

A REVIEW OF THE COMMISSION'S ADMINISTRATIVE
POLICIES RELATING TO FINANCIAL REPORTING
UNDER THE SECURITIES ACTS

Address by

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before

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In the course of preparing for this meeting today, I have spent a great deal of time tracing the activities of many predecessors on the Commission, members of our staff and members of the accounting profession who over the years have spoken out as to the meaning and purpose of accounting and the proper role of an agency such as ours in overseeing the marshaling and presentation of corporate financial data. In fact, at times I thought I must have become involved in the longest of all debates. For certainly, a debate which seems to have persisted for a whole generation can hardly be called a short argument.

Clearly, we have made a great deal of progress since the early years of our statutes--though not nearly as much as some might wish. It is clear, too, that the basic problems of definition and policy remain largely unchanged--problems for which no easy solutions or "generally accepted principles"--if I may borrow a phrase--are readily at hand.

In our Federal regulatory scheme as it pertains to the securities business, which surely is unique among all such systems, the particular aspect of that scheme as it relates to corporate accounting for public consumption is not only itself unique--it is remarkable, and to some apparently quite incomprehensible. Further, I gather that on occasion it is viewed, even by some of those in the profession, as a most tantalizing exercise in frustration.

Let us begin with the Securities Act, which, as you know, provides for the delivery to the buyer of a prospectus for registered issues of securities and governs the content of the prospectus and the underlying registration statement. With respect to accounting matters, it conveys the most simple and explicit direction and authority of all of our statutes. It provides in Schedule A, paragraph 25, for a balance sheet--in such detail and form as the Commission shall prescribe--certified by an independent public or certified accountant. And in accordance with paragraph 26, a profit and loss statement of the business must be furnished--in effect for three years, year by year--certified by an independent public or certified accountant.

Although paragraphs 25 and 25 specify considerable detail as to the content and form of these statements--"as the Commission shall prescribe," a much more comprehensive authority as to accounting matters is to be found in Section 19(a). I will avoid restating statutory provisions, but I believe it generally to be conceded that the Commission has broad powers to prescribe accounting rules of all types; that is, not only procedural rules but those having to do with the nature and content of accounts, their classification and their manner of presentation.

The very first Rules and Regulations under the Securities Act were issued by the Federal Trade Commission and are dated July 6, 1933. They consisted of seven and one half pages and could be purchased from the Superintendent of Documents for five cents. Article 15 of these rules was entitled "Certifications by accountants or other experts" and prescribed the content of the certificate.

The Securities Act requires financial statements and requires that those financial statements be certified. Nowhere in the Act, however, is there any indication of what an accountant is supposed to say in his certificate or what he is supposed to do before he says it.

It is noteworthy, it seems to me, that among the very first rules adopted by that first Commission over thirty years ago, the only one of a really substantive nature was an effort to provide a meaningful expression by the accountant of his views as to the financial statements. It is fairly clear, too, that that first Commission felt it must look to the statute itself for the standard to apply to the accountant and his certification, and in doing so, it selected a standard based on the civil-liability provisions of Section 11 of the Act.

A year later the Securities Exchange Act (1934) dealt somewhat differently with accounting matters for listed companies. Section 12(b)(1)(j) called for balance sheets for not more than the three preceding fiscal years certified--if required by the rules and regulations of the Commission--by independent public accountants. Subparagraph (k) required profit and loss statements for not more than the three preceding fiscal years also certified--if required by the rules and regulations of the Commission by independent public accountants.

This statute also in Sections 3(b) and 13(b) grants the Commission broad powers with respect to accounting methods to be followed in the preparation of financial statements for inclusion in applications for registration and periodic reports filed with the exchanges and the Commission. Here, unlike the Securities Act--whether certification of financial statements should be required was left to the discretion of the Commission. Here--as in the Securities Act--no statutory standard with particular reference to the scope of the accountant's activity or the content of his certificate was indicated.

I will mention two other statutes only briefly just to round out the statutory framework as it pertains to our immediate subject. In the Public Utility Holding Company Act of 1935 is to be found the first statutory reference to the need for uniform standard accounts, and Section 15 grants authority for a requirement for a uniform system of accounts. Here, as in the 1934 Act, it is left to the discretion of the Commission whether financial statements shall be certified.

