Developments in Accounting Theory and Practice Since 1929

A Round Table

LEADER:
Rodney F. Starkey, *Price, Waterhouse & Co.*, New York.

PARTICIPANTS:
Geo. D. Bailey, *Ernst & Ernst*, Detroit, Mich.
William H. Bell, *Haskins & Sells*, New York, N.Y.
Carman G. Blough, chief accountant, *Securities and Exchange Commission*, Washington, D.C.
Samuel J. Broad, *Peat, Marwick, Mitchell & Co.*, New York, N.Y.
W.R. Donaldson, *Miller, Donaldson and Company*, New York, N.Y.
J.P Friedman, *Touche, Niven & Co.*, New York, N.Y.
Anson Herrick, *Lester Herrick & Herrick*, San Francisco, Calif.
F.H. Hurdman, *Hurdman and Cranstoun*, New York, N.Y.
Charles S. Rockey, *Charles S. Rockey & Co.*, Philadelphia, Pa.
Walter A. Staub, *Lybrand, Ross Bros. & Montgomery*, New York, N.Y.
And others

TOPICS OF DISCUSSION

Developments in Accounting Theory and Practice Since 1929

A Round Table

THE MEETING convened at 2:30 P.M. on October 19th at the Waldorf-Astoria, New York, with Mr. Rodney F. Starkey, of New York, presiding.

CHAIRMAN STARKEY: Gentlemen, the purpose of this meeting is to have as many questions and as much discussion on those questions as possible.

In starting this open discussion I am going to state rather definitely, but briefly, some of my own opinions on the developments in accounting theory and practice since 1929, with the hope that those of you who care to take exception to any of these opinions, or care to elaborate on them further will do so.

Obviously, the topic of this discussion divides itself into two distinct questions—"What, if any, developments have there been in the theory of accounting as accepted and applied by professional accountants during the period?" and "What, if any, changes have occurred in the practice of our profession?"

DEVELOPMENTS IN THEORY

As to the first point, from my own experience during this period, and even for some years before 1929, I do not believe that there has been much important new development in accounting theory. There has been, unfortunately, a great deal of loose thinking on this question, as evidenced by newspaper articles and speeches from various sources—some from within the body of our profession itself, some from academic accountants, some from newspaper writers and some from the representatives of the Securities and Exchange Commission. In many instances the inference has been given that since 1929 or, better perhaps, since 1933 accounting theories and principles have been discovered and enunciated which heretofore were practically unknown to the large body of professional accountants. Even such an unfortunate statement has been made to the effect that the accounting profession is experiencing a renaissance. I say "unfortunate" with respect to such expressions because during this period the appropriate committees of the American Institute of Accountants have been spending a great deal of time and effort in an educational program. This program has been conducted, not primarily for the benefit of practicing professional accountants, but to assist the New York Stock Exchange listing committee and others interested in obtaining a more comprehensive understanding of the principles which professional accountants had been following, and to discuss and develop more satisfactory means of applying and expressing these principles in the presentation of financial statements by corporations to their security holders. The outstanding contribution of this kind, of course, is the booklet issued by the Institute in September, 1932, entitled *Audits of Corporate Accounts—Correspondence between the Special Committee on Coöperation with Stock Exchanges and the Committee on Stock List of the New York Stock Exchange.*

One of the most important things developed by the correspondence was that it is a practical impossibility to establish more than a very few so-called fundamental principles of accounting. This has been borne out further by the fact that, although many months ago the Securities and Exchange Commission stated that is proposed to issue from time to time releases enunciating accounting principles to be followed in the presentation of accounts, to date only two of these releases have been issued, strictly on accounting principles, and both of them are merely the application to specific cases of principles which I think generally have been adhered to for at least the last twenty years.

DEVELOPMENTS IN PRACTICE

As regards the second part of our discussion, the question of the developments in practice, quite the opposite condition exists. These developments, I believe, have been many and varied in type. Perhaps the outstanding development in the practice of the professional accountant in recent years has been the conception of that naïve document, the deficiency letter, which seems to be a constant source of communication between most practicing accountants and those responsible for administering the two securities acts in Washington. Another, and one which must cause all of us a great deal of concern, has been the development of the voluminous explanatory footnotes. In many instances the primary accounts presented have receded into the background, buried under a deluge of such notes—some important and many unimportant.

A third development, which started before the enactment of either of the securities acts, initiated by the accountants themselves even prior to the period which we are now discussing, but slow of adoption by stock exchanges, bankers and corporation managers, has been the attempt to prepare more comprehensive accounts containing more details, so that the average security holder would not be compelled to consult statistical services to learn of the more important developments during the period reported on by the company whose securities he holds. In a recent address Mr. Carman G. Blough, chief accountant for the Securities and Exchange Commission, urged that this development be continued.

Even in the development of practice, however, I think it must clearly be kept in mind that the standards first adopted and publicized for the New York Stock Exchange before the enactment of the securities acts and the standards subsequently adopted for the presentation of forms and content of financial statements by the Securities and Exchange Commission and its various form, with the accompanying rules and regulations, primarily were those developed over a great many years by practicing accountants themselves. I think it is only fair to say that the rules and regulations promulgated under the securities acts for the most part represent only a codification of the best practices that have been followed by the leading professional accountants during the previous two decades. The codification which has been accomplished of the standards for the presentation of form and content of accounts undoubtedly has been helpful; if not primarily to practicing accountants, it has been helpful to laymen. However, I believe that any development from this point on must be very carefully considered if we are to avoid a repetition of such voluminous classifications of accounts as have been promulgated by the Interstate Commerce Commission and the various state public-service commissions.

I am going to ask Mr. Samuel J. Broad to carry on from here for just a few moments and then I am going to ask for questions from the floor, and I hope that you will all participate. Mr.Broad!

MR. SAMUEL J. BROAD (New York): I would like to say first that I am in general agreement with Mr. Starkey that since 1929, or even for some years before that, there has not been much important new development in accounting theory. It would be a reflection upon ourselves, however, to hold that accounting practice has not registered advances, and that accounting technique has not shown improvement.

For many years accountants have been carrying on, systematically and otherwise, a process of education in accounting theory and accounting practice. This they have done by means of discussions within professional circles, discussions with stock exchanges, with commercial and investment bankers and others, as well as through what has been called their "daily impacts" with their clients. Since 1933 their efforts have been strongly implemented by governmental authority. I believe we would all agree that in their endeavors to bring about proper practices and fuller disclosure the road of accountants has been made much easier since 1933.

