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Speeches. SEC Staff

AN APPROACH TO ACCOUNTING PROBLEMS

ADDRESS

of

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In the last few decades accounting has passed from an era of high stools in the ante-room to an era of important seats at the conference table. Its present important position has not been won by accepting subserviently the opinions of others, but rather by offering independent, intelligent and practical solutions to vexing problems confronting managers, creditors and owners. This growth has not been accomplished by any one method. Some of it has resulted from the pressing need of the moment; some of it from the reflections of students of particular problems or general principles; some of it from the shrewd conclusions of hindsight. Some has come by compulsion from statutes, courts and regulatory commissions.

Out of the financial excesses of the 20's came the most recent of such statutes, the regulatory authority of the Securities Act of 1933 and the Securities Exchange Act of 1934. Perhaps their major innovation, so far as accountants are concerned, is the grant of broad powers over the form and content of financial statements required to be filed. In fact, the provisions go even further and permit among other things the adoption of rules as to the principles of valuing assets, of providing for depreciation and of determining income. To accounting in general the exercise of these powers offers another means, more ready and compelling than convention, to make secure the progress that has been won by bitter struggle and in new fields to enable more rapid advances.

But the integration of these new sanctions with existing doctrines in accounting and finance is not to be accomplished at a single stroke or in a single year. Four years ago many accountants "viewed with alarm" the introduction of the controls established over financial information in prospectuses and listing statements. I believe many felt that progress would be hampered, others that individual cases would be straight-jacketed without opportunity for discussion, others that rules would be adopted without careful weighing of divergent views and practical needs. That this has not been the case is clear from the machinery which the Commission has set up to handle the accounting problems presented. It is my intention tonight to outline briefly the principal avenues by which accounting problems come to us, and to illustrate by means of some examples how these problems are handled.

Generally speaking, these problems arise in one of three ways; first, in the course of preparing accounting regulations and, under the Holding Company Act, prescribing uniform systems of accounts; second, in connection with the financial statements which a particular company may be required to file; and third, in the preparation of accounting opinions for the use of the staff or for publication. In addition, of course, special problems arise with more or less regularity in other ways.

I think the steps preceding the adoption of an important form or regulation will best serve to explain the handling of problems falling in the first group. At the present time, an additional form is not ordinarily novel but rather represents an improvement on existing forms in the light of our experience with them. Many of you are doubtless aware that it is proposed to codify the requirements as to the form and content of financial statements in a single document rather than to continue the present method of having a set of instructions in each of the major forms under the 1933 and 1934 Acts. The Forms and Regulations Division set out to accomplish this oejective. It first collated all of the existing requirements and prepared from them a single draft which integrated in a single set of instructions not only the original

provisions of Form 10 and Form A-2 but also the improvements that had been effected in later forms. After obtaining a working draft the experience of the Commission with all of its existing forms was reviewed. Representative filed statements, deficiency memoranda, interpretive opinions and office memoranda were carefully culled with a view to determining what existing language was ambiguous, what provisions had worked badly in practice, what problems had arisen that were not covered, what new principles had been developed, what inconsistencies there were in the various requirements. A revision of the working draft gave effect to the information obtained. The revised draft was scrutinized by the other divisions of the Commission for comments and suggestions on the problems of particular interest to them. Finally, the proposed regulation was presented to the Commission point by point and tentative decisions reached on the major controversial problems.

The next step, of course, was to obtain adequate criticism of the materials by those who would in the future have to work with them. To do this, cooperation was sought of a great number of accountants, lawyers, companies and professional groups. In addition to a large volume of correspondence, conferences were held both in Washington and elsewhere at which members of the staff discussed the new features of the regulation, answered questions concerning it and received personally the criticisms and recommendations of those present. All suggestions received at the conferences or in correspondence were collected and analyzed and, in the light of these, and further thought and study on the part of the staff, a new draft of the materials has been made. When completed this will again be presented to the Commission for its consideration with a view to adoption in the form of a general accounting regulation.

