

Memorandum
3-20-42

For Release Upon Delivery

ACCOUNTING AND SECURITIES FINANCING

Address

of

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Before the

Reading Chapter

National Association of Cost Accountants

Reading, Pennsylvania

Friday, March 20, 1942, 6:00 p.m.

The interdependence between accounting and the process of securities financing is quite clear. Several billion dollars' worth of securities were sold to the public in 1941, but offerings of such size could not have been made had there been no means by which investors could form some reasonable judgment as to the likelihood of future earnings. While the most that accounting can provide is reasonably approximate accuracy with respect to past earnings, this in conjunction with other data is sufficient to reduce the uncertainties of investment to a point where people are willing to act upon their judgments. A different testimonial as to the importance of accounting data is found in the fact that in 1941 156,000 pages of public information registered with the Securities and Exchange Commission was photocopied for the public. Most of the material copied was financial information. During the same period almost 28,000 persons visited the public reference rooms of the Commission, many if not most of them for the purpose of examining financial statements of particular registrants.

These examples serve to emphasize only one of the services rendered by accounting in facilitating the financing of corporate enterprises. In addition to providing information on the financial affairs of the issuer it also plays a significant role in the preliminary investigation and consideration that determine the type of security to be issued. Such preliminary work of course involves much more than accounting data. Legal and economic factors obviously

must receive careful consideration. However, unless the financial position and earning power of the issuing corporation are ^{appreciated} known and the new securities properly adapted thereto, sale may be handicapped and financial difficulties invited for future years. For example, unless the decision as to whether to issue bonds or stock takes into careful consideration the amount and stability of the net earnings available for servicing the new security, a security may be chosen which the market will absorb only at an excessive discount or which will result in a top-heavy and perilous financial structure. Likewise, sinking fund or redemption requirements must give recognition to the effect of such provisions on financial condition and to the amount of funds that seem likely to be provided through earnings.

The several acts under which the Securities and Exchange Commission has responsibilities have made it necessary for the Commission to rely on the services of accounting in both of these ways. Four of the acts administered by the Commission require inter alia that registrants make public financial information adequate for the protection of investors, present or prospective. On the other hand, one of these acts, the Public Utility Holding Company Act, involves, under some circumstances, the additional responsibility of judging whether a particular security to be issued is well adapted to the needs of the issuer. A somewhat similar responsibility is entailed under Chapter X of the National Bankruptcy Act, which requires, under certain circumstances, that the Commission file an advisory report on corporate plans of reorganization

that are being considered by the court.

In point of time one of the first questions that must be decided after the need for financing has been established, is the proper form of security to issue. The Commission's responsibility in this matter arises most frequently under Section 7 of the Public Utility Holding Company Act. Subsection (d) of this section states that the Commission may not approve a security issue if it finds, among other things, that the issue is not reasonably adapted to the security structure of the issuer and other companies in the same holding company system, or that the security is not reasonably adapted to the earning power of the issuer.

In interpreting these requirements the Commission has had to deal with accounting problems of all kinds and degrees of complexity, but perhaps the two problems that have most frequently required careful attention are the adequacy of depreciation provisions and the propriety of the valuations reflected in property accounts. Both of these questions may have considerable bearing on the suitability of a proposed security and both of them are questions that draw heavily upon the accountant's work.

The Commission has not developed any self-executing formula that may be applied to determine the adequacy of depreciation provisions and the related reserves. It has clearly indicated, however, that it considers the sufficiency of the depreciation policy to be of prime importance. Especially is it of importance in the public utility field where depreciation is almost invariably a material

element to be reckoned with in determining earning power. There was one instance in which a utility approached the Commission with a highly inadequate depreciation reserve, amounting to less than 2% of its gross depreciable property. There have been numerous other instances in which the Commission has approved a security issue but has conditioned its order by requiring a bolstering of the annual depreciation provision. The depreciation provision affects, of course, not only recorded earnings but also the true size of the residual and protective stock equity -- or viewed conversely it may alter greatly the apparent asset coverage enjoyed by the proposed security. All these are important matters on which management, as well as regulatory commissions, should be accurately advised if decisions are to be wisely made. The day is long since past when depreciation could be looked on as an optional item to be recognized to the extent profits permitted.

The second question that has been considered frequently in Commission decisions under Section 7 is the propriety of valuations placed on the property account. Here again it is possible for improper accounting practices to result in serious misguidance in formulating financing plans. There have been many cases before the Commission where the elimination of unconscionable write-ups or intra-system profits from the property account would exhaust all the available surplus and would seriously effect the margin available to protect the new security.