The Investment Company Act of 1940 seems to me to deal more elaborately in a general sort of way with the subjects of accounts, record-keeping and reports to security holders than any other of our statutes. An extensive preamble emphasizes the importance of financial and accounting policies of investment companies. There is broad rule-making authority with respect to financial records and accounts. There is to be found in Section 31(c) authority for the Commission to issue rules and regulations providing for “a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounts and in preparing financial statements required pursuant to this title.”

This is the only reference to accounting principles I've been able to find in our statutes. In this connection, I might add that Section 19 makes it unlawful for any registered investment company to pay any dividend . . . from any source other than . . . accumulated net income determined in accordance “with good accounting practice.”

So there is the origin of our problem. History, common sense and experience tell us that at the heart of our whole system of securities markets, securities credit, public ownership of business, raising funds for industry and the mobility of capital are faith and trust in the honesty of corporate financial records and the honest, objective and timely distillation of those records in

published financial statements which provide a basis for a multitude of business judgments. One who weakens that trust without good cause does no one a service. One who trusts a system which really is not serving well its purposes may on occasion be deceived.

Our statutes deal in different ways with powers and authority concerning form and content of financial statements, rule-making, certificates and liabilities. But Congress made it abundantly clear in all of them that the ultimate responsibility for the quality, integrity and content of corporate financial statements filed with the Commission or prepared pursuant to these statutes rested with the Commission, and I think it is clear that it was intended that we use that power to discharge such responsibilities within the general policies and objectives stated in the various Acts. However, the legislative recognition of the need for the skilled objective scrutiny of the independent accountant was not only a Congressional tribute to a profession; it also reflected a hope and provided an opportunity for professional action which would emphasize the significance of "independent."

The new Securities and Exchange Commission was faced immediately with the problems of corporate reporting under the Exchange Act, and the form and content of financial statements to be furnished with applications for permanent registration on the exchanges and to be supplied on a periodic basis under Section 13.

The first major effort in this respect was reflected in the adoption of Form 10 for listing applications and Form A-2 for registration of securities of seasoned companies under the Securities Act.

In January, 1935, Commissioner George C. Mathews made an address before the Illinois Society of Certified Public Accountants explaining the purpose of the two new forms, that they had been prepared in consultation with experts from industry and the universities, and expressing the hope of the new Commission that industry would find them useful and workable. He then went on to make a statement which obviously reflected a major-policy decision. He doesn't tell us whether that decision was one compelled by limitations of time or knowledge or was one reflective of a philosophy committed to disclosure until disclosure proved inadequate.

I quote from Mr. Mathews: "I should like to point out that the Commission has carefully avoided requiring uniformity of accounting either as to matters of classification or as to matters of principle. It has provided for a degree of uniformity in methods of reporting the results of business operations and the financial condition of the business, but even here its requirements are not rigid"--I continue to quote--"Let me read you from the instructions issued with Form 10, the following:

"The registrant may file statements and schedules in such form, order and using such generally accepted terminology as will best indicate their significance and character in the light of the instructions."

Two years later, in January, 1937, Commissioner Mathews spoke before the Milwaukee Chapter of the Wisconsin Society of Certified Public Accountants. He referred to the fact that the Commission had not adopted general regulations governing accounting methods; that it had

sought to attack each problem as presented in an individual case, sorting out, case by case, improper accounting practices, securing correction of statements and criticizing methods reflected in some statements.

He mentioned that there had developed some difference of views among the accountants as to this policy--some leading accountants reporting considerable improvement and urging the Commission to continue its case-by-case appraisal--others favoring the formulation of general rules, believing that these would be helpful to them and their clients.

He observed that a "governmental agency should frame rules to govern the exercise of professional functions only when the need for such rules has been shown to be of real public importance. Mere preference of the administrative agency for one form or one method is not sufficient reason for taking the formulation of principles and practices out of the hands of the members of a profession, and where the profession gives evidence of its capacity and willingness to develop and apply proper methods without evasion or undue delay, it should be encouraged to take on the responsibility."