Distinction between Principles and Methods

In dealing with this subject we should draw a distinction between accounting principles, which are few in number and must necessarily be general in their nature, and the methods of application of accounting principles. For example, one fundamental and very broad principle is that the income account for a year should bear all the charges applicable to that year, and under this general principle we make provision for depreciation, we write off unrealized inventory losses, we amortize discount on bonds, and so forth. There are, however, several approved methods of providing for depreciation, and the one most commonly in use is possibly not the most accurate. Similarly, in determining inventory losses there are many methods of applying the formula which up to the present has been considered the preferable one for most industries, namely, cost or market, whichever is lower; and the volume of written and oral discussion regarding methods of treating bond discount has, I sometimes think, been out of proportion to the importance of the item itself.

In view of the variety of approved methods which may be adopted in applying accounting principles, and in recognition of the effect which such choice may have on the financial and earnings picture, we have during the last few years come to emphasize strongly the importance of consistency in the use of the method selected. Consistency was first prominently emphasized in the correspondence with the New York Stock Exchange, to which Mr. Starkey has referred; later a committee of the American Institute of Accountants in a formal report submitted on August 3, 1934, to the then newly formed Securities and Exchange Commission stated that "the application of consistent practice to the accounts of a corporation in successive years is of prime importance." The idea was further emphasized in the bulletin, *Examination of Financial Statements by Independent Public Accountants*, issued by the Institute in January, 1936. Provided of course that an acceptable method is adopted, the present view is that more importance may be attached to consistency in the application of that method than to the particular method chosen. This emphasis on consistency, in my view, is a notable development, a long step towards a more dependable record of progress.

Extent of Disclosure

As Mr. Starkey has pointed out, another important development during this period has to do with the extent of disclosure in financial statements. Improvements in disclosure have to do with the amount of detail given, the bases on which the accounts are stated, and the particular accounting practice adopted in cases where different practices are permissible.

The amount of detail contained in financial reports to stockholders, both in relation to the figures themselves and also to the bases on which they are stated, certainly reflects in the majority of cases a marked improvement over what it was ten years ago. We have made substantial progress in this direction. That progress must be continued; we cannot yet feel that we have reached the goal or that criticisms sometimes directed at the limitations of financial statements have no justification. Perhaps the fault is that the emphasis has been misplaced; changes during the year may, perhaps, be of more significance than the bare historical record.

Even more marked is the improvement in disclosure as to the accounting practices followed by a corporation. We have by no means found an ideal solution to this problem and efforts to solve it are partly responsible for the multiplicity of notes on financial statements to which Mr. Starkey has referred.

In the 1932 correspondence with the New York Stock Exchange, one of the suggestions made was that a statement of the methods of accounting and reporting to be employed by a corporation should be adopted by the board so as to be binding on its accounting officers, and that such statement should be furnished to the exchange and made available to stockholders upon request; and further that if any change should be made in the principles or any material change in the manner of their application, the stockholders and the exchange should be advised when the first subsequent accounts were presented.

A similar suggestion was contained in the 1934 report to the Securities and Exchange Commission. It was recommended that for the purposes of the original registration one of the financial statements should consist of "a concise statement by the corporation as to the major accounting principles and practices followed during the period under review and any changes in such principles and practices since the preceding year." While the Securities and Exchange Commission did not adopt this suggestion in its entirety, it gave recognition to it in that throughout the regulations disclosure is required as to many individual practices or methods which would fall within such a summary and also as to the bases on which specific items are stated. Perhaps in the interests of simplification we shall yet see the adoption of the original recommendation. It would, I think, make possible the elimination of many of the notes now appearing on financial statements and place comparatively greater emphasis upon consistency of method.

The major developments in accounting practice during the period since 1929 would thus seem to be (1) this emphasis on consistency, and (2) the additional extent of disclosure of financial details, of the bases on which the accounts are stated, and of the methods followed in arriving at the results reported.

ACCOUNTING NOT STATIC

We have by no means reached the end of the road; we are still "on our way." We are not members of a profession that is static; a young profession, we are still, fortunately, in a state of flux. And, while measurement of progress may be desirable from time to time, any attempt to crystallize the flux in its present immature state would, I sincerely believe, work vast injury to our further progress.

CHAIRMAN STARKEY: Gentlemen, I would like to hear any dissenting opinions or elaborations of these ideas or any other matters. Mr. Staub, I see you sitting there thinking of a question; would you like to comment?

MR. WALTER A. STAUB (New York): It was a fortunate thing that the background of practice for a dozen years or perhaps two decades prior to the passage of the securities act was such that the profession was ready to avail itself of the additional support that came from the

Securities and Exchange Commission and the stock exchange listing committee, enabling us to move forward with renewed force toward those principles and those methods of practice that we felt contributed to a better type of financial statement and more fully met the needs that seem to us to be there on the part of the security holders. While I imagine the last thing we want to do here is to indulge in the practices of a mutual admiration society and throw bouquets at ourselves, I do think that sometimes there has been a bit of inadequacy in the recognition given to the profession itself in doing foundation work and spade work that has led up to what I regard as real advance during recent years in practice, particularly as distinguished from the pure theory accounting.

MR. WILLIAM H. BELL (New York): I should like to speak a little on the subject of consistency that Mr. Broad has made quite a bit of. I do not think any advance has been made in respect to consistency. I think, on the contrary, that we may have had some retrogression on that account, owing to the wording of the standard certificate that, in accordance with the general accepted principle, consistency should be maintained during the period under review.

CONSISTENCY IN ACCOUNTING PRACTICES

Now, the good practitioners of accounting have always recognized that practices ought to be consistent from period to period, but I am just as sure as I can be that many practitioners of accounting have availed themselves of the apparent meaning of that term, "during the period under review," merely to make sure that everything was the same during the year, whether or not it had any relation to what happened in the previous year.

I think that is a decided weakness in that form of certificate. Instead of making progress, I think we have gone back on that.

CHAIRMAN STARKEY: It may be that there is a misunderstanding.

MR. STAUB: It seems to me that there is something in what has just been said there that ought to be challenged. The committee of the Institute which was responsible for putting forth the suggested form of certificate which was subsequently adopted and which is in wide use today was careful to make plain in the pamphlet, to which the chairman of the meeting referred in his remarks, what the intent was of that phrase— "consistently maintained during the period under review."

I think that phrase will have little meaning if it is simply restricted to the practices or the principles adopted within the period under review. The thought behind it was that the principle "consistently maintained during the period" should be consistent with what had gone before.

That was made very plain in that publication and it seemed to me that the adoption of that form of certificate marked a real advance in that it put the question squarely before corporations, and especially before the accountant, that it was necessary to make certain that there had been such consistency of practice that the statement for the latest period would be comparable with the statement of the period before.