Where it has not been possible to secure the removal of all write-ups from the property accounts of companies filing under Section 7 of the Holding Company Act, it has been the practice to determine these write-ups and, in judging the wisdom of issuing a particular type of security, to compare the capital structure and asset coverages both before and after excluding the effect of the write-ups. However, while seeking the elimination of appreciation from the accounts, the Commission has been sensitive to the method by which the write-off is accomplished. There was one case, for example, in which a declarant proposed to remove a sizable appreciation element from its property account but presumably did not want to make the charge against its existing surplus. Hence it proposed a procedure which resurrected an earlier charge-off of abandoned property against a capital surplus that had been created by reducing stated capital. This charge-off was reversed, not in total, but only in an amount approximately equivalent to the appreciation to be eliminated, and then the restored amount of abandoned property was charged off to retirement reserve which, incidentally, was at that time admitted to be inadequate. The capital surplus so established was then used to absorb the appreciation write-off. The net effect of this maneuvering was to charge the appreciation to the retirement reserve. The company then proposed to restore its retirement reserve by periodic appropriations of earned surplus extending over not more than six years. The Commission was very critical of this accounting procedure in its decision.

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No rigid formula has been used for deciding when a proposed issue is well adapted to the security structure and earning power of a declarant. The fact that there is a substantial amount of residual or common capital has, however, always been considered important as has the existence of a satisfactory earning margin for both the outstanding and proposed security issues. For some time ~~the~~ weight was given to the purpose of the financing. Where the new issue was for the purpose of refunding an outstanding security, the Commission was somewhat less severe in its judgments, on the assumption "that any improvement of a bad financial structure is necessarily a step in the right direction, and that the issuer should be permitted to take steps in the right direction, even though his proposals stop short of the point where the resultant financial structure is consistent with sound finance and the objectives of the Act." However, in the recent El Paso case^{1/} this viewpoint was discarded and it was ~~settled~~^{announced} that in the future refunding and new issues would be judged by a single standard.

A significant application of this policy arose in a recent case. A utility filed a declaration covering an issue of refunding bonds at a time when its bonded indebtedness was almost 75% of its consolidated capitalization and bonds plus preferred stock equaled 95% of its capitalization. The common stock equity constituted the remaining 4%. Furthermore, the depreciation reserve ~~was substantially~~^{amounted to}

^{1/} Holding Company Act Release No. 2535 (1941).

inadequate, being about 7% of depreciable property, a condition which further emphasized the top-heavy character of the debt structure of the company. The refinancing proposed provided in substance for the redemption of the outstanding bonds from the proceeds of a new bond issue. Although a slight improvement in the financial structure would result, the Commission concluded that the plan could not be approved since the new security was not well adapted to the capital structure of the declarant.

In both this and the El Paso cases the Commission took occasion to point out the twin perils of excessive bond financing, that is, the risk of inability to pay off or refinance the bonds at their maturity and the risk involved in a burden of heavy fixed charges in the interim period. Blind disregard of these perils may lead and often has led to a temporary advantage for the junior security holders, but in the long run the risks are so large that management, as a matter of self-interest, should seek to keep them within manageable limits. The only thoroughgoing solution is an increased reliance on equity financing. Too often, however, there is a failure to repair a faulty financial structure because ^{of the ready market for} securities bearing a low interest rate can be easily sold in a receptive market. This reasoning, however, is likely to mean that repairs will never be made, for when the market for senior securities is good it is likely that the sale of residual equity shares will also be possible on attractive terms but when senior securities no longer have a ready market it is ordinarily too late to sell common shares.

I have already indicated that the Commission has responsibilities of a related order under Chapter X of the National Bankruptcy Act. This chapter, covering corporate reorganizations, states in Section 172 that in cases where the debtor has indebtedness exceeding \$3,000,000 any plan or plans of reorganization deemed worthy of consideration by the court must be submitted to the Commission for examination and report. This report, however, is only advisory in character. Where the indebtedness is \$3,000,000 or less, the court may at its option request such an advisory report from the Commission. Also under Section 208 the Commission may, on its own volition or, at the request of the court, file a notice of its appearance as a party to the proceeding under Chapter X.

Advisory reports filed by the Commission are primarily intended to assist the court and security holders in the consummation of the reorganization. Securities issued pursuant to a plan of reorganization under chapter X are exempt from the registration requirements of the Securities Act, and, consequently, much pertinent information about these securities may not be brought to the public eye. The advisory report of the Commission, however, can call the attention to any proposed securities that appear to be unsound or that seem likely to prove misleading or otherwise injurious to the investing public.

Perhaps the most difficult question which the Commission encounters in its activities under this Act is whether the plan of reorganization contemplated is fair and equitable, and feasible, as required by the statute. It is not possible to describe in the abstract those detailed characteristics that will make a plan acceptable as to fairness and feasibility, but certain norms have been followed by the Commission in the formulation of its judgment. These norms embody considerable reliance on accurate accounting representations.

