ACCOUNTING REQUIREMENTS OF THE SECURITIES AND EXCHANGE COMMISSION

Address

of

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before the

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at

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In the past two years I have addressed a number of meetings such as yours, as well as meetings of cost accountants and controllers, of the American Institute of Accountants and of the American Accounting Association. To me these meetings are the best possible evidence of the determination of accountants in recent years to explore the full extent of their responsibilities and to meet them. Gatherings of this sort indicate a desire upon the part of accountants to direct their attention beyond the accounts themselves in order to obtain a fuller realization of the implication of accounts in present day society.

Our interest at the Securities and Exchange Commission in the development of accounting goes back to the financial excesses of the 20's, the enormous losses suffered by thousands of Americans on securities floated in that boom period, and to the years in which a few far-sighted pioneers struggled for regulation of some kind in the securities markets.

Seven years ago the United States Congress enacted the Federal Securities Act of 1933. At first this Act was administered by the Federal Trade Commission. A year later the Securities Exchange Act of 1934 became law. Under this Act the Securities and Exchange Commission was organized to administer both the Securities Act of 1933 and the Securities Exchange Act of 1934. Since then there has been expansion of the regulatory and administrative functions of the Commission, so that at present the Commission also administers the Public Utility Act of 1935, the Maloney Act, and the Trust Indenture Act of 1939. In addition, it is required by Chapter X of the revised National Bankruptcy Act to perform certain duties in connection with corporate reorganization proceedings in Federal Courts.

Financial and accounting information plays an important part in the administration of all of these Acts. And in administering all of them the Commission relies upon the work of public accountants. However, it has been the 1933 and 1934 Acts, commonly referred to as the Federal Securities Acts, that have most influenced recent developments in accounting. For that reason my remarks will be limited to the accounting requirements under those Acts.

As you probably know, neither of the Securities Acts gives the Commission power to pass upon the merits of any security, or to approve or disapprove any security. The primary purpose of the Securities Act of 1933 is to bring about full and fair disclosure to investors of material facts regarding securities publicly offered for sale or sold in interstate commerce or through the mails. Similarly one of the major purposes of the Securities Exchange Act of 1934 is to bring about the public dissemination of significant information concerning corporations whose securities are listed on national securities exchanges to enable investors to act intelligently in making or retaining investments and in exercising their rights as security holders. These purposes are accomplished in part by requiring issuers of new securities and issuers of listed securities to file registration statements and periodic reports with the Commission and the exchanges. Forms for all of these statements and reports are prescribed by the Commission.

Form A-1, the first form prescribed by the Federal Trade Commission, was designed to be generally applicable. Its content followed closely the language of the 1933 Act. Because of its lack of particularization and because of the extent of the information required as to property acquisitions and promoters' rewards, this form was found to be more suitable for promotional enterprises than for seasoned companies. To overcome this difficulty Form A-2 was designed for seasoned companies. In addition to numerous revisions throughout the body of the Form dealing with questions regarding the registrant's organization, history and business, property, capital securities, underwriting, application of proceeds from sale of securities, management and control, and other miscellaneous items, the requirements as to financial statements were also revised. At about the same time Form 10, a form somewhat similar to Form A-2, was adopted under the Securities Exchange Act of 1934.

As part of its program of seeking simplification of its accounting requirements, the Commission about three years ago determined to delete from the various instruction books the requirements as to the form and content of financial statements and the several positive accounting rules that had been adopted. This determination rested on the known facts that the language of the several forms was not identical, due to the incorporation of improvements in the later forms and the difficulty of an amendment policy which would change all of the forms whenever an improvement or change in any one was made. In lieu of these many sets of instructions, it was determined to have a single pamphlet containing the accounting rules, and the requirements as to the form, content and detail of financial statements and schedules. This would be applicable to nearly all statements filed under the two Securities Acts, and would eliminate even the possibility of inconsistencies between forms and inadvertent differences. Instructions as to the persons and periods for which statements must be filed will continue to be found in the several forms. Upon adoption February 21, 1940, this pamphlet was designated Regulation S-X and was made applicable to all forms under the Exchange Act except that for railroads, and to Form A-2 under the Securities Act. It is intended that it shall be extended to other Securities Act forms as soon as these can be adapted to its use. However, where special financial requirements are necessary, as in the case of outright promotional companies, fixed investment trusts, or the registration of oil and gas interests, these will continue to appear in the individual forms.