While acknowledging progress, he pointed to three or four reasons why much remained to be done--the profession is highly competitive--traditionally, the services of American public accountants have been rendered to management as distinguished from investors (this is 1937, remember)--this phenomenon is referred to in a later speech of Mr. Mathews as "...manifestations of environmental influences in the work of accountants before us . . .," a tendency to rely on precedent and authority rather than on the scientific method. Again, he refers to a situation which obviously concerned him--"The competitive nature of the profession and its traditional affiliation with management make the acceptance of precedent dangerous."

Then in December of 1937, Commissioner Healy spoke on the subject "The Next Step In Accounting" before the American Accounting Association. He referred to the disappointment which followed from the decisions of the Commission by a divided vote not to attack the registration statements filed under the Securities Act by four then and now well-known companies. "It seems interesting," he said, "to note that the most serious differences of opinion that have ever occurred among the commissioners [this was in December, 1937] centered about an accounting problem, and yet, as you will see, there was no difference of opinion as to the accounting."

In the four cases referred to, what had happened in effect was that assets had been written up and charges for unamortized debt discount or other costs chargeable to income had been written off against the appraisal surplus. The accountants' certificates either approved or failed to disapprove of the accounting procedures followed.

Judge Healy stated that all of the Commissioners disapproved the accounting. The majority believed that there was such complete disclosure by footnote or otherwise in the registration statement as to comply with the statute and make a stop-order proceeding improvident, and further that the accountant's certificate had in effect condemned the accounting. The minority took the view that the accountants had expressed no clear opinion as to whether the accounting was good or bad, that the Company's earning record and earned-

surplus balance as stated in the registration statement were in effect untrue--amounted to a misrepresentation and therefore were violations of the statute. He went on: "The argument as I have tried to indicate revolved about differences as to the law rather than differences as to accounting. I regret that an attempt was not made in these cases to establish the principle that if an earnings statement and a balance sheet reflect the results of improper accounting, they amount to misrepresentations or misleading statements in violation of the Securities Act."

Both Judge Healy and Mr. Mathews indicated quite clearly that the Commission was well aware of its powers (under Section 19(a) and Section 13(b)) and that thought had been given as to when and how those powers might or should be employed. Judge Healy, who had spent six years on the public-utility investigation of the Federal Trade Commission (which eventually led to the 1935 Act), was probably the most experienced in accounting matters. He mentioned that the staff was giving thought to rules dealing with accounting and appraisals and went on to say, ". . . my experience with accountants leads me to the conviction that they regret that standards are not more exactly defined. They recognize as we do that in many aspects of accounting, inflexible rules cannot now be laid down. But it cannot be that there are no real standards in accounting. It seems to me, that one great difficulty has been that there has been no body which had the authority to fix and maintain standards. I believe that such a body now exists in the Securities and Exchange Commission. Its success or failure will depend in large measure on how wisely it exercises this function."

These observations by two of the members of the first S.E.C. concerning accounting matters reveal a thorough appreciation of the fundamental importance of a proper choice by the Commission of the policies and role to be followed by the Commission in the administration of the Acts. They also reveal, in my judgment, a great deal about progress, or claims as to the lack of it, in the matter of accounting principles or procedures and the qualifications of accountants.

Most of the matters they mentioned in those days as representing serious flaws in need of correction and many of the problems which then seemed to call for rules by the Commission have long since ceased to be problems or are now rarely so, and solutions or eliminations, however you view it, have been accomplished by the operation of a system which I think has been quite effective despite the absence of the rule-making hat then seemed perhaps inevitable.

In this connection, I shall draw on Mr. Mathews once more before I resume my historical journey. In a speech delivered in May of 1938 before the Institute of Accounting of The Ohio State University, he comments again on what he terms the Commission's response to the accountant's desire that he be given no too rigid standard--

"And if several years of administration of the legislation have taught us anything, it is that, in large portions of the field of accountancy, we cannot predict that tomorrow's case can be adequately handled by today's technique, for yesterday's technique has so often proved insufficient today. As administrators, we are loath to trust our judgment much beyond the particular case. We can advance or withhold criticism on the particular facts but we are hesitant of treating our decision as precedent or principle."

In April, 1938, a major-policy decision of the Commission--which I am told grew out of the dispute mentioned by Judge Healy--was reflected in the adoption of Accounting Release No. 4:

“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.”

