

CORPORATE ACCOUNTING STANDARDS UNDER
FEDERAL SECURITIES LAWS

Address of

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It is a great pleasure for me to have the opportunity to address the Eighteenth Annual Accounting Institute of the College of Commerce of Ohio State University on the subject of corporate accounting standards under the Federal securities laws. The eighteen years during which this great university has annually sponsored this two-day gathering of distinguished scholars, practitioners and students in the accounting field are the years in which the great evolution of accounting standards has occurred, under guide lines and standards set by the Acts of Congress administered by the Securities and Exchange Commission.

Parenthetically, may I say, as a member and Chairman of the Securities and Exchange Commission, I feel a close relationship with Ohio State University, in this way. As an independent agency, the Commission is by statute under the surveillance of two standing Committees of the Congress. In the Senate the Committee which watches over the Commission is the Committee on Banking and Currency, of which your trustee and distinguished Senator, John W. Bricker, is a member. In my talks with him from time to time he has often spoken of his great interest in the growth and accomplishments of Ohio State University, and of its College of Commerce, under whose auspices this Accounting Institute is held.

Before discussing accounting standards as such, I want to emphasize the great importance the accounting standards developed under guidance of the Securities and Exchange Commission, with the aid of the profession, over the past quarter century have had for the economy of America, and hence for the people of America. Good accounting is the essence of financial reporting. Good financial reporting to investors and security holders is the only way by which the public can be put in a position to make intelligent investment judgment. There are at the present time 2,238 issuers required by the Securities Exchange Act of 1934 to file financial reports with the Commission because their securities are listed and traded on national securities exchanges and 1,104 additional issuers required by the Securities Act of 1933 to file such reports because of having made public sale of their securities in interstate commerce. The development of the enormous body of financial information, by reports prepared under the accounting standards of the Securities and Exchange Commission and in accordance with accounting principles deemed by the accounting profession to be generally acceptable, with respect to these listed and publicly financed corporations has been a vital factor in the restoration in the past few years of investor confidence in the securities markets. This confidence was badly shaken in the 1920's and early 1930's, as a result of abuses in the securities markets. On continued public confidence in the securities markets of the country depends the ability of the privately owned system of productive enterprises to raise the capital which will be needed in enormous amounts to finance the industrial expansion required for our increasing population and higher standard of living in the years immediately ahead.

The capital requirements of American industry in the next decade are expected to be very much greater than those of the years just passed, but let me tell you of them briefly to give you a glimpse of the enormous amounts of money involved.

In the years 1946 to the present new records for industrial expansion were established and for public financing by business corporations. In this period business corporations spent \$52 billion on increases in working capital and \$196 billion on plant and equipment. The corporations obtained \$178 billion of the funds required from internal sources, retained earnings, depreciation accruals and the like, but raised \$63 billion of new money (net of retirements) from the sale of new securities and bank and mortgage financing. Furthermore, of the securities sold, 22% were equities, that is capital stock. The confidence of the investing public in the securities of corporations can only be based on sound financial reporting. With that confidence continuing he enormous amounts of capital funds which must be channeled from the savings of the American people into our privately owned corporate enterprises will be raised and our free enterprise system will advance in accordance with our expanding needs.

With this larger orientation, now let me come to the more specific area of discussion, corporate accounting standards under the Federal securities laws. These are the laws administered by the Securities and Exchange Commission.

The rapid increase in the use of corporate forms of organization and the great size to which some corporations have grown, with the accompanying subdivision of ownership and the separation of immediate control of operating policies from the stockholder owners, have made reliable accounting reports a vital necessity for managerial control and investment management. While investors cannot expect to obtain from financial statements all the information necessary to the exercise of investment judgment, nevertheless financial statements come close to being the only common measure of comparison of different companies and are the basic sources of all financial information.

Accounting and financial information plays an important part in all of the work of the Securities and Exchange Commission. In the administration of the Securities Act and the Exchange Act accounting plays a most important role. These Acts have had the greatest influence on the development of the present character of corporate accounting standards. The important role accounting plays in the administration of the Securities Acts is foreshadowed in the Acts themselves.

The title of the Securities Act states that it is "an Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."

