intelligible to all.

" . . . This, then, is the ultimate defense of publicity. It is not as an adjunct to democratization through exercise of voting power, but as a contribution to the making of a true market price. This is a point but half appreciated at its real worth."

Not only is the information concerning its financial affairs important to the present and prospective investor as a means of evaluating the security which he owns or considers buying, but it is obviously the most significant source of information for the Commission and the courts in carrying out the regulatory provisions of the statutes which Congress has enacted in the public interest and for the protection of investors. In other words, accurate accounts are a tool for performing most of the jobs required to attain the general objectives which I listed a few minutes ago.

I will not enumerate these powers beyond saying that the statutory language in each case is broad enough to give the Commission power to prescribe principles of accounting and classification of accounts.

The Commission nevertheless has not generally speaking adopted rules which prescribe principles of accounting except in the case of public utility holding companies and service companies.

Rather, the Commission looks to the standard of general acceptability of the accounting principles followed in a particular report or registration statement in

determining whether or not such report or statement should be accepted without comment. The basic concept is stated in Accounting Series Release No. 4, April 25, 1938:

“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.”

If a registrant makes a filing stating accounts on principles for which it claims there is substantial authoritative support, there can readily arise arguments as to whether the claim for support is well founded.

You cannot write rules to answer questions like that. The discussions will go on through the years because accounting is not a branch of mathematics like arithmetic or geometry.

I would like to associate myself with a thought expressed in the introduction to the Restatement and Revision of Accounting Research Bulletins, published in 1953 by the American Institute of Accountants:

“Changes of emphasis and objective as well as changes in conditions under which business operates have led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently diversity of practice may continue as new practices are adopted before old ones are completely discarded.”

It is not possible forever to clothe a growing boy in the same suit of clothes. If it is not practicable to have accounting principles formulated for SEC purposes, the occasional arguments and disagreements must go on. We must reconcile ourselves to suffering together from accountancy's growing pains.

The ideas which survive are those which become accepted because their application produces sound results in the multiplicity of particular situations which arise in a practical world.

From my own field, the law, I call to your mind Justice Holmes' remark: "The life of the law is not logic but experience."

Recognizing the fluid character of the stuff we work with, the Commission tries to keep itself informed not only through careful discussions in passing on specific problems, but also by conferences with representatives of the accounting profession, both with controllers and with independent accountants. We have been taught the importance of moving but not moving too fast. We are inclined to heed the injunction of the eighteenth century poet who said:

"Be not the first by whom the new is tried,
Nor yet the last to lay the old aside."

We have had discussions on accounting for stock options and the accounting problems raised by accelerated amortization. On the former we have adopted a rule permitting disclosure treatment. On the matter of amortization of emergency facilities, we have been pulled both ways by registrants, by the June, 1953 Bulletin of the Controllers Institute and by Bulletin 42 of the American Institute of Accountants. We are accepting in respect of 1953 reports statements of accounts which amortize the portion of the cost of properties covered by certificates of necessity over the five year period as well as statements of accounts which depreciate the cost of such facilities over the probable useful life of the facilities but give recognition to the resulting reduction in income tax benefit after the close of the amortization period. The transitional stage of the thinking on this subject exemplifies the process of getting an accounting principle generally accepted. The registrants in filing statements on either basis have been making adequate disclosures as to the method followed and the effect which would have been produced if the alternative method had been followed.

We have been importuned to greater liberality in balance sheet treatment of assets acquired as a result of a fortunate purchase, but we shall continue to be practically deaf to the persuasion of appraisals.

We have had several discussions – some practical and some academic – on departures from cost in the handling of depreciation. We find that that last mentioned subject stimulates equally passionate argument on the part of both proponents and opponents. I will not breathe a thought on that subject this morning. We have had discussions as to the responsibility of the independent accountant to insist upon employing adequate auditing procedures.

We have had several problems in respect of foreign issuers. Nice questions are frequently posed by the arithmetical impossibility of converting the result achieved by one method of accounting into a result which would have been achieved by the application of another. An overall policy question is presented to us in the matter of accounts and other disclosures by foreign issuers. The national interest in encouraging American investment abroad would naturally suggest removal of purely artificial barriers to the access of foreign issuers to American capital markets. On the other hand, if foreign

standards to disclosure and accounting are not up to our standards, it might well be that lowering our standards for foreign issuers would result in a general lowering which would not be in the public interest. It is hard to conceive of an aggressive, two-fisted, American corporate executive not insisting upon "most favored nation" treatment from an American regulatory commission.

The fact that these problems exist does not indicate a turmoil of controversy. When one considers the vast complex presented by the accounting problems of American industry, it is almost a miracle that the areas of controversy are so small.

Private organizations like the Controllers Institute and like the American Institute of Accountants have had a great deal to do with the achievement of the high standard of American accounting. The Securities and Exchange Commission and the Acts administered by it have contributed to the development of better and more informative corporate accounting and reporting.

The discipline of legal liability has been imposed upon issuers, officers, directors, controlling stockholders, underwriters and experts. At the time the Securities Act was adopted there was strong protest to the effect that the imposition of such liability would deter capital formation. While the liability provisions have restrained exuberance in the presentation of material, they have not materially slowed down the process of capital formation nor have they resulted in a wave of law suits. As controllers your name goes on a registration statement under the Securities Act. The Form S-1, as you know, calls for the signature of the issuer's controller or principal accounting officer. The liabilities of Section 11 of the Securities Act are imposed upon every person who signs the registration statement. On matters of accounting, therefore, the controller cannot avoid being "it". It would be hard to argue that this liability has not contributed to improved accounting standards and procedures.

The Commission has loaned both moral and legal support to those who have helped to develop better and more informative corporate accounting practices. It has goaded a good many stragglers into falling in line. I cannot see, in view of the categorical language of the statutes which it administers, how the Commission can do otherwise.

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