When the interests of a particular class of companies are primarily affected, special effort is made to obtain the views of specialists in that field. Thus in preparing the Uniform System of Accounts for Public Utility Holding Companies, numerous conferences were held with representatives of public utility companies and associations as well as with representatives of state utility commissions and public accountants. Similar special efforts were made in the case of forms provided for promotional mining companies, for investment companies, and for insurance companies.

By thus drawing freely upon the time and thought of those who will be concerned with filings under the new accounting regulation and of others who have given thought to the development of accounting, it is our belief that a far more satisfactory and effective document can be obtained which at the same time will be entirely workable from the point of view of registrants.

In the second group I have mentioned, composed of statements filed under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Holding Company Act, lies the largest volume of accounting problems and the most intimate contacts with companies and accountants. Under the 1934 and 1935 Acts, moreover, the annual reports result in a continuing relationship from year to year.

In this group it seems probable that the more important and controversial problems which may arise with respect to a particular set of financial statements will be known to the company or its accountants before the statements are actually filed. Under such circumstances correspondence, or in

some cases informal discussions, in advance of filing have proved that a solution can generally be found which will be acceptable to the Commission, the company and its accountants. The advantages of such correspondence and round-table conferences are apparent - not the least of them being the mutual understanding of the views and the problems of the registrant and the Commission.

Once a filing has been made, an examination of the financial statements follows as a matter of course. Under the 1933 Act, each registration statement is assigned to a group consisting of an accountant, a lawyer, an analyst and appropriate assistants. A memorandum of deficiencies is prepared from reports of the several experts. As to accounting matters, the deficiency memorandum is then reviewed by a supervising accountant. Under the 1934 Act a comparable procedure is followed as to applications for registration and annual reports. Before forwarding the deficiency memorandum, however, novel and important questions of accounting policy and principle are taken up with the Chief Accountant, and in exceptional cases with the Commission.

If the registrant involved should take exception to any of the deficiencies cited and the matter is not satisfactorily settled by correspondence, a conference may be arranged between the registrant and members of the examining staff for the purpose of clarifying the issues involved and obtaining further information as to the facts and circumstances of the particular problem. If no solution can be reached as to the accounting difficulties and the matter is of sufficient importance, further discussion or correspondence with the Chief Accountant may be requested by the registrant, and again, if necessary, the staff may present the issues to the Commission for its consideration. Ordinarily, however, agreement is reached as to an appropriate method of correcting by change or disclosure the points which have been questioned. Here again the mutual exchange of views and detailed discussion of the issues irons out what often appear at first glance to be major disputes.

If the subject of the controversy is of limited application, a decision made in the case may go no further. If, however, the matter is one of broader application, it may be made the subject of a memorandum for the guidance of all members of the Commission's staff. If the issue involves a general principle of accounting, it may lead to a public release for the guidance of all registrants.

It is in the preparation of such releases that problems falling in the third group arise. The subject matter of these releases may have developed in the manner described from the problems of a particular registrant or may have been suggested in the course of a general survey of statements on file. In either case, the whole area in which the problem falls is first thoroughly canvassed by members of the staff. All available written material is consulted and registrations involving the question are reviewed. In some instances special opinions are obtained from accountants and others in much the same manner as in connection with the drafting of important forms. I think I may safely say, however, that not yet have we sought an opinion and received an unanimous answer. With these opinions in hand and digested, a general conclusion is reached and an appropriate release drafted. In not a few cases, the conclusion is that no release should be drawn. Prior to final approval and publication of a release, the views of cooperating committees of the American Institute of Accountants, the Controllers Institute of America and the American Accounting Association are also obtained.

