

SEC AND CORPORATE ACCOUNTING

Address by

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I would like to talk to you about your role and the Commission's role in those phases of corporate enterprise in which we work together. In the operation of that complex machine of enterprise in corporate form, you as independent accountants and we as commissioners are in a sense technicians. We each have our separate and distinct responsibilities in keeping the machine running the way the law intends it to run. And you know and we know that occasionally there are those about the shop who want to run the machine in a way that the instruction book says it should not be run.

Metaphors and analogies are always misleading, of course. What I am trying to say is this. Operation of the corporate form of enterprise calls for the collaboration of many types of talents. It needs imagination and daring in the matter of engineering production and selling. It needs judgment, analytical ability and integrity, and perhaps the gift of prophecy in the matter of financing. It needs administrative skill and a warm human understanding in handling the multiple problems of personnel. But it also needs people whose primary responsibility is to see to it that the game is played according to the rules, and that's where we fit in. And by the word "we" I mean corporate counsel, corporate controllers, you independent accountants, on the owner-management side and regulatory commissions on the government side.

Your function as independent accountants, of course, is to serve the interests of creditors, stockholders and management by the auditing and certification of accounts prepared by the company's accounting officers. The functions of the Securities and Exchange Commission under the several acts administered by it insofar as such functions relate to accounts, are concerned chiefly with the effectiveness of the presentation of corporate accounts as a medium of information to investors. It is only a statement of the obvious to say that the information most determinative of the value of a security and the progress of its issuer is the financial condition of a business and the financial results of its operations.

Many of you remember the comment made in 1926 in William Z. Ripley's book "Main Street and Wall Street":

"The advocacy of really informative publicity as a corrective for certain of our present corporate ills must be placed in its proper relation to the whole matter of democratization of control. A prime argument which raises its head at the outset of all discussion of shareholders' participation in direction is that the shareholder - the owner, in other words - is hopelessly indifferent to the whole business. His inertia as respects the exercise of voting power, and almost everything else, is an acknowledged fact. But no one expects it to be otherwise. No one believes that a great enterprise can be operated by town meeting. It never has been done successfully; nor will it ever be. The ordinary run of folks are too busy, even were they competent enough. Nor is it true that the primary purpose of publicity, the sharing of full information with owners, is to enable these shareholders to obtrude themselves obsequiously upon their own managements. But such information, if rendered, will at all events serve as fair warning in case of impending danger. And this danger will be revealed, not because each shareholder, male or female, old or young, will bother to remove the wrapping from the annual report in the post, but because specialists, analysts, bankers and others will promptly disseminate the information, translating it into terms intelligible to all.

" . . . This, then, is the ultimate defense of publicity. It is not as an adjunct to democratization through exercise of voting power, but as a contribution to the making of a true market price. This is a point but half appreciated at its real worth. "

Not only is the information concerning its financial affairs important to the present and prospective investor as a means of evaluating the security which he owns or considers buying, but it is obviously the most significant source of information for the Commission and the courts in carrying out the regulatory provisions of the statutes which Congress has enacted in the public interest and for the protection of investors.

That philosophy was enacted into law in most of the Acts administered by the Commission. To implement that philosophy with respect to financial information, the Congress vested in the Commission extensive powers over accounting matters.

I will not bore you by quoting from each of several acts administered by the Commission the very broad powers which have been vested in the Commission by the Congress. You might make note of the fact, however, that Section 19(a) of the Securities Act of 1933 and Section 13(b) of the Securities Exchange Act of 1934 give the Commission authority to prescribe the items or details to be shown in the balance sheet and earnings statement, the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income and in the preparation of consolidated balance sheets or income accounts. Even broader powers are vested in the Commission by Section 15(i) of the Public Utility Holding Company Act and Section 31(c) of the Investment Company Act of 1940.

The Commission has not, except in the case of public utility holding companies and service companies, adopted general rules prescribing principles of accounting.

The basic concept is stated in Accounting Series Release No. 4, April 25, 1938:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position

of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."

Regulation S-X, which is the Commission's principal accounting regulation, specifies the form and content of the financial statements required to be filed under all of the Acts just mentioned. In addition, when the Commission adopted in December 1950 a major revision of this regulation, the Commission's Accounting Series Releases were coupled with the Regulation as a reflection of considered Commission policy. These releases, as many of you know, include opinions on specific accounting questions, amendments to Regulation S-X and reports of proceedings with respect to accountants under the Commission's rules of practice.

The application of the principle stated in Accounting Series Release No. 