If that was not the case, that fact should be brought out. I think we have observed in registration statements and in published reports in recent years, particularly since the adoption of that form of certificate, that that is exactly the meaning that has been drawn and has been recognized as inherent in that phrase.

I can think of several instances offhand where, for example, the method of inventory valuations has been changed, and that has been brought to the attention of those for whom those statements have been prepared. In the case of the oil companies, in recent years a number of them have changed their method of dealing with the expenditures for drilling wells; where previously they may have absorbed those expenses in operating costs, they have now adopted the policy of capitalizing. Where that has been done, I think it has been brought out and expression given to the change in the current year so that a fair comparison could be made.

I do not very often find myself at odds with Mr. Bell, because I have a very high regard for his views, but in the present instance I felt a difference. I think we have made progress in that direction.

MR. BELL: Mr. Staub, I was not challenging you. I said that all good practitioners, including you, have done that all along. But I really think I am right; I heard a lot of accountants say that all that means is that you be consistent during the period. That has been the consensus of opinion among accountants, I believe.

CHAIRMAN STARKEY: Mr. Bell, may I enter into that for a moment? It would be difficult, would it not, to have an inconsistent basis of valuation of inventories at the beginning and end of the year and still say that consistency "during the year under review" would be one of the most important things?

MR. BELL: Quite.

MR. J.P. FRIEDMAN (New York): I am just wondering whether that very clause that Mr. Bell and Mr. Staub talked about is not very dangerous to the accounting profession from another point of view.

CRITICISM OF STANDARD CERTIFICATE

The definition as given in the correspondence with the stock exchange clearly shows that it calls for consistency with the previous year, but the certificate itself doesn't say so.

I wonder whether some court may not some day interpret that to mean consistency over a period of a great many years and whether they might not say that, if you had not been consistent over a great many years, you ought to point out cumulative exceptions each time. In view of all that and in view of Mr. Bell's pointer, I wonder whether the time has not come to adopt the phrase "on the basis of consistency with the previous year?"

MR. W.R. DONALDSON (New York): I recall a couple of years ago my late partner, Philip Miller, was working with Sam Broad on that revision. He felt very strongly at that time that it was not well worded in order to emphasize consistency from year to year. Now, there is no question about it that it doesn't really bring out that point. As Mr. Staub has said and as Mr. Bell has said, all good practitioners do attempt to be consistent from year to year, but there are some practitioners who might like to take advantage of that phraseology.

However, suppose you get a case such as I had, in which a client did change his methods. We wanted to bring out the change. He said:

"Well, you do not have to do that. Your certificate simply says that the practices are consistent within the year and that is what you and all accountants certify to. There are many companies—we know some in our own industry, for example—that have changed their methods and nothing has been said about them. Now, you may say that you want to note the change because all accountants do so, but we say that you are not required to by the pamphlet gotten out by your own organization."

So there you see, again backing Mr. Bell, the very wording of the certificate may be used against the accountant who wants to do a decent job.

That should be cleared up. There is no question in my mind that something should be done to change the wording of the certificate.

CHAIRMAN STARKEY: That point is at least worth considering and I think we might refer it to Mr. Hurdman's committee. He is the chairman of the committee on cooperation with stock exchanges.

We might pass that question, however, for the moment. Are there any other questions?

WHAT IS CONSISTENCY?

MR. GEORGE D. BAILEY (Detroit): I should like to see that question carried along a little bit from a different angle. We got into it from the standpoint of the certificate. We still have left open the question of what is consistency? Is consistency merely six accepted accounting principles, or is it consistency of procedure? What is the general feeling as to what constitutes a material departure? Is it consistency only of the income statement or of the balance-sheet as well?

CHAIRMAN STARKEY: Mr. Bailey calls for some discussion of what is consistency. I think that is a worthwhile question. Has any one any ideas on that?

Mr. Blough, would you like to enter the discussion on that question?

MR. C.G. BLOUGH (Securities and Exchange Commission): I do not know that I have anything particular on that but I would like to revert a little bit to what was said. First, with regard to the general acceptance of the meaning of that term by the accountants in the country.

I think you will find that a very large proportion of them take that to mean within the period and bearing no relation to the previous period. We feel that so strongly that we, in a tentative revision of requirements, have included a requirement specifically calling for comments as to differences from preceding periods.

With regard to what is consistency, I do not think it should be limited by any six principles of accounting that have been expressed by the Institute committee. I think it applies to things which tend to make one year's statement different from what it would have been—significantly different from what it would have been had the procedures followed in prior years been followed during the period for which the report is drawn. Changes in methods of depreciation, changes in depletion, charges in handling changes for dry holes in the oil industry are examples.

As far as the balance-sheet is concerned, I am a little at a loss to know just what I think about that, but certainly if there are significant write-downs or write-ups or other adjustments that affect a comparison with previous years, there ought to be some clear revelation of that fact. I do not know whether it is called for in the accountants' certificate, if it is shown elsewhere carefully, but at least it should be called attention to so that any person who reads the statement is in a position to understand. I am not at all sure that it shouldn't call for comment by the accountants.

Certainly anything in the profit-and-loss statement which causes a significant difference from the result, had a previous policy been followed, calls for definite and complete comment by the accountants.

CHAIRMAN STARKEY: Are there any others who would like to offer some ideas?

MR. HURDMAN: Mr. Blough who has had, of course, a great deal of experience with registration statements, has, I believe, in several of his speeches rather indicted the accounting profession because of lack of consistency in the application of accounting principles. I do not think that we should pat ourselves too much on the back without heeding that criticism which has fairly been leveled against the accounting profession as a whole.

Criticism of the Profession

There have been some different methods of treatment. Mr. Blough has brought a number of them out in his speeches and his articles. I think he has generally placed the accountants on the defensive to adopt more generally accepted practices.

I do not think that there is so much dispute on general principles, but I think that on practices he has failed to find a consistency in these statements which have been submitted to the Securities and Exchange Commission.

Perhaps he would be glad to augment that and give us more of his views, particularly on the consistency of accounting practices.

Mr. Blough: Well, that gives me an opportunity to say something that I was wondering whether I wanted to say or not. I was a little embarrassed when accounting release No. 1 from the commission came out because it came out actually in my absence from the office and the little foreword about the extensiveness of the releases that were to be brought out in the future was not a part of my release.

The S.E.C. Releases

I have been criticized rather harshly from within the commission for not bringing out more of these releases. I did not expect to be criticized very harshly by Mr. Rodney Starkey for not bringing out the releases in view of conversations that I had with him in which he has urged that we go very slowly.