In an effort to give some general publicity to the type of accounting problems being decided in individual cases, the Commission, a little over a year ago, agreed to supply the editors of The Accounting Review with the facts involved in interesting cases. A total of twenty of these have been published with comments by the editors in the September and December issues of 1937 and the March and June issues of 1938. To continue general publicity for this phase of our work we now plan the publication of such material in a series of releases paralleling our opinions on accounting principles. While some of these releases will indicate merely the manner of treating a particular or peculiar set of facts, others may be looked upon as the first step in the development of an opinion covering a general principle of accounting.

Such is the machinery. I believe you will be interested in observing how it worked in practice in the case of what is known now as Accounting Series Release No. 1. The problem appeared in an application for registration under the Securities Exchange Act. The examiner's report contained a paragraph noting that although earned surplus was present, a write-down of fixed assets against capital surplus had been made at the beginning of the three-year period covered by the financial statements. This had the effect of substantially reducing depreciation charges during subsequent years, and in consequence overstating income and earned surplus. Although the examiner considered this a violation of accounting principles, the facts were disclosed in footnotes to the balance sheet and profit and loss statements, and on this basis no action was at the time recommended. Nor did the examiner comment at the time on the auditor's certificate which stated that the accounts, with notations, were fairly presented in accordance with accepted principles of accounting consistently maintained by the company during the period under review. In connection with this certificate it should be noted that an earlier write-down of property had been charged to earned surplus.

Later, however, the examiner prepared a memorandum discussing the propriety of the registrant's action in writing off the property to capital surplus and asking what, if any, action could be taken. Extensive pencil notes by a reviewing accountant indicate that he was disposed to challenge the propriety of the charge to capital surplus and insist upon an explanation.

The next step was the issuance of a formal memorandum of deficiencies in which the accountants for the registrant were asked to prepare a letter to the Commission justifying the charge to capital surplus before first exhausting earned surplus. The reply to this came from the secretary of the registrant who explained that the write-down was of obsolete plants and excess capacity all supported by proper action of stockholders and directors.

Although the examiner seemed satisfied with this explanation, the facts were presented to the Chief Accountant for his opinion on the principles involved. After reviewing the entire situation, the Chief Accountant drafted a letter to the registrant stating his opinion in the case in such a manner as to be satisfactory for publication. Prior to publication, however, the views of the cooperating committee of the American Institute of Accountants and of the Executive Assistant to the Committee on Stock List of the New York Stock Exchange were obtained as to the proposed opinion. Shortly afterwards the opinion was approved for publication by the Commission and became what we now term Accounting Series Release No. 1. As you know, that release concluded

that reductions in the carrying value of fixed assets made to give recognition to previous under-depreciation, unrecognized obsolescence, and similar conditions must be charged against earned surplus.

This case is only one of a large number involving the practice of restating asset values. Accounting Release No. 8 recites the facts of a case involving a promotional enterprise in which the Commission took exception to the company's intention to use appraised values far above cost in a pro forma balance sheet to be used in a prospectus. The release concludes with the Commission's decision to require the registrant to amend its balance sheet so as to eliminate the appraisal surplus and show the fixed assets at cost. It is of particular importance in this instance to note that the company was in the promotional stage and had no record of earnings. The appraisers defined "sound value" to mean "the value for use by a going concern having prospects for the profitable use, at normal plant capacity, of the properties appraised". Yet the prospectus announced an intention to operate at one-third of plant capacity until sales volume developed.

A related problem of importance in determining income on the one hand and production costs on the other is the amount that should be taken as depreciation when assets are carried at restated values. If written down, I have found few who object to computing depreciation on the basis of the restated amounts. The same unanimity of opinion is not evoked when carrying amounts are restated upward. Under both the 1933 and 1934 Acts the Commission has, of course, the power to determine the method of valuing assets to be followed in statements filed with us. The Securities Act goes somewhat further and in paragraph (25) of Schedule A there is an indication that cost should be used. However, in the case of enterprises having some financial history the entry of sound appraisal values has not ordinarily been questioned, although not infrequently the method of arriving at appraisal values has been made the subject of attack. Even though the entry of appraisals is not attacked, there remains the question, if new and higher amounts are shown for fixed assets, of whether the provision for depreciation should not be based on the new carrying value and, if so taken on that basis, whether any part of the charge may be omitted from the income statement and charged directly to earned surplus, or paid-in surplus, or revaluation surplus.