Regulation S-X represents more than a readoption of existing rules. As part of the process, a comprehensive study of the experience gained under the forms was undertaken. First, the original provisions of Form A-2 and Form 10, the improvements that had been effected in later forms and the opinions expressed in Accounting Series Releases were integrated in a draft of a single set of instructions. Registration statements, deficiency memoranda, letters and conference memoranda were reviewed for the purpose of ascertaining how particular provisions had worked out in practice, whether old provisions should be changed or deleted, whether new provisions should be added. On the basis of this review, the first draft was thoroughly revised and submitted to several hundred individuals and professional groups outside the Commission, including among others, registrants, public accountants, controllers, attorneys, and state securities commissioners. The criticisms and suggestions received were carefully analyzed and considered in preparing a further revised draft for submission to the Commission. Following review by the Commission additional changes were made after consultation with public accountants and others. Finally S-X was promulgated in its present form. Not its least advantage is the ease with which the advance of the profession to new levels may be recognized through adoption of new rules from time to time.

Most of S-X consists of what has been in the earlier forms. Most of the changes do no more than incorporate what has been recognized as desirable practice in corporate reporting for many years. Time is too short to review the requirements in detail. I will, however, describe some of their principal features and the more important changes incorporated in the new regulation.

The general requirements of the Commission as to what financial statements are necessary for a registration statement or a periodic report are not essentially different from what accountants have for a long time considered to be best practice. In brief, they consist of a balance sheet, a profit and loss statement, and such supporting schedules as are necessary to present adequately the more significant details of the financial condition and results of operation. In one respect our requirements have perhaps gone beyond customary practice. In the case of holding company systems we have not been satisfied with a consolidated statement but have requested separate statements for the parent and in addition statements for all of the significant subsidiaries either in consolidation with the parent or separately. The practice of accompanying basic statements with schedules is a commonplace feature of accountants' reports to management. Ordinarily such supporting information has not previously been available even to the expert analyst. While we have asked for such information to be furnished us and so made available to those interested and of sufficient experience to use it, it has not been required that most of these schedules be included in the prospectus or documents to be sent to stockholders. The new regulation has also moved in the direction of eliminating schedules which do not provide significant information. Thus, specific rules are included permitting a schedule to be omitted if inapplicable or if the amounts involved are not significant. However, as applied to moving schedules, those which show the opening balance of an account, the additions and reductions and the closing balance, a schedule is significant to our mind if either the closing balances or the additions or the reductions during the period are significant in amount. From the old forms there have been preserved the usual schedules relating to marketable securities, tangible and intangible assets, reserves, supplementary profit and loss information, and income from dividends. New schedules have been drafted to replace those formerly in use which called for information as to each class of securities issued by the companies for which statements are filed. Special attention has been given in the new schedules to the problem of classifying securities held by the issuer in its treasury or in special funds and in making clear, in the case of a holding company system, the amounts owned by affiliates.

Three new schedules have been added. Two of these relate to indebtedness to and from affiliates and ask merely for a breakdown by companies of the amounts owed or owing. The third schedule asks for information as to the amounts owed by any officer, director, or principal security holder who during the period owed as much as $20,000 or one percent of total assets, whichever is less. Amounts owing with respect to ordinary business transactions such as purchases on the usual trade terms or advances for travel and other necessary expenses have been excluded. When the schedule is required to be filed, information must be given as to the entire history of the account during the period. The reason for expanding this requirement is well illustrated by a case in which it was found to be customary practice for certain of the officers to borrow a considerable amount of money shortly after the opening of the year. These loans were then repaid, in at least one case after cancellation of the interest, shortly before the close of the period. As a result, the previous requirement for analysis as of the balance sheet date only gave no indication of the true state of affairs.