The failure to bring out those releases I think is not due to the lack of necessity for some clarification or some uniformity of the procedure, but has been due to two things: First, the press of general administrative work has made it impossible for me to devote to the questions that came before me meriting some release, the consideration that I would like to give to them before expressing any public opinion; but, second and more important, I have a realization that there is a good deal of significance given to those expressions and the sense of responsibility that goes with that has made me hesitate when I was not positive as to the best procedure to be taken.

Now, I am not at all sure that the accounting profession might not in many instances be better off, where there is an equal argument as between two procedures, if some position were taken and made a general procedure to be adopted by the profession.

On the other hand, I hesitate to express an opinion myself until I feel that there is a large weight of argument on that side.

I do not know exactly what Mr. Starkey had in mind with reference to statements from the commission with regard to these accounting principles. I do not think that there is anything in any of my own writings or any of my own statements that indicates that the Securities and Exchange Commission has established any principles of accounting.

As a matter of fact, I think I have emphasized at numerous times that the policy of the Securities and Exchange Commission was to encourage the accountants to develop uniformity of procedure themselves, in which case we would follow. We expected to be able to follow the better thought in the profession and only as a last resort would the commission feel the necessity to step in.

The expressions of opinion that have come from my office have been expressions of opinion as to what we considered to be the most generally accepted accounting practice among the better accountants in the country and not a promulgation of any new ideas or anything that had not been followed by accountants rather generally.

If the time comes when the commission is convinced that a procedure which is not generally accepted in the profession is a procedure that should nevertheless be followed, the matter will be handled not through the release of an opinion by the chief accountant, but through a rule or regulation of the commission requiring that such procedure be followed.

I think, in the paper that was published in the *Accounting Review* last spring, the talk that I gave before the American Accounting Association, and again one that was published in the *New York Certified Public Accountant* last February indicate enough places in which accountants have differed in methods of presenting identical materials; it isn't necessary for me at this time to make any comments as to the necessity for the accountants to get together somewhat further than they have to date.

CHAIRMAN STARKEY: I think that in all fairness to Mr. Blough I must hasten to clarify my remarks to this respect: I know quite well the philosophy that he has used in his work.

The thing that I referred to in my opening remarks was the unfortunate publicity in the newspapers to the effect that public accountants were going to be set straight on accounting principles. My criticism was not directed toward either the scarcity of the releases nor to the wording of the releases and I am sure there is no conflict between Mr. Blough and ourselves on that point.

Any other remarks on this question?

Do you want to explore this question of consistency any further, Mr. Bailey?

MR. BAILEY: All right! It seems to me we have two problems. Consistency of principle and consistency of procedure. Consistency of procedure opens up many avenues. For instance, take the question of depreciation. A company follows its general principle—the writing off of all the useful life of that property, the asset value, the carrying value. From time to time it is forced to adjust its estimate of remaining useful life of that property—sometimes upward but usually downward; sometimes it is voluntary, sometimes it is caused by the Income Tax Department coming in and setting new rates.

Is there considered to have been no change in the depreciation policy of writing off over a period of useful life? It may be a continuation of both the same principle and the same procedure, and yet there is inconsistency. I merely cite that as one illustration. I am frank to say that I do not know the answer to it. It seems to me to depend upon the degree of departure from previous policy, but what degree of departure calls for special mention by the accountants?

In some published reports exception is taken even though the departure may make a difference of considerably less than one per cent in the income; in others no exception may be taken even though there has been a very substantial change.

The question of inventory, of course, is a standard one. I think it settles itself very readily if you assume that the comparison must be between this year and last year. There can be different methods of determining cost. If there is a shift in determining cost, is it a change in policy? I think it is, but I am wondering if there is any uniformity of thinking on that?

MR. BROAD: I frankly cannot get all excited about this question of consistency and what it means. If we look up the correspondence of the New York Stock Exchange and the form of certificate which goes with it, we will find prominently displayed there a note to the effect that the phrase in question relates to consistency with the previous year. As practicing accountants I think we are to a certain extent bound by that general practice of the profession as a minimum.

Now, I think there may be some accountants, as Mr. Bell said, who hide behind the letter of the certificate rather than the spirit; any accountant can very readily show his client what is intended—not that there should be consistency within the year, but rather consistency in comparison with the previous year.

There is this further statement in the Stock Exchange correspondence, “that if any change should be made in the principles or any material change in the manner of their application, the stockholders and the Exchange should be advised.”

WHAT IS MATERIAL?

I sometimes refer to the bulletin, *Examination of Financial Statements by Independent Public Accountants*. I lived with it so long that at one time I knew it by heart. I have not a copy with me, but I think the wording on the subject is substantially to this effect: that if there has been any material change in the method of applying accounting principles that affects the results for the year in comparison with the previous period, it should be indicated in the financial statements.

Now, we did bring the word “material” in there and I do not think we can go further than that. What is “material”? I think that is a question of judgment. We cannot lay down rules as to what “material” means. That would be going too far, but an accountant, I think, is required to use his own judgment as to what is a material change.

CHAIRMAN STARKEY: Any other ideas on this question?

I think we might well pass from the question of consistency, unless some one has some definite ideas on some other point.

Are there any differences of opinion as to treatment of bond discount, treatment of treasury stock, treatment of profits or losses under sale of the company’s own stock? Has any one any ideas to express?

PROFIT ON RESALE OF TREASURY STOCK

MR. BELL: I have some ideas to express on that at the risk of being thrown out of the room. I am entirely in disagreement with the present so-called principle of accounting that says that profit on the resale of treasury stock—I am speaking now, not of 30 per cent of the company’s own stock, but of incidental acquisitions and resales of treasury stock—must be capital surplus and that any losses therefrom should be charged to surplus. I think it is all nonsense. It is really a profit from an incidental purchase of a company’s own stock—relatively few shares—and it is just as much earnings as any other earnings. The theory that a company reduces its capital when it buys 200 shares or 1,000 shares, with several hundred thousand outstanding, is, I think, ridiculous.

All right! Now, let somebody answer that.

CHAIRMAN STARKEY: Can we get an answer to that? Well, I would like to answer that very briefly myself. It seems to me that if you are talking about 200 shares no one is going to argue with you, simply because it isn’t material. There is a principle, however, and departing from the principle when small amounts are involved leaves the door open and I think there is danger in that.

Has any one any other ideas on that?

MR. ANSON HERRICK (San Francisco): It seems to me that when you deal with the purchase or sale of capital stock you cannot avoid basic principles; that there can be no income or no loss, as we consider income and loss, from such transaction.

When a corporation repurchases its capital stock, it reduces the amount of the aggregate outstanding capital in surplus. In that act we are faced with certain provisions of corporation law, which I agree are not uniform throughout the states but which provide generally that there shall be no reduction in stated capital. Your corporation laws require that purchases of common stock be a deduction in the entire amount from your earned surplus or, in some states, from any surplus.