It is designed to make available to investors the business and financial facts deemed by the Congress to be necessary for the investing public on which to base an informed judgment as to whether to buy new issues of securities being offered.

The title of the Exchange Act states that it is "An Act to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

This law provides for, among other things, the filing by listed companies of periodic financial reports. It provides for regulation by the Commission of solicitation by listed companies of proxies from their stockholders. It requires brokers and dealers to maintain certain records and file certain reports with the Commission. All of these provisions in most instances require the filing of financial statements certified by independent accountants. The aim of this legislation is broader than that of the Securities Act in that it is to provide the information to be used by the investor in determining what securities to buy, hold or sell. It also contains regulatory provisions regarding the stock exchanges and the over-the-counter markets.

The enactment of the Federal securities laws and the establishment of an administrative agency, the Securities and Exchange Commission, to effect recognition of the investor's interests have created unusual demands on accounting and the accounting profession and have had a forceful impact on the trend of accounting thought and development of reporting techniques. Under these laws the fundamental basis of regulation is disclosure -- disclosure of all pertinent information concerning the securities and the issuers. Neither the Securities Act nor the Exchange Act gives the Commission authority to pass on the merits of any security, or to approve or disapprove any security. For this reason these laws are called disclosures Acts. They also include vital antifraud provisions.

The components of a matured investment judgment are not susceptible of exact mathematical determination. Particular facts which induce the investor to buy or sell or hold are often extraneous to the business itself or even the industry. Judgment as to the future of the industry or the competitive position of a company in its industry, or judgment as to the ability of the management may be the immediate motivating force in reaching an investment decision. Such a decision to be an informed judgment, however, could be made only after an analytical study of the available financial information.

The backbone of the information to be used in arriving at such a decision is the operating history and financial position of the corporation as reflected in its financial statements. This is basic information. This factual information is the starting point for any analytical study, whether it be to review the operating efficiency of the company, to appraise its financial position or the caliber of its management, to formulate business plans, such as for expansion, retrenchment, or direction of sales effort, or for investment analysis.

The statements required in the Commission's forms are the conventional balance sheets, income and surplus statements and certain supporting schedules. The registration statement forms for new issues of securities usually require three-year income and surplus statements and in the prospectus to be delivered to the investor a summary of earnings for an appropriate period, usually not less than five years.

The form and content of the required financial statements are set forth in the Commission's accounting rules, known as Regulation S-X. This regulation does not

purport to define accounting principles. It merely defines the extent of the detailed information required in conventional terminology and present accounting practice. It was worked out with the advice and cooperation of the accounting profession, and is under constant revision in the same spirit of cooperation.

The Securities and Exchange Commission has often been importuned to write accounting principles into Regulation S-X. We have even been petitioned to adopt rules requiring corporations to conform to advanced accounting theories, such as “economic depreciation.” But the Commission has wisely left the development of accounting principles and practices to the accounting profession and the educators. This approach has been urged upon us in the past by leaders in both the practicing and the academic sectors of the profession.

This does not mean that we have abdicated our authority or delegated it to the accounting profession. The Securities Acts give the Commission authority to require financial statements certified by independent accountants. In most instances we require that the statements be certified by independent accountants and we have taken steps to insure that the accountants will be independent.

Likewise, the Securities Acts require that a broad schedule of information be furnished and leaves the Commission a wide latitude as to the amount of detail to be required, even to defining the method to be followed in the preparation of the reports. Section 13(b) of the Exchange Act states:

“The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income***.”

But the Securities Acts do not attempt to define corporate accounting standards to be used in writing those rules and regulations. They do not even mention accounting principles. These matters are left to the discretion of the Commission.

Consequently, while our regulations use generally accepted accounting terminology and we expect financial statements filed with us to be prepared in accordance with generally accepted accounting principles and practices, as we believe that this will best indicate their significance and character, we are in no way limited to accepted accounting practice in obtaining such information as we deem necessary or appropriate for investors. Many requirements in Regulation S-X were not required by generally accepted practice at the time the rules were adopted. For example, Rule 3-19 of Regulation S-X requires disclosure in footnotes of assets subject to lien, intercompany profits and losses, defaults, terms of preferred shares, pension and retirement plans,

restrictions on the availability of surplus for dividend purposes, and contingent liabilities. Likewise, Rule 3-20 requires disclosure of installment sales, intercompany profits and losses, depreciation and amortization policies, and stock options to officers and employees.