The greater part of the new accounting regulation is devoted to a statement of a number of accounting principles and to a reasonably detailed set of instructions as to the detail to be given in the balance sheet and profit and loss statement. It will not be necessary for me to describe in detail what these requirements are, since in general they are similar to the form of statements recommended in the bulletin "Examination of Financial Statements by Independent Public Accountants," published by the American Institute of Accountants in 1936, with which I am sure you are all familiar. Instead, I shall try to develop those sections of the statements which I feel are of particular interest to accountants and investors and to indicate in what respects the new regulations represent a change from the earlier forms.

First, I may consider together a group of changes which hardly involve substantive accounting principles but which, if I may use the phrase, affect "accounting principles of display." For many years it has been one of the first principles given to accounting students that reserves for depreciation and similar items represent a hole in the assets and not a reservation of surplus or a liability. Yet until recently it has been quite common to find such reserves prominently displayed among the liability and proprietorship items. While the old forms indicated a preference for treatment as deductions from the assets in accordance with generally accepted accounting practice, the new regulation takes the firm position that any valuation or qualifying reserve must be shown as a deduction from the asset to which it applies. Reserves which do not reflect the accounting concepts of depreciation or which are not meant to value an asset are not affected by the new rule.

A second point of this character is the provision as to reacquired securities. At the 1938 annual meeting of the American Institute of Accountants a very excellent presentation by Major Watkins of the problem of treasury stock indicated the trend of thought in this field. The new regulation follows his trend of thought in requiring treasury stock be treated as a deduction from capital, surplus, or the sum of the two as the applicable state law may require. Comparable treatment as a deduction from outstanding liabilities is provided for reacquired bonds and other evidences of indebtedness except where such securities are included in a sinking fund not related to the particular issue or in a pension or other similar fund. These changes, to my mind, represent an effort to remove from the asset column items which in no true investment sense may be considered to be assets. In the same vein, discount on capital stock is required to be shown as a deduction from the proprietorship items. While to creditors such an item may have some of the attributes of an asset in liquidation, it has little if any significance as an asset, to an investor in a going concern. A final, minor point in this field of display may be made. The question has frequently been raised as to why the forms have indicated that prepaid expenses are to be considered a deferred charge when the trend of modern thought is that many of these items represent current assets. This trend has been recognized by the permission to include, under current assets, prepayments for services which will be received within one year.

Before moving on to a consideration of some of the specific accounting problems, I think some mention of the footnote question is in order. Criticism has been leveled against the Commission forms, on the ground that too many footnotes are required and that as a result their former province as a warning to the investor is endangered. A great many of the footnotes which we have required deal with the accounting policies pursued by the company. Others ask for disclosure of significant items of financial information which have no proper place in the face of the statements. I do not think anyone will question the necessity of disclosure to investors of the accounting policies followed by a company in a field in which practice has not become settled and in which different and often diametrically opposed practices are the rule rather than the exception. However, the problem of satisfactory disclosure remains. Regulation S-X suggests but does not require that such footnotes be collected in an integrated statement of accounting policies to which appropriate cross-reference from the pertinent captions may easily be made. Moreover, the footnotes which I have found contribute most to the complexity of the statements and tend most to obscure the investment merits of the company are not those which disclose accounting policies of the company nor yet those which seek to disclose important financial information which has no place in the face of the statements, but instead are those which become necessary by virtue of complex and sometimes incomprehensible capital and corporate structures and those which are necessary to reveal the effects of past aberrations from what has long been recognized as sound and generally accepted accounting.

The remedy lies, I think, not in the omission of the information nor in the abandonment of sound accounting principles but rather in the adaptation of corporate structures to their present environment and in the recognition of the importance of sound accounting as a method of properly interpreting business facts.

Recent trends in accounting and investment thought have laid particular emphasis on the profit and loss statement and for that reason it may be appropriate to consider next our requirements as to the detail to be included in the profit and loss statement and its supplementary schedules. In general, the form of the profit and loss statement follows that recommended by the American Institute. As drafted, the statement seeks to determine only the major elements -- sales, costs of sales, other operating expenses, and in reasonable detail the financial and non-recurrent items of income and expense. Supplementary schedules are designed to bring out information with respect to such major items of expense as depreciation, taxes, maintenance and repairs, rents and royalties, and management fees. A separate schedule requires an analysis of the dividends received, particularly from subsidiaries, and a comparison thereof with the earnings of such subsidiaries. In most respects the previous instructions as to the profit and loss statement have operated satisfactorily.