It seems to me that to permit the inclusion within an ordinary income statement or within earned surplus of profits or losses from the trading in a company's stock gets rather far afield from a procedure which will develop the true earnings and the true earned surplus of a corporation.

ACCOUNTING PRINCIPLES AND CORPORATION STATUTES

MR. STAUB: Mr. Chairman, at the risk of wearing the group down, I would like to introduce one other angle on that general subject. There is one thing that has been emphasized over the years with respect to accounting principles and that is that they are not necessarily controlled by the corporate statutes of a given state. There is usually no legal basis for the preparation of a consolidated balance-sheet or a consolidated income statement; nevertheless, each of them serves a very useful purpose because they are prepared for the purpose primarily of presenting the position and the results of operations in the most informative way.

So it seems to me, on this matter of treasury stock, that while theoretically there is no retirement of treasury stock unless the corporation law requirements are met with respect to retirement, nevertheless, in substance there is a retirement whenever stock is bought in for the treasury, and the transaction is subject to the requirement that a corporation must not buy in its own stock unless it has surplus with which to do it.

It seems to me that we must recognize the practical situation as distinguished from the mere legal situation and for that reason, among others, we must deal with any profit on such a transaction, or under certain circumstances perhaps a loss, as one where there is in substance a retirement for the time being of stock, even though distinguished from a legal retirement.

CHAIRMAN STARKEY: Does any one else have any ideas on this subject?

MR. BELL: Yes; I would like to answer Mr. Staub. The practical aspect of this thing—this is practically a retirement, although it actually is not legal. I say practically in many cases, perhaps most cases, the capital stock of a corporation is purchased as a commodity, therefore it is just as reasonable to assume or take the position that it is a commodity as though it were a security of some other company, as it is to assume that it is a retirement of our own stock.

We are not talking about a wholesale reduction of capital stock, but we frequently have these incidental transactions. On the principle as proposed by the chairman to be laid down invariably, "if you apply the rule to a thousand shares or a million shares you have got to apply it to ten or a hundred shares."

I say that circumstances do alter cases; that is the whole contention of the accounting profession. I say that, if you are considering what practically happens, it is just as reasonable to take the position that you have bought a security; comparable to any security, that you have had to take over stock from your debtors, or that for some incidental reason you bought it for issuance to employees and officers as bonuses, and things of that sort.

I cannot just get through my head that the company had retired its capital either practically or legally under those conditions.

Treasury Stock and Stock Unissued

Mr. Herrick: I would just like to comment on what has been said by asking a question. What is the difference? What is the difference in substance between capital stock authorized by unissued and treasury stock?

Chairman Starkey: Is there any one who would like to answer that question? Mr. Bell, would you like to answer that?

Mr. Bell: No.

Mr. Herrick: I might elaborate on that. In a great many states it is a requirement that a corporation obtain permission from the corporation commissioner of the state prior to selling treasury stock, and in exactly the same way it is necessary prior to the sale of authorized stock.

Chairman Starkey: Well, Mr. Bell, would it be fair to sum up the discussion on that question this way: that you have no objection to the principle, except that you feel that there should be allowance made to deviate from that principle in the case of very small unimportant amounts?

Mr. Bell: Yes; and if that is so, then it does not seem to me that it is a very serious point. I would not recognize it as serious, but I dislike very much to have these ironclad principles that give no consideration to exceptional circumstances.

Chairman Starkey: I think we can all agree on that.

Mr. Blough: Mr. Chairman, I would like to comment on that a minute. That is just one of the difficulties that I found with regard to accounting principles in some previous criticisms. There is a lot of leeway left. If it is not material, of course, then it is not material and nobody is going to be hurt very much, one way or the other.

On the other hand, if there is a basic principle involved that applies to a large proportion, why does not it equally apply to a smaller proportion? A corporation is not in business to reacquire its own stock.

I do not like to refer to state laws as being an authority for accounting because there are some state laws that permit the most ridiculous things to be done, with which accountants take exception, but I think one of the basic reasons for these various state laws restricting the amount of the company's own stock that may be reacquired to the amount of the surplus is to prevent the corporation in that way from reducing its capital unduly and to give it recognition as a transaction in the company's capital.

It seems to me that if capital stock is not a commodity when you buy it in large quantities, then it is not a commodity when you buy it in small quantities.

Chairman Starkey: Any comments on this expression of opinion?

Shall we pass the question of treasury stock and go on to something else? Has any one any other questions in mind?

Revaluation of Preferred Stock

Mr. Blough: I have something else that I would like to raise at this time. I do not know how many of you have run into it, but it is not an uncommon practice and it is one that has disturbed us quite a bit.

A corporation with preferred stock outstanding reduces the par or stated value of the preferred stock and does not change the rights of the preferred stockholders at all. For example, I have in mind a company that reduced a $100 preferred stock, having a 7 per cent dividend rate and a value of $100 in case of involuntary liquidation, $105 in case of voluntary liquidation—the company reduced the par value of this preferred stock to $25, changed the rate of dividends from 7 per cent to $7, left the liquidation figures identically with what they had been before, thereby creating $75 of capital surplus for every share of capital stock outstanding.

The attorneys say that under the law of the state it is perfectly proper. I would like to have the reaction of the accountants in this group as to the propriety of that procedure and how it ought to be shown.

Chairman Starkey: Would any one like to express an opinion on that point?

Mr. Staub: I would like to ask a further question, if I might, because it may help us, Mr. Chairman, in giving consideration to this question, and that is: What is the opinion of counsel as to total availability of surplus for distribution under the laws of the state in which that corporation is organized and in which it is domiciled?

In the majority of the states capital surplus is available for distribution just as much as so-called earned surplus; in a great majority of the states they make no distinction of that kind.

Now, would the laws of the state in which that corporation functions permit that capital surplus of $75 a share to be distributed in dividends to common stockholders?

Mr. Blough: We have had, as I said, quite a number of such cases and quite a number of them were in the state of Delaware. We have called for an opinion of counsel in each instance and opinion of counsel has differed.

One firm of lawyers expressed the unqualified opinion that the surplus so created was available for dividends on preferred stock; that it was available for charging off any losses.

Another firm of attorneys, a very reputable firm of New York attorneys, refused to express an opinion on that. They said they had no idea as to what the court would hold and they had no basis for assuming.

Another firm, also of quite reputable, well-known attorneys, stated that they had no court precedent for the matter, but that they were satisfied that, if the matter came before a court, it would be held that there had been an impairment of the company's capital by any such distribution.