As to fairness the Commission has adhered to the policy of advocating participation by creditors or security holders in conformity with the priority of their contractual claims. On several occasions the Commission has branded as "unfair" a proposal to grant participation to shareholders when the best indication was that these shareholders had no equity remaining in the properties. In one case the Commission disapproved a plan which provided that a portion of the funds secured from liquidation of assets of the debtor were to be withheld and used to buy on the open market mortgage bonds of the debtor at prices considerably below par. This was deemed by the Commission to be no more than a device for securing benefits for the junior security holders to which they were not entitled in view of their virtually non-existent equity in the properties.

Determination of the interest that may fairly be attributed to each class of persons with claims against the debtor depends of course on a valuation of the existing assets of the concern. The Commission has indicated that it feels the soundest approach to this problem is not solely by way of the balance sheet, but rather largely through the income statement, relying on earning power as the fundamental determinant. Special consideration would, of course, be given to such assets as were to be disposed of. Where reliable judgments of past earnings do not exist, other data must be utilized, and where past earnings appear to be a faulty indicator of future

earnings the needed corrective factors must be applied. It is true in most cases, however, that past earnings reports are an important part of the raw material from which a judgment as to fairness may be produced. The further question involved, as to whether the terms of the plan recognize the proper priority among the various claims, is not simple. Several cases have presented troublesome problems of this sort but their solution ordinarily does not depend on data supplied by the accountant.

The second essential of an acceptable plan of reorganization is feasibility. This can only be determined by an analysis of all the facts of a case, but the Commission has indicated rather clearly the criteria which it considers to be controlling. In its most general terms the test of feasibility for a company that is to be continued as a going concern is the existence of a reasonable probability that a lasting solution of the debtor's problems has been effected. More specifically, the Commission has indicated that this implies that the proposed working capital will be adequate and that the new securities proposed to be issued will be properly related to the earning power and property values of the debtor. In one instance a reorganization plan was labelled "not feasible" when it provided for a temporary respite that might indeed have lasted nine or ten years but seemed very likely to require further revamping within the foreseeable future. In another case the Commission found a proposed reorganization plan to be not feasible since the securities proposed bore no

reasonable relation to earning power. The debtor was a toll bridge company operating under a franchise which stipulated that the bridge was to become a free public highway at the end of the franchise period. The securities proposed to be issued included income bonds, cumulative Class A stock and Class B stock. The foreseeable annual gross revenues of the bridge were liberally estimated to be only \$300,000. Annual net operating income before interest and without any allowance for depreciation could not, even optimistically, be estimated at more than \$180,000. Yet the contingent interest on the proposed bonds was cumulative and amounted to about \$280,000 a year. The company not only would be unable to meet its interest charges but would have no way of providing for the retirement of the bonds. The Class A and Class B stock, of course, had no likelihood of receiving a return in the form of either an earned or liquidating dividend. It was felt that issuing such stocks might result in deception of investors since court approval of a plan of reorganization would ordinarily imply at least prospective values, which in this case did not appear to exist.

From these few examples it seems to me that the contribution of accounting to the proper planning of the type and amount of securities to be issued, while not always spectacular, is nonetheless substantial. Whether the data be used by management alone, by a regulatory agency such as the Securities and Exchange Commission or by the courts in reorganization proceedings, it is a necessary

prerequisite to sound administration of financial matters. Not only is it important that accounting reports be available but it is equally important that they be prepared in accordance with sound principles that fairly present the financial position and earning power of the concern in question.

The second service of accounting previously mentioned is that of providing reliable information for investors. There are few investors that do not now recognize that clear and dependable financial statements are an important aid in making intelligent investment decisions. This is not to say that all investors utilize these statements effectively. There are many who admittedly can derive but scant benefit from examining a balance sheet and income statement, but the fact that these statements contain significant information is, I believe, nearly unquestioned even by those persons who are unable to exploit them fully.

Most of the acts administered by the Securities and Exchange Commission have given recognition to the importance of financial information by requiring that it be made available to the security holders of issuing companies subject to the Commission's rules. Also the New York Stock Exchange has done much to promote fuller disclosure in the stockholders' reports of listed corporations.

Granted that financial statements are essential to intelligent security analysis, the further question is raised as to what constitutes adequate disclosure. There is considerable disagreement

(and not only among accountants) as to the proper showing to be given to a specific type of transaction or to a certain set of facts, but the amount and kind of information that financial statements should reveal is a matter on which at least minimum standards are discernible. Discussion of the specific areas within which there is agreement or disagreement as to proper accounting methods or disclosures would be too formidable a task for this evening. Therefore, I would like to pass to another, and perhaps even more important problem, that of promoting a fuller utilization of financial information by investors.

It is unfortunately true that many investors, not all of them "small", are in that group that are unable to analyse financial statements intelligently. The "line loss" in the transmission of ideas between the accountant who prepares financial statements and the average investor who reads them is one of the most disturbing wastages in accounting. The past decade has seen greatly increased attention being given in the preparation of financial statements to the needs of investors. However, the ability of investors to utilise this information has not shown a corresponding advance. Accountants, regulatory bodies and schools have done something to improve this situation but the difficulties that remain are considerable.