A few changes have, however, been introduced. First, a note is required in connection with the profit and loss statement to explain the policy of the company in its accounting for fixed capital. Heretofore, as a footnote to one of the schedules, a statement of the depreciation and depletion policy was required. In practice it was found that the disclosures under this footnote frequently left much to be desired by the investor. The depreciation policy was not ordinarily integrated with the maintenance and repair policy, as was it in all cases made clear what type of charges were to be made against the reserve created. The new requirement calls for a statement not only of the depreciation, depletion, and amortization policies but also an explanation of the accounting treatment for maintenance, repairs, renewals, and betterments and the policy followed in adjusting the accumulated reserves at the time properties are retired or disposed of. To make the statement of depreciation more concrete, the rates used in computing annual amounts are to be stated if practicable. To my mind the preparation of this note presents a challenge to the accountant. He will, I think, be faced in many cases with a conglomerate depreciation policy involving varying rates for different types of property; with policies of retirement which may be difficult of statement; and with policies of maintenance and repair which are not easily clarified. The note is not intended to bring forth an accounting manual such as might be used by a registrant. What is intended is an integrated and informative description of the way in which a particular registrant seeks to charge its fixed capital costs against the income of various years. To do this satisfactorily will require the best efforts of the accountant as well as of the issuer.

A second change that may be of interest is in the breakdown required of the expenses of management investment companies. The regulation provides a special form of balance sheet and profit and loss statement for the management investment company as it does also for insurance and bank holding companies. Heretofore, there was required in the profit and loss statement merely a disclosure of the total of management and other service fees paid to outside organizations and separately a statement of the other expenses in connection with research. Experience with the investment trust study led us to refine this classification so as to require a distinction between fees paid to unaffiliated persons and those paid to affiliated persons. Fees to affiliates must also be broken down to show the name and amount applicable to each affiliate accounting for ten percent or more of the total fee paid to affiliates. This breakdown seems essential to disclose emoluments from the ordinary operation of the trust which accrue to those who have sponsored its organization or are otherwise affiliated with it. While no comparable changes have been made in the industrial profit and loss statement looking to a more informative classification of recurrent income and expense, it may be noted in passing that many companies, large and small, have given far greater analysis of sales and expenses than the present instructions make mandatory. To my mind this problem of presenting an informative subclassification of the major items of income and expense represents the next step in the development of the profit and loss statement.

A third point under this section is a modification in the instructions as to the schedule on income from dividends. A number of cases were found in which a non-cash dividend was taken up by the parent on a basis differing from that at which it was charged to income or earned surplus by the distributing subsidiary. In several cases the difference in treatment was of significance. To obtain full disclosure of the extent of this practice and its effect on the income statement, the schedule now requires a specific disclosure of the amount of any such difference and an explanation of the basis for such treatment. Another change affects the determination of the equity of the parent in the annual earnings of the subsidiary. This schedule has always required that the amount of equity in net profit and loss for the period be reported. However, many inquiries were received as to whether such equity was to be computed as shown by the books of the immediate subsidiary or whether it should be computed on the basis of the statements of such subsidiary and its sub-subsidiaries consolidated. The schedule now requires that this information be given on an individual basis but suggests the addition of information on a consolidated basis if that is significant.

A final point on the income statement is the incorporation of two accounting releases which appeared a year or two ago. The first of these prohibits the inclusion in the income statement of dividends received on treasury shares. Similarly, gains from transactions in treasury shares are excluded from the income statement. Both of these rules are of course consistent with the requirement that treasury shares be deducted in the proprietorship section.