Now, in most of these instances this capital surplus was immediately used to write off substantial amounts of property and, in one instance, an accumulated deficit. The obvious result was that subsequent earnings would, if the property were reduced, be increased on the assumption that they are doing it for the purpose of getting a lower depreciation charge—subsequent earnings would be increased and would be available for dividends to all parties, including preferred and common stockholders.

It seems to me that in that case it virtually constitutes creation of surplus which indirectly is available for dividends to all kinds of stockholders in that the earnings are increased and, therefore, dividends can be paid to common stockholders that could not have been paid to common stockholders if this procedure had not been followed; and the equity of the common stockholders is certainly reduced by that procedure, because in case of liquidation the preferred stockholders step in with the full amount that they were entitled to before and consequently the common stockholders would undoubtedly have less available to them than is shown on the face of the balance-sheet.

CHAIRMAN STARKEY: Mr. Blough, I would like to give you a recent case that I ran across in New York state. The company had preferred stock and reduced the par or stated value. They had accumulated dividends which they took care of out of surplus by an issue of new common stock. They also had some good will and patents, and so forth, that were to be written off against that surplus.

Three firms of lawyers held that under the New York law, which states that the value of the assets must exceed the liabilities and capital before dividends can be paid, since the new capital of the company was stated under the law at the lower figure, regardless of the price at which it would be liquidated either voluntarily or involuntarily, the company had the right to pay dividends on both the new preferred and common stocks.

COST IN A CONSOLIDATED STATEMENT

MR. HERRICK: We have been on this question of consistency—we have had the problem from time to time of what is cost in a consolidated balance-sheet. Is cost as to one subsidiary required to stand as cost to another subsidiary? Do we mean cost to the parent, or do we mean cost to the subsidiary company?

For example, Corporation "A" acquires the entire capital stock of Corporation "B", and Corporation "A" issues no-par-value common stock. You prepare a consolidated balance-sheet at that point. Do you continue the values shown for fixed assets on Corporation "B's" books, or are you required to revalue them based upon the values at the time the stock of Corporation "B" was acquired by Corporation "A"?

Now, of course, when you are dealing with no-par-value stock issued in exchange for the stock of Corporation "B", the issue is a little clouded, but take the situation where Corporation "A" pays cash for the stock of Corporation "B"; you may then find that the total assets of Corporation "B" are higher or lower than the cash which Corporation "A" paid for the stock.

What is cost in a consolidated statement? Is it cost to the parent or is it cost to the subsidiary, and must you be consistent as to the subsidiaries? I think I would like to have a little discussion on that.

CHAIRMAN STARKEY: Well, just to start the discussion off, it would seem to me that the consolidated balance-sheet is primarily the picture of the parent company taking in the subsidiaries, and cost there would be to that parent company.

If you paid a premium for the assets in cash or stock, the disposition of the premium would depend upon what assets you bought, but you would have to consider, I should think, the cost to the top company.

MR. HERRICK: Stock, not the assets.

CHAIRMAN STARKEY: Has any one any expression of ideas on this question?

MR. BELL: It seems to me it must be so; just as you say, Mr. Starkey. Otherwise, a lot of corporations would have to throw a lot of money out of the window.

CHAIRMAN STARKEY: Yes.

MR. BELL: And that would certainly be unfair to them.

While I am on my feet, I would like to revert to Mr. Blough's discussion. He inquires whether, under proper accounting procedure, a corporation ought to be allowed to create a capital surplus by reduction of the value assigned to preferred stock.

It seems to me that we have got to approach these things by determining, first, what any accounting principle is from the standpoint of good common sense and, second, how it is going to affect the various interests involved, whether or not it is good business.

We know very well we cannot accept all the corporation laws. That is one of the postulates, I think, that we are working on. We cannot be restricted by corporation laws. We cannot be entirely governed by corporation laws. It would be impossible to do so anyway because we have such a variety of them; but I would think—now this is purely generalization—that accounting opinion ought not to be established which is in such plain disregard of common sense as to permit the corporation to establish this capital surplus and utilize it for various purposes.

CHAIRMAN STARKEY: Well, the difficulty is, how would you treat it? Take the case of the New York corporation that we were discussing a while ago. It creates the surplus and then uses it all. When the question of distributing its earnings the next month arises—what are you going to do about it?

MR. BELL: Well, the only question is as to the expression of opinion by the accountants, whether it is good in accordance –

CHAIRMAN STARKEY: Well, of course, those are the earnings at that time distributed.

MR. BELL: Sure, but these other things happened. As to whether they are correct—if the capital surplus is kept intact, I take it, the only harm can be in the utilization of this.

CHAIRMAN STARKEY: In this particular case the directors stated that they felt that the good will should be written down and thereby admitted that it had no value, which thereby placed them in jeopardy under the New York law.

There is not anything more you can do about it, it seems to me. They have the right to state what their opinion of the value is. It is their responsibility.

MR. BLOUGH: Isn't that the kind of situation where it would be desirable to require part of the equity of the common stockholders to be shown as attributable to the preferred stockholders and show a deficit in the common stock?

CHAIRMAN STARKEY: I am not sure that that would have much meaning, if there were a deficiency.

MR. BLOUGH: Well, as the matter now stands, you get nothing on the face of the balance-sheet indicating that there is any impairment of common capital.

CHAIRMAN STARKEY: Well, in this case there was nothing put on the balance-sheet showing the extent to which this preferred might share in the surplus when the surplus was created from future earnings.

MR. BLOUGH: Far be it from me to say too much about footnotes, but after all, it seems to me that this is something so basic in the presentation of a balance-sheet that it is not adequately taken care of by a footnote struck down at the bottom somewhere.

CHAIRMAN STARKEY: Any one else have any ideas on this?

MR. SEIDMAN: It seems to me, if a stockholder's action is affirmative for the utilization of the capital surplus with a subsequent use of dated earned surplus, that new stockholders are automatically governed by that action.

MR. BLOUGH: Well, this was approved by both common and preferred stockholders in all these instances, as I remember, but I do not think that alters the situation at all. After all, these statements that we are interested in are primarily prepared, not only for existing stockholders, but for persons that might be interested in buying the company's securities either from other present holders on the exchanges or in a new issue that you are presenting.

You are failing to present, it seems to me, a very significant and important fact with regard to the existing equity of the common stockholder, irrespective of how much persons who were in the company previously knew about the action at the time it was taken.

CHAIRMAN STARKEY: Has any one else any questions on this point?

PLANT VALUATIONS

MR. HERRICK: Mr. Starkey, in the case that Mr. Blough just described, a recitation on the balance-sheet of the liquidation value, possibly with comment upon the effect of that liquidation value upon the common stock, makes the situation rather clear upon the face of the balance-sheet.