The importance of this and related accounting problems has prompted an extensive study of the present practice and principles followed in reflecting changes in the carrying values of property. We have sought to find answers for such questions as these. Should the higher amounts be entered in the books or displayed only as a collateral notation? Is accounting at cost inconsistent with determination of sales prices on the basis of present replacement cost? Does the carrying of assets at amounts higher than cost infer the intention to estimate profitableness of operation on the basis of such higher amounts, or at least to earmark permanently any revaluation surplus involved? Or is a requirement of disclosure sufficient?

Some argue the well-established theory that depreciation merely measures the expiration of cost outlays for assets consumed in production. Others that accounting should produce information of value in fixing prices and in planning the financing of replacements. Still others point to a need for consistency whether assets be restated upwards or downwards. Still others to possible inferences by creditors and stockholders when upward restatements are made.

A review of the available cases and authorities has disclosed a well-defined trend among certifying accountants in favor of charging operations with depreciation on the full carrying value of assets in those cases in which new and higher values have been recorded on the books. A number of cases have come to our attention in which the registrant has charged operations with depreciation on cost and the accountants in a footnote have expressed a preference for the higher base. This thought was also expressed, I believe, by several of the speakers at the annual meeting of the American Institute of Accountants last September.

So far the method of disclosure has been followed by the Commission. For example, the problem under discussion came up in the registration statement of a well-known corporation which had appraised its properties and then capitalized appraisal surplus by declaring a stock dividend. The company thereafter charged the depreciation on appreciation to paid-in surplus. A deficiency followed on the grounds that, under the circumstances, the depreciation on the full appraised value should have been charged to operations. The criticism was met by an amendment to the accountant's certificate so as to include the following language: "the companies charged paid-in surplus with depreciation applicable to that portion of the book value of property which represented appreciation ... In our opinion such charges would more properly have been made against current income."

The conclusions of the study have not been drawn. In the meantime individual cases are largely disposed of at the conference table. But the seeds of future rules are sown. As the issues become clarified and the results of various methods are revealed in subsequent annual reports, other releases may be expected to appear, dealing with particular parts of the problem or clarifying certain of the principles.

A somewhat closely related problem is presented by the question of whether depletion is a necessary deduction in arriving at the income of companies exploiting natural resources. It is clear from statements filed with us that practice is not uniform. The oil industry, coal and iron mining companies, and quarrying companies have very generally made such a deduction. In the case of precious metal and certain other non-ferrous mining companies, practice is far from uniform. Some deduct depletion and include it in valuing inventories. Others charge depletion to surplus and do not include it in valuing inventories. Still others merely state that depletion is not taken.

Our examination of this problem has indicated that accounting texts and most practicing accountants treat depletion of wasting assets as a necessary deduction before arriving at the annual profits. Certainly, the costs of acquiring and developing mineral lands or rights must be recovered, that is, allowed for, in any final attempt to determine whether the extraction and processing of the mineral body proved profitable to the operators. A few practicing accountants specializing in this field deny this position. Others seem to recognize the theory but claim there are cogent reasons for ignoring it - for example, that in many cases there is no practicable way of determining the dollar amount to be taken.

It has seemed to us that in principle deduction of depletion in the income account is necessary. Accordingly, in case of deviation from this procedure there has been required in the accountant's certificate a clear statement of the method followed and its consequences in the balance sheet and income statement. This, however, introduces the further problem of whether such a statement in the certificate constitutes a qualification of the accounts or is a mere statement of fact. At the present time such cases as arise are being handled as individual problems by means of discussion and round-table conferences with those interested. In the meantime, the whole group of cases is the subject of another extensive study in the hope of ultimately clarifying the situation by means of accounting releases or appropriate amendment of the rules and regulations.