From the profit and loss statement I turn next to the most closely related section of the balance sheet -- the proprietorship items. In general, we have asked for separate disclosure as to each class of stock issued by the company. On the face of the balance sheet there must be shown par or stated value, the amount authorized and issued, and, under the new rules, the amount reacquired by the company. At first thought it would appear that requirements such as these should not present any difficult problems. However, such problems occasionally arise. Recently a company proposed to eliminate existing preferred stock through a sale of common. Dividends on the preferred stock had over a period of years been paid by an affiliate directly to the stockholders, in default of their payment by the company. Under the terms of the guaranty, the affiliate was entitled to recover the amounts advanced with interest through a claim that was junior to that of the preferred stock but prior to the common stock. Such claim would mature only if profits were adequate to meet it after providing for the current preferred stock dividend requirements, or upon liquidation. No reflection of this claim appeared in the accounts themselves since earnings had been inadequate, and liquidation was not contemplated. Thus in effect, the claim was in many respects similar to ___ of dividends in arrears. However, the company proposed to sell additional shares of its common stock to provide the funds for redeeming the preferred and meeting the dividend guaranty obligation. Provision for this obligation would have reduced earned surplus to a negligible amount. Notwithstanding that one of the prime purposes of the proposed offering was to eliminate this obligation, the statements as filed merely indicated parenthetically in connection with the surplus account that surplus might be subject to a contingent liability for the repayment of the dividend guaranty obligation stating the amount. It appeared to us that the dividend obligation, particularly in view of the purpose of the proposed offering, was more in the nature of a security of the registrant for which proper provision should have been made in the balance sheet. After discussion the statements were revised to reflect among the stock items a provision for the amount to be paid on the guaranty agreement and under the earned surplus account there was shown the aggregate earned surplus, a deduction in the amount of the provision made, and a very small net balance.

A second problem with respect to capital stock arises out of the practice of issuing securities which have a fixed involuntary liquidating value far in excess of the amount reflected in the capital stock account. In some cases this difference between the carrying value and the liquidating value has been in excess of the entire surplus and capital junior to the preferred stock. There have been many variations of this practice. In some the original amount received for the preferred was substantially less than the liquidating value. In others the difference has arisen through a reduction in stated value and a concurrent credit to capital surplus which was then sometimes used to eliminate an existing deficit. Under these circumstances we felt that stockholders, both common and preferred, were entitled to the clearest kind of disclosure as to the nature and effect of this overhanging claim of the preferred stock. Accordingly, at first by means of one of our accounting releases and now by a rule in the new regulation, it is required that the involuntary liquidating value of preferred stock is stated per share and in total. If the excess of this liquidating value is significant, it is required that the difference between the aggregate preference on liquidation and the aggregate par or stated value by shown. If this difference plus any arrears of dividends exceeds the sum of the par or stated value of the junior capital shares and the surplus, a statement to that effect must be made. Finally a statement must be made as to the existence or absence of any restrictions upon surplus springing from such an excess. This latter requirement arose out of the feeling that, if surplus has been contributed by the preferred shareholders, a court of equity might enjoin dividends, at least to common shareholders, which reduced such surplus below an amount necessary to satisfy the liquidating value of the preferred shares and might also enjoin dividends out of subsequent earnings if a deficit had so reduced that surplus.

Most of the problems in the proprietorship section are found in the determination and display of the surplus balances. In substance, our forms have required that surplus be segregated into the usual categories of earned, paid-in, and other capital surplus. This has been subject to the exception, in the case of seasoned companies, that if in the accounts balances for these classes of surplus were not maintained it would not be necessary to make a segregation for the purpose of the statements filed with us. Moreover, the balances in such accounts as were maintained could be taken as of the beginning of the period for which audited statements were required. The new surplus rules have introduced several modifications of these requirements. The first of these was brought about simply by the lapse of time. Cases began to arise in which companies had filed statements for three years with the Commission, then there had been a lapse of several years and then a refiling. The anomalous situation resulted that three of the past years had been subject to Commission requirements, followed by an interval which under the cut-off provision was not subject to our requirements, followed in turn by the three-year period currently being filed. The new regulation, therefore, requires that a company which has once filed with the Commission must in its next filing go back to the balances reflected in the most recent certified statements on file with the Commission, thus applying the Commission's requirements to any intervening period.

Experience with the old rules also indicated that in a number of cases misleading captions had been applied to the surplus accounts. In more than a few instances a surplus account in which there were known to be elements of both capital and earned surplus was designated merely "surplus." In others it was reasonably clear that the caption used was not fairly descriptive of the content of the account. Accordingly, it is now required that companies which do not reflect a complete segregation of surplus must nevertheless employ such account titles as will indicate the general types of surplus included in each account. Under this rule I have seen captions such as "capital and earned surplus."