That is a situation which results when values are written down. Now, let us take another case in which values are not written down. Certain plants possibly may become obsolete and be no longer in use, but through the operation of normal depreciation and upon the theory that a recovery of production requirements may permit their economical use in the future, they are not written down.

There is a considerable item for goodwill upon the balance-sheet, all of which had to do with the original capitalization. Now, there is a situation in which, if valuation had been reduced in the same way as they had been reduced in the case of Mr. Blough's, there truly would be exhibited a deficit in the common capital account and yet there would be nothing upon the balance-sheet to indicate that such a deficit existed.

Now, to what extent may accountants be required to express their opinion or to ear-mark or comment upon plant valuations, the possible recovery of which through future depreciation is extremely doubtful?

CHAIRMAN STARKEY: Have you any ideas on that, Mr. Blough, that you would like to add?

MR. BLOUGH: I do not believe that I have.

CHAIRMAN STARKEY: Has any one else any comments on that?

MR. BLOUGH: That is one thing that I would very much like to have these older heads in the accounting profession say something about.

Repeatedly accounting firms take the position that they are not valuation experts, and that we all admit, and for that reason it is not necessary for them to call attention to any failure to correct or to adjust for overvaluations.

ACCOUNTANT'S RESPONSIBILITY

I have had the feeling myself that when an accountant found a situation where properties are obviously overvalued and are so recognized by the company, though not to the extent of putting them on the books, there is a responsibility for the accountant to comment on the fact that there is an overvaluation, and yet I am fully cognizant of the fact that the valuation of properties is not primarily an accountant's function. I am thinking only of cases where it is obvious.

Now, as a similar problem, take a case where the accountant is convinced that there is inadequate depreciation. It seems to me that he is duty-bound to say something about it, even though he is not a valuation expert.

I do not believe he is responsible for saying that it should be 6 per cent when as a matter of fact it is 5 ½, or something like that; but if it is 1 per cent and he feels it is 6 per cent, I think he is obligated to comment with regard to the inadequacy of depreciation.

The same is true with regard to the inadequacy of provision for recognized losses that have taken place in the property of the industry.

CHAIRMAN STARKEY: Well, certainly he is responsible to call attention to any inadequacy in depreciation and I think that it may be presumed from most accountants' certificates that this question has been covered within the bounds of reason.

On the question of valuation, however, the bounds would be very broad, and it seems to me that he would have to have some very important and probably independent facts brought to his attention before he would be in a position to express his ideas on that question.

MEMBER: Mr. Blough, taking that case that you cited where a corporation has its plant on the books at a million dollars. It is not worth a million. They can not make any money. So they write it down to five hundred thousand. Should the depreciation in the sequence of those facts be half what it was? There is quite a difference of opinion with accountants as to what it should be, the old or the reduced figure.

MR. BLOUGH: I think I am doing too much talking.

CHAIRMAN STARKEY: No; you are very helpful. I wish you would continue.

MR. BLOUGH: I cannot say that I am fully convinced as to just what ought to be done with regard to that. When property is purchased for future use, it seems to me that proper accounting for property is more or less to account for a deferred charge—that is, actually what you are paying for future service of the property—and it ought to be taken care of out of the future products of the property.

When a company realizes that there has been a definite reduction in value, I think there is a good deal of argument for providing a surplus reserve against the reduction in value and continuing to recover out of current earnings the amount of the original cost of the property so that those costs will get into the accounts as long as the property is used and the surplus reserve will be carried into surplus as it is provided for out of income.

Now, I realize that is quite a departure from general accounting practice and I am not ready to say that I am committed to the idea that that is practicable. I think it merits a good deal of consideration.

THE SHAREHOLDERS' INTEREST

CHAIRMAN STARKEY: You are raising an interesting point. It seems to me that there is a very important matter that has to be considered in this connection.

Let us assume that, as often happens, a public-utility company through change of method and so forth loses the use of a large part of its property. If you apply that method it would mean that from then on the shareholders would get nothing until that property had been entirely recovered out of future earnings.

A company engaged in several allied lines of business may lose one of those businesses overnight, so to speak, through obsolescence, and so forth. I think there is a serious question as to whether the security holders in future years should be deprived of all dividends and all earnings just because of that sudden and unexpected loss.

MR. BLOUGH: In my comments I was not talking about a piece of property that was lost. If the value of it is gone and it is out of service, it is lost and I think it should be recognized as having been lost and it should be taken out of earned surplus and not out of capital surplus.

What I was talking about was a piece of property that cost a million dollars and was bought in high prices. Now, we are in the period of low prices and the company wants to recognize the loss in value of the property. The mere fact that they paid for it in high prices does not alter the fact that they are going to pay for it out of earnings during the period when prices are low.

I am talking about a change in value. That is what I understood this gentleman to refer to: change of value due to current changes.

CHAIRMAN STARKEY: Well, the difficulty is that you get close to the borderline of cases of the other type.

Any one else have any ideas on this?

MR. STAUB: The procedure described by Mr. Blough is interesting in relation to the case of highly competitive manufacturing companies where competitors start in with their investments on a very low price level. It is important in such cases to include in current costs at least the present cost of replacement of the necessary operating assets; if that is not done, decisions may be based on old high-level costs, which puts competitors in a very advantageous position.

This method of separating from surplus a portion called capital reserve, if you please, and restoring it to earned surplus currently and in the future is a practical thing and is working in a number of cases.

I want to go back and say in reference to the matter of putting on the balance-sheet a preferred stock in the capital account at a price lower than the eventual retirement or liquidating retirement price per share; that becomes very vital in cases where you must have a stated value per share on the balance-sheet. New corporations sometimes have been known to provide $5 per share of the stated value of a preferred stock that has a $7 annual dividend, with $100 and $105 involuntary and voluntary liquidation value, respectively.

What is the accountant going to do in a case of a brand-new organization? That is a very interesting question.

CHAIRMAN STARKEY: Any one any comments on that question?

MR. BAILEY: It seems to me that Mr. Blough's question is twofold: One is whether the charges are to capital or under surplus. The second is, what should be the charges regardless of what the charge-off was made to?

The difficulty is that you may perpetrate a past error by treating depreciation as an annual determinative cost. Perhaps the company made a mistake in purchasing the property at a high price; it may eliminate that mistake and go along as a relatively successful company, whereas if it tries to pay for that mistake out of all future years it appears as a highly unsuccessful company.

It is a question of whether what is taking place is a very real thing or whether it is pure bookkeeping. Where the prices were high and not justified under present conditions, either competitive or otherwise, it might easily be a mistake to charge earnings in statements for the current or immediate future years with depreciation resulting solely from a mistake of prior years.