As accountants you may have particularly direct interests in another problem of importance in financial reporting. I refer to the problem of valuing inventories. In this field, the Commission has adopted no rules other than to require disclosure of the principles of valuation followed. In consequence, nearly all generally recognized methods of inventory valuation have, I believe, been followed in one or another of the statements filed. Only seldom has there been objection by the Commission to the use of a particular method. Despite this latitude of choice, the disclosure requirements have raised some difficulties. Is an explanation such as "cost or market" adequate? It is commonplace that cost on a first-in, first-out basis may be vastly different from an average, last-in, first-out, or standard cost. Like variation is possible in the methods of determining market. The question is made more complex by the use of different methods for different classes of goods held in inventory by a particular company. When a requirement was proposed calling for a clear indication of what was meant by cost or market, numerous commentators made the point that if the operations of a company were at all complex, several pages of explanation would be required by reason of the use of diverse methods. Others indicated that not much less than a text on cost accounting would suffice to illumine "standard" costs. Yet the problem remains. When inventories bulk large, are financial statements adequately informative if only the passing comment, cost or market, whichever is lower, is given as explanation of the basis of inventory values, and consequently of profit determination?

In considering the merits of particular methods of inventory valuation, the inquiry in one direction is naturally as to the effect on the profit and loss statement. If a business is truly cyclical both, let us say, as to volume of sales and as to profitableness, it seems improper to pursue an inventory policy which nevertheless results in a constant or relatively constant showing of profits, irrespective of variations in sales volume. But criteria have not yet been established for conclusively distinguishing an inventory policy which merely reflects the fact of stability from one which gives only an appearance of stability and in reality conceals the ebb and flow which is the distinguishing investment characteristic of some kinds of business.

An interesting case involving judgment on this point was recently presented to the Commission. It has not yet been resolved, but I believe the facts are worth stating. From the information in the application and annual reports the facts appear to be these. The registrant in question is engaged

in a reclaiming operation. Salability of the products depends on a market which is highly erratic both as to price and quantity demanded. Occasionally, one of the products has to be made synthetically in order to satisfy peak demands and retain the market. On the other hand, the company is under contract to take all of the waste products of certain companies and production therefore cannot be regulated to keep step with the demand. The company has followed the policy of making commitments on a sliding scale basis so that the prices eventually paid for the waste product are adjusted to the current market price of the reclaimed products. The company's accounting for finished products seems at first glance to be a variation of the base stock method often used for certain basic raw materials. The striking feature is a candid admission that it is designed to smooth out the ups and downs of each period's operating income that would otherwise appear. But the desired goal is reached by an unusual procedure.

Extremely low base prices are established for the entire finished products inventory. In years when sales exceed production and inventories accordingly decrease, the excess of selling price over the base price of goods taken from inventory is credited to a "Price Equalization Reserve" account and a corresponding charge made to cost of sales. In years when the inventory increases, the added quantities are carried to inventory at the base price, and if actual cost exceeds the base price, the excess is absorbed in cost of sales. This charge is, however, offset by transfers from the price equalization reserve, presumably using all of the reserve or only so much as is necessary to offset the charge to cost of sales. Thus when sales exceed production the reduction in inventory is charged against sales at selling prices, but the excess over the base price is credited to the reserve. When production exceeds sales, it is apparently intended that the increase in inventory is to be deducted from cost of sales at the base price and there is also to be deducted from cost of sales and from the reserve an amount equal to the excess of the current selling price over the base inventory price. As a result, if production were constant and there were no other variants, the business would show exactly the same dollar profit regardless of the volume of sales - as long as the reserve lasted. Yet sale is not assured.