Another general problem in this field has been the question of surplus arising from the revaluation of assets. The new requirements ask for a segregation to show any such appreciation separately, but this by no means solves the problem. Turning to the asset side, there is first raised the question as to whether, if at all, it is proper to reflect an upward revaluation of fixed properties on the books and in the statements. While formal reorganization or thoroughgoing internal rehabilitation of a company may not only justify but require such revaluations under particular circumstances, I do not believe that any sound purpose is served by such a procedure in the case of the ordinary going concern. Any information as to values other than properly amortized cost which may be thought of significance to investors can better be displayed, it seems to me, by one form or another of supplementary disclosure. This position, you may recall, has recently been the subject of comment by the American Institute of Accountants. Perhaps the more important immediate problem, however, is the treatment to be accorded past revaluations of assets and the surplus arising therefrom. As to this, I think the position recently taken by the Institute, that depreciation should be based upon the same valuation that is carried in the balance sheet, is entirely sound. I doubt, however, whether any exception in this respect should be extended to particular companies on the basis of a long-continued prior practice. And it is of interest to note that recent consideration of this problem has resulted in a significant number of companies eliminating appreciation from the records by appropriate reversing entries.

Finally, we have changed the requirements as to surplus to call for a disclosure of the amount of any undistributed earnings of subsidiaries that are included in the parent company's earned surplus account. While this disclosure has frequently been made in the past it has not been universal. An interesting result of the application of this principle recently occurred. A company which had kept its investment accounts on the equity basis showed for the first time the amount of its surplus represented by undistributed earnings of its subsidiaries. Moreover, the company indicated that as of the beginning of the current fiscal year it had determined to return to the cost basis of accounting for its investments in subsidiaries. This disclosure and the positive action taken by the company may serve to inject a new point of view into the discussion by accountants of the proper basis of accounting for investments in subsidiaries, namely, whether inclusion in the parent's earned surplus is a representation that undistributed earnings of the subsidiaries are legally available for dividends by the parent, and whether that representation is a correct expression of the applicable law, and the indenture or contractual obligations entered upon by the company and its subsidiaries. This point, of course, becomes particularly significant when by virtue of dividend payments or losses of the parent company, the corporate surplus, on the equity basis, is less than the undistributed earnings of subsidiaries.

No discussion with accountants of the Commission's requirements as to financial statements would be complete without some mention of the accountants' certificate. The new regulation has modified previous rules in only two important respects. If there have been changes in the accounting principles followed by the company either at the beginning of or during periods covered by the statements, the accountant is now required to express a clear opinion as to the propriety and significance of these changes. The second change related to the omission of generally recognized auditing procedures. In the previous rules there was the provision that "nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit." Experience with this provision led us to the feeling that the term "regular annual audit" was not sufficiently descriptive of the intent of the sentence. For that reason we have broadened the base upon which the rule rests by inserting the more informative words "an audit made for the purpose of presenting comprehensive and dependable financial statements."

As was announced at the time of adoption of Regulation S-X, further modification of the requirements as to accountants' certificates may be made upon completion of our present studies in the Interstate, McKesson & Robbins, and other cases involving auditing procedures. In the meantime, however, it may be worthwhile to indicate in broad outline the function of a certificate accompanying statements filed with the Commission. That certificate is the medium by which the independent public accountant, who is a person whose profession gives authority to a statement made by him, tells the investor what he has done and what he has found. The prime requisite of the certificate is that it faithfully represents, in the clearest possible language, the job that has been done and the opinion that the accountant has formed. This means to me that, while a standard form of certificate is of great assistance, nevertheless its use in a given case should be accompanied by the most careful consideration of modification necessary to meet the exigencies of that particular case. Finally, before the signature is attached to the certificate, the accountant must not only satisfy himself that the certificate and the financial statements contain no misrepresentation but must go further and discharge the other half of his obligation as a professional expert and make certain that there has been no omission of information necessary to make those statements not misleading under the circumstances.

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