In the meantime, another important development was occurring. The accountants had not been satisfied with the form of certificate prescribed by the first rule I mentioned, and discussions between the profession and the Commission resulted in a modification of the rule in early 1934. The most significant change was to call for an opinion that . . . the attached financial statements truly and fairly reflect the application of accepted accounting practices to the facts disclosed by our investigation....

This rule also was not satisfactory to the profession or the Commission and a further change was made in March of 1935. For the first time the rule required the certificate to be reasonably comprehensive as to the scope of the audit and “shall state clearly the opinion of the accountant or accountants in respect of financial statements of and the accounting principles and procedures followed by the registrant.” The rule was amended again in 1936. The present requirements for accountants’ certificates (as reflected in Rule 2-02 of Regulation S-X) embody the fundamentals of the 1936 revision.

It seems clear that Judge Healy, in referring to the divided vote, had in mind a confrontation which might well have led to a court test of the principle the minority sought to establish as a basis for administering the Securities Act. It also seems clear, in looking back over the development of the law and the growth of administrative experience in handling disclosure problems under the two securities acts, that in the final analysis, Judge Healy’s objective in many respects has been achieved, by methods less dramatic, and in a manner more consistent with the general approach of the early Commissions and their successors to many other problems.

These procedures evolved in part because of the deliberate policy choice alluded to and in part because of the willingness of issuers and the professions to cooperate in the case-by-case approach, although I know from personal experience that at times there have been some in the legal and accounting professions who found it easy to respond to comment or suggestion with a

demand for a rule. But by and large this has not been so, and the accountants in particular have asked for the opportunity to grow and develop free of rules.

The Commission has employed a number of techniques to inform issuers and accountants as to its views in accounting matters without resorting to rule-making procedures. Speeches by members of the Commission, its Chief Accountants or Division Directors, participations in panel discussions and briefing sessions have served a useful purpose. I think that progress in the development of auditing standards and notions as to the independence of accountants and the purpose and intent of the "subject to" language in the early certificates was accelerated by some pointed critical public observations on these subjects by responsible members of the accounting profession as well as by Commission personnel.

Opinions of the Commission in administrative proceedings involving the adequacy and accuracy of registration statements filed with us have been the means of developing policies as to disclosures and announcing Commission positions and views on a variety of subjects. For example, for the period ending September 30, 1939, the published volumes of opinions of the Commission indicate approximately 116 stop-order opinions issued under the 1933 Act. A large number of these included comment on various accounting matters and the form and content of accountants' certificates.

Accounting Series Releases have been published since January, 1937. These include opinions on accounting principles published from time to time for the purpose of contributing to the development of uniform standards and practice in major accounting questions. They are specifically referred to in Regulation S-X, which in turn states the requirements applicable to the form and content of most financial statements required to be filed with the Commission. About one hundred of these releases are outstanding as of now, and they may be regarded as policy pronouncements or indications of a probable course of administrative conduct in the event their message is ignored in a manner that materially affects the quality or nature of disclosures.

I have given you the text of the Accounting Series Release most frequently relied upon and most often quoted; i.e., No. 4.

Many of these releases, however, deal with matters other than accounting principles, and it certainly cannot be said that by this means we have prejudiced the opportunity of the profession, in any significant way, to proceed to develop its own policy positions.

A third source of Commission expression and policy as to accounting matters would include all published opinions in disciplinary proceedings pursuant to Rule 2(e) of our Rules of Practice. These may be found either among the Accounting Series Releases or in the volumes of published Commission opinions. More often than not they have to do with sins of omission or commission with respect to auditing standards and procedures than with accounting principles, although there are a few of the latter.

A fourth source of administrative policy, and comment of course is the daily grist of comment letters flowing from the offices of the Commission to issuers and the accountants. From these and the prospectuses, proxy statements and '34 Act reports it should be possible to

secure ample background data to aid in the solution of an accounting problem under our statutes. It has been our experience that in this field, as in other areas of disclosure, industry and the professions are quick to discern administrative variations on our part--inadvertent or otherwise--and to seek explanations. In fact, I would say that issuers, their counsel and their accountants are more adept at achieving uniformity of behavior on our part than we are, at times, in persuading accountants and their clients that what they seek to do is not consistent with generally accepted accounting principles.