The Commission's staff has recently made a study of the stockholders reports of some 1,200 unlisted companies which have at least 750 stockholders of one class and \$2 million of total assets. This study showed that while about 85% of the reports gave a complete set of financial statements, that is, balance sheet, income and surplus accounts, and generally followed accepted accounting principles and practices, at least 50% of them failed to give the type of information I have just mentioned.

Even more important than the extent of the detail of information required or the endeavor to obtain adequate information is the accuracy and integrity of the information obtained. The Commission attempts to restrict the financial statements to pertinent factual information and to avoid the inclusion of forecasts or evaluations of securities. It is the Commission's practice to test the information furnished for substantial truth and accuracy but to leave the investor to draw his own conclusions.

Financial statements filed with us are required to be prepared on the historical cost basis as determined by conventional accounting practices. They are in most cases required to be certified by an independent public accountant. Under both the Securities Act and the Exchange Act, the corporation filing must sign the registration statement or annual report through an authorized officer. In addition, in a registration statement under the Securities Act the principal executive officer, principal financial officer, and principal accounting officer, and a majority of the board of directors must sign the registration statement. The management is therefore responsible for the preparation and reliability of the financial statements, which are required to be reviewed independently by accountants who are not connected with the business. Thus there is a dual responsibility imposed upon both management and independent accountants for the financial statements. This dual responsibility is not satisfied if the accountant is not independent as defined in our rules and regulations, or if the management has left its accounting responsibilities to be performed by outside accountants. This does not, of course, prevent the management from relying on the report and audit of an independent accountant to the extent that they may legally rely upon the report of an expert.

Although we discourage persons filing registration statements and other statements and reports from including evaluations of the security being offered and forecasts of earnings, we do not underrate the importance of current values, economic and financial analysis, and interpretations and forecasts. But we consider that these are beyond the scope of financial statements and of the basic factual information required by the Securities Acts under their disclosure standards. A sharp distinction should be drawn between the presentation of factual information and interpretations, forecasts and conclusions. As a general rule, for a person preparing and certifying accounting data to go beyond factual information detracts from the reliability, integrity and usefulness of the report.

It is because the Commission considers the integrity and accuracy of this basic financial information of first importance that it has throughout its existence resisted the pressure to accept the reflection in financial statements of departures from historical cost. By historical cost is meant the appropriate cost basis as determined by conventional accounting practices and techniques. There are many problems connected with determination of historical cost. We do not, however, object to showing in a proper manner factual evidence of increases in value of assets during the time held by the corporation, or the effect on the operating results or financial position of changes in price levels.

While, in general, we adhere to the historical cost principle, we also have to deal with all problems which come before us in the regular course of business. For example, in certain instances we have not objected to the determination of an appropriate initial carrying value in excess of cost to the last purchaser in situations in which historical cost principles were deemed not to apply. These situations are concerned with the determination of original carrying value, usually to a new corporation under circumstances approaching arm's-length bargaining, and where the value of the assets in question have been substantiated by appropriate means. We do not, however, consider these determinations as judgments of principle, but rather as interpretations of conflicting principles. We do not consider them necessarily as precedents, but as each such problem arises we consider its own merits. We have indicated in recent discussions with representatives of the accounting profession our desire to review this area of accounting thought to determine whether a satisfactory expression of the principles could be developed.

In summary, the main aim of the Securities Acts is good financial reporting. Accounting does not encompass all financial reporting, but it is the backbone of financial reporting and is of vital importance in the administration of the Federal securities laws. It is most significant for corporate accounting standards under the Federal securities laws that the accounting profession, industry and the Securities and Exchange Commission have cooperated in the development of appropriate standards of reporting and disclosure to meet changing conditions. This progress must continue if the confidence of the American people in the corporate securities markets is to be earned in the years ahead, and this, as I stated at the beginning of these remarks, is of vital importance to the continued success of our free enterprise system.