Is this merely a somewhat unusual method of solving the valuation of joint products? Is it a method of allocating profits to the period in which production occurs? Does the fact that sale is not made and is not assured make its use improper? The new policy was installed at the close of a particular year. The necessary reduction of inventory to the base prices selected was charged against the operations of that fiscal year. In the first full year of operation, inventories decreased and a reserve resulted. What should be done if in the next year an increase in inventories wipes out the reserve and if in the following period there are still further increases in inventories? Does the possibility of such a situation invalidate the method or merely serve to limit its usefulness? Finally, is such a method a part of the body of "accounting principles for which there is substantial authoritative support"?

A good deal of the result of the approach we use to accounting problems is not apparent in the statements filed, for in many cases the result of correspondence and conference is that no change in the filed statements is made. An excellent example of how cooperation at the right time can be mutually advantageous to the registrant and the Commission arose at one time

in an entire industry, in connection with the method of displaying inventories. The instruction book for one of the forms for annual reports requires that major classes of inventory such as raw materials, work in process, finished goods and supplies be stated separately and that the basis of determining the amounts be shown. It also permits the use of any other classification that is reasonably informative.

Annual reports for companies in this industry came in with balance sheets as at December 31, 1937 showing inventories in a single aggregate. In some cases, footnotes briefly explained that under the system of accounting employed by the company it was impossible to break down the amount as requested. The notes also explained that physical inventories had been taken in August or September. Since previous years' reports for the several companies had shown the required classification, the companies were requested to explain the apparent inconsistency between the practice of the current and prior years. This correspondence developed the information that the industry had adopted a uniform method of accounting which classified expenditures on production between direct materials, direct labor and overhead but that no work in process or finished goods accounts were used. When sales were made the primary accounts were credited for the proper proportion of cost, and cost of sales was debited. The balances in the direct cost and overhead accounts constituted the closing inventory for balance sheet pruposes. Since nearly all production in this industry is under contract and a system of specific raw materials purchases is used, all costs incurred on undelivered goods could be considered contracts in process. It was claimed by the companies that any attempt to report inventories classified in the conventional manner would entail an excessive cost if determined by physical count and in any case the result would be uniformative if not misleading.

The explanation of the circumstances was felt to justify the position taken by the several companies as to figures supplied at December 31 and the deficiency noted against the companies on this point was abandoned. This situation, however, suggests a way in which registrants may avoid certain deficiencies in such cases. If a marked departure from the form and content of statements previously filed is contemplated, a discussion with us of the problems present and the changes proposed to handle them should make possible a solution which would avoid the citation of deficiencies. In a case such as this the discussion might well be handled by representatives of the industry rather than an individual registrant. In other cases it would seem sufficient for the registrant merely to outline fully the circumstances underlying the changes either in the statements themselves or in supplemental letters.

This case, also, invites consideration of another point in which most accountants are deeply interested. I refer to the use of the natural business year as the accounting period. The accountants involved in the case indicated that the inventories were verified by count during the summer months, August 31 being the most usual date, since at that time quantities were at a minimum. While a change to that date seems indicated, the choice of fiscal periods is not ours. But it may be noted in passing that a profit and loss statement covering a single cycle of operations rather than parts of two is ordinarily more informative. In addition, variations due to changing inventory values would be minimized and in the instant case another qualification by the accountant omitted.

Such is the operation of the machinery we have set up to handle accounting questions. What Chairman William O. Douglas recently said in another connection is equally applicable here:

> "The virtue of the administrative process is its ability to deal with technical, debatable, undefinable or imponderable matters in a discretionary manner. It provides a realistic and sound alternative to hard and inflexible rules which proceed on the false assumption that right or wrong, black or white, constitute the only choice. But beyond that it permits of action not only case by case but by rules. A rule can be expanded, contracted or repealed in light of changed conditions or new experience."

En route, the round-table conference is a requisite step. I hope that no accountant or company will hesitate to employ it.

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