CHAIRMAN STARKEY: Any other comments on that?

It seems to me that the company might prefer to go through some form of reorganization to change those values. That might be one of the exceptions. I think it would depend very much on circumstances.

REORGANIZATION THROUGH REVALUATION

MR. BLOUGH: While you are on that point, may I just call attention to a comment that was made by Mr. George O. May in his Harvard lectures this last year, in clarification of what the committee intended with respect to the occasions when you might use capital surplus to write down properties where it was virtually a reorganization.

A good many accountants have interpreted that to mean that if you go through with one of these virtual reorganizations, write down your capital stock and revalue your assets, you can go ahead and use this capital surplus, leaving your earned surplus as it was.

I think Mr. May pointed out rather clearly that what was intended was that that capital surplus should be dipped into only after you had used all accumulations of earned surplus, and it seems to me that that is the only conclusion that could be drawn from the phraseology of the committee. Because if it is virtually a reorganization you cannot come out with a bunch of earned surplus.

CHAIRMAN STARKEY: Is there any one with contrary ideas on that?

MR. BELL: I have one question to state: Is a company justified in reducing its charges for depreciation, subsequently charging to income and its records on the property?

It is my belief that if the property is written down legitimately, or is written up legitimately, the depreciation charged to income ought to be based upon present book value of the property. It does not make any difference whether that is a write-up or write-down. So far as we are concerned, it establishes a virtually new coat.

Now, it all depends on whether it is legitimate to write up the property or write it down. There certainly are cases where that property could be written down in recognition of changes, and there are certainly cases where property can be written up too, but I think a company has got to take its medicine when it writes up the property. It must take depreciation upon the increased book value.

STATEMENT OF QUALIFICATION

MR. CHARLES S. ROCKEY (Philadelphia): We recently had a communication from the S.E.C. that made us do some thinking. As I remember the second paragraph of our certificate, we said, "based upon such examination," and so forth and so forth, "the attached balance-sheet and statement of profit and loss subject to comments thereon, or subject to explanatory notes thereon, presented" so and so, and so and so. That was last June.

We used the same certificate just a month ago and the S.E.C. now tells us that that phrase "subject to comments thereon" is a very important qualification. They are asking us in this particular case to add an additional sentence to the certificate indicating that we take no exception to the accounting practices of the company, but they say that if we would change those few words, "subject to comment thereon" to the words "together with comments thereon," the certificate would be O.K.

I had thought that "subject to comment thereon," was a real qualification in the certificate. I had always believed that the accountants were not taking so much responsibility for a balance-sheet so qualified. I think we are taking a greater responsibility if we say "together with comments" and not use the word "subject."

CHAIRMAN STARKEY: Before asking Mr. Blough to give you a clear explanation of it, I might say that the committee on coöperation with the S.E.C. had several discussions with the various members of the commission on that point, and personally I am in entire sympathy with their position.

FOOTNOTES AND QUALIFICATIONS

I think that if there are exceptions in the accounts which the accountant wishes to mention—if there is anything in the accounts to which he takes exception—he should say so clearly. If there is something in the scope of his examination that he wishes to point out, he should say that clearly in his certificate; to say "subject to the notes," when that may either mean that you are taking exception to certain items explained in the notes or that you are calling attention to the explanatory portions of the notes, is not clear. I think the commission has taken a very sensible stand on that.

Would you like to elaborate on that, Mr. Blough?

MR. BLOUGH: Well, in the first place, it seems to me that financial statements are not the places to tell what the accountant has or has not done. Financial statements are the presentation of the company, and the related footnotes are the presentation of the company.

In my opinion, it is wholly improper for a balance-sheet or a profit-and-loss statement to make a statement and then in a footnote to say it is not so.

In some cases it is almost as if the company were to say in the face of the balance-sheet "We have five hogs," and then in the footnote say, "It is not five hogs; it is four sheep." The footnotes are there for explanation. They expand facts which are already in the financial statements, or explain what is there.

The certificate is the place for expressions of the accountant with respect to what his opinion of the financial statement is, or with respect to his opinion of the audit.

Now, when the accountant says "subject to the footnotes," we have not yet been able to discover what that means. I intend to reserve my comments on this until the discussion tomorrow on "Accountants certificates," but our commission has taken the phrase to have no definite meaning. Nobody knows what it means.

One set of accountants uses the words "subject to" in the final paragraph, and they say, "We merely wish to call attention to what we said previously in our certificate and we are not qualifying at all. We take no exception to what has been done." Another set of accountants says, "We specifically intend to use the words 'subject to' to reflect an exception on our part; we are intending to take exception."

Now, as I see it, the proper procedure for the accountant is in the body of this certificate to state the scope of his work, to state wherein he differs with the financial statements of the registrant. If the registrant prepares a statement in which five hogs are shown and the accountant cannot get them to change it, and he feels that is not sufficiently significant, that he wishes to withdraw from the phrase in his certificate, he should say, "The company shows under so-and-so five hogs, but as a matter of fact the company has four sheep," and then when he comes to his final paragraph he says "except for the foregoing, the financial statements clearly reflect—"

If in order to reflect the facts clearly, the financial statements require the use of footnotes, I see no reason why the accountant should not say, "The accompanying financial statements together with the footnotes thereon correctly reflect the facts with respect to the company."

MR. ROCKEY: Mr. Blough, you say, "The financial statements together with the footnotes thereon correctly reflect the financial position of the company." Yes, we say that; but heretofore I think accountants have not been making a real qualification.

For instance, in this particular case we did not confirm installment notes received. That is a footnote. We believe that a statement is correct, but four or five years from now we would not want a stockholder to indicate to us that a number of these notes were fraudulent.

In this particular instance, are we supposed to state in the certificate the fact that we are not taking responsibility for the value of the accounts receivable?

MR. BLOUGH: In the first place, it is not proper in the footnote to the balance-sheet to say, "The accountants did not verify accounts receivable." That is not the place for it. The place for that is in the body of the certificate. State the scope of the audit and then state, "We did not verify accounts receivable," and then based on the audit, "the statements are considered to be correct."

Now, if the scope of the audit does not appear adequate we may take a different action. We had a small loan company not long ago in which the accountant started off by stating, "We made an investigation of the company, but we did not verify notes, and we did not verify any of the accounts." We said, "Well, do you think you made an audit?"

They said, "Yes, we think we did," and we said, "We do not think that you made an audit such as would ordinarily be made for a regular annual audit and it is not a sufficient audit to meet the requirements of the certificate. You have got to go back and make another examination and certify to it on the basis of an adequate audit."

CHAIRMAN STARKEY: Has anyone else any comments on this question? If not, I will call for an adjournment.