Through the years, we have continued as a matter of policy our case-by-case approach--in general, we have avoided rule-making in the accounting area--we have tried in our day-to-day work and, in particular, through the efforts of our chief accountants, to encourage the acceptance by the profession of the difficult task of defining and refining accounting principles.

We have insisted that the financial statements in the documents filed with us are those of the issuer--that the issuer has the burden of producing fairly and in accordance with generally accepted principles of accounting all the required financial statements and schedules--that what was sought was the best and most appropriate disclosures consistent with the facts of the particular business or industry. Consistency of reporting for different periods by the same issuer has been emphasized. We have recognized, however, that, as between different issuers which may or may not be otherwise comparable, alternative accounting procedures with respect to a particular accounting presentation might be employed if there was--to quote Release No. 4 again, substantial authoritative support for the practice followed. I think it is fair to say that we have not sought to insure as an end in itself that the financial statements of Company A were comparable in all material respects with those of Company B.

It may be that Accounting Release No. 4 is too simple and unsophisticated as a statement of administrative policy for a more complex age. It may also be that we should have made greater use of our Accounting Series Releases for the purpose of announcing firm policies on more accounting matters.

Certainly, if the academic and operating branches of the accounting profession continue to join certain analysts and commentators in suggesting the absence of accounting principles and the noncomparability, and therefore the limited usefulness, of corporate financial statements, it will become increasingly difficult as a policy matter for us to justify and rely upon Accounting Release No. 4 and Rule 2-02 of S-X, which governs the content of a certificate.

One hears little from issuers with respect to these problems, but it is quite clear they are responsible for much of the confusion in accounting matters, and it is also they who have learned to exploit that confusion for their own purposes in many cases. A not unusual situation is one where the management goes off on an accounting frolic of its own in its reports to the press or its stockholders, when it knows, or could easily find out, that it was following a practice not consistent with the best practice in its own field. It later then engages in a dispute with the staff of the Commission with all sorts of reasons for not changing--reasons ranging from public relations, fear of litigation to sought-for and discovered "authoritative support" under these special circumstances.

A few more personal observations--hopefully to be received as they are offered--in friendly fashion. If we have said too little on accounting matters in an effort to guide and shape policy--my review of accounting literature leads me to conclude that that literature reflects considerable voluble confusion. It is my impression that no proposition can be proposed for discussion for which there cannot be produced a multiplicity of plausible contentions reflecting every shade of opinion. The end result in too many cases is lack of decision, consignment to committee--more research and no action. As to some subjects, this might well be a fitting disposition, but one of the most important problems in this business is to decide what first needs decision.

I would say that the profession, aided and abetted by the Commission, has overemphasized the short-form certificate. A short-form clean certificate these days consists of two brief antiseptic paragraphs. If the meaning of the key term "generally accepted accounting principles" continues to be beclouded, the opinion thus given in a species of shorthand will become less than meaningful. It may be that where there are acceptable alternative procedures, and a minority view is followed, the certification might contain some useful comment or explanation.

Who can say in this business where business judgment and financial policy end and accounting principles begin? Who can define the point at which a phenomenon reflected in an account ceases to be merely fact and assumes the aspects of judgment and opinion, and who can monitor all of the many judgments that contribute to the final figures appearing in a balance sheet or profit and loss statement? Those who prepare reports for filing and for public consumption, and we who review them, are faced with this judgment-opinion factor at all times.

In our own experience as administrators we have never been very successful in codifying substantive requirements in any very extensive way. And I am speaking now of all aspects of the disclosure process--financial as well as nonfinancial. Each case--particularly those under the Securities Act and the proxy rules--is and must be largely handcrafted--in an atmosphere frequently that seems to demand assembly-line techniques.

It is for such reasons that I personally have had grave doubts that the search for uniformity in accounting principles of universal or widespread application would be likely to embrace a very wide range of subjects. On the other hand, it should be possible, in a considerable range, to exclude from usage that which is not sound and to limit alternatives without giving comfort to every variation for which some plausible explanation may be devised.