An understanding of the causes of this "line loss" is a necessary starting point in dealing with the problem. There has been ample recognition of the fact that the lack of technical knowledge on the part of many investors is one of the most formidable obstacles in the way of his understanding financial statements. So long as investors

are burdened with misconceptions such as that of interpreting a reserve for depreciation, or surplus, as a quasi-cash account, or of considering the precise-appearing dollar amounts of the assets in the balance sheet as indicative of scientifically exact "values" or of viewing the accountants' certificate as a sort of blanket guarantee, it will be difficult for them to avoid being confused or misled in some measure by financial statements.

Various devices have tended to reduce this "accounting illiteracy". Pamphlets and radio programs, couched in simple non-technical language, have been employed by several professional organizations as a means of educating some investors to a better understanding of financial statements. Financial statements have occasionally been prepared in novel forms designed to describe financial condition in non-technical or even narrative terms, although the danger of sacrificing accuracy for simplicity is ever present in such endeavors, and will perhaps limit the extent to which they may be pursued. Undoubtedly a good deal of responsibility for improvement of the situation rests on the individual investor but there is much that accountants can do to assist him. The developments we have cited are merely indicative of techniques which may be useful in working at this task.

Investors labor under other handicaps in their utilization of financial statements. Even with a good working knowledge of accounting, the uncertainties in the analysis of financial statements are

considerable. For one thing, judgments as to business performance must be subjective rather than objective. It is not possible to compute a reliable index of financial strength by purely routine calculations. The favorable and unfavorable developments must first be recognized and then weighed in the mind before a decision can be reached as to the prospects of the company. The exercise of judgment plays so important a part that probably no two analysts would place identical emphasis on each item reported in a set of statements. Hence, even with full financial information the task is at best one of approximation or of forming enlightened opinions. If in addition financial information is scanty, the task of statement analysis becomes even more difficult.

Accountants have responsibilities in this field as well as in technical matters of recording and reporting. While an accountant cannot certify to an analysis of the financial condition of a company, he can do something toward promoting sound and well considered techniques of analysis and in publicizing those techniques. The field of statement analysis has too seldom been explored in writing by trained accountants. A good deal has been written on the subject that is largely without substance. The increasing recognition of the importance of the income statement for analytical purposes is one example of a significant advance that has been actively encouraged by accountants. There is still room for a good deal of constructive effort in this field and an articulate accounting profession could

accomplish much in deflating some of the misconceptions and in making statement analysis more available and intelligible to investors. It is anomalous, to my mind, to find that the writings on the analysis and interpretation of financial statements should come to such a large extent from those who are only accountants in transitu.

The difficulties facing the investor are compounded by the fact that the basic data he deals with cannot be precisely determined in many important respects. Finespun conclusions from data of only approximate accuracy are more delusion. He must, for example, remember that the difference resulting from capitalizing earnings at 10% instead of 11% is as great as a 10% variation in the earnings themselves. Large investors are ordinarily well aware of these limitations and take steps to supplement their analysis to whatever extent is possible but the small investor is less aware of the limitation and in any event has restricted possibilities for securing supplementary information.

The fact that accounting only reports certain selected aspects of financial condition and reports this information after a considerable amount of estimation or judicious choosing of alternatives, is a limitation that is well nigh ineluctable. It is a necessary by-product of the complexity of business affairs and the fiction of an annual accounting period. However, the fact that accountants may report identical situations in a variety of ways, due to disagreement on the appropriate principles of accounting, and the fact that sometimes financial statements are not made sufficiently revealing

are difficulties with which accountants are familiar and as to which substantial progress has been made in recent years. The search for accounting principles has resulted in a degree of clarification that is difficult to appreciate because of the remoteness of outmoded practices. It is, nevertheless, material. Likewise, the amount of information given to investors has been considerably expanded, even to include the disclosure of accounting policies followed -- an item of great importance that was frequently unrevealed in earlier days. Finally, improvements and extensions in auditing standards and the clarification and fortifying of standards of professional conduct have permitted an increased reliance on the accuracy of the representations in certified financial statements.

These advances within the technical framework of accounting and auditing practice represent the major achievements of the past in improving the service that accounting may render to investors.

I have sought to emphasize, however, that these advances are sterilized to the extent that investors remain uninformed as to the meaning and interpretative possibilities of accounting reports. Some things have been mentioned that have been done or might still be done in dealing with this latter problem. In addition, the future may produce new approaches that will prove useful. The responsibility for progress in this matter does not rest solely on the accountant, but it would seem that under existing conditions a sustained effort to improve the situation must come from within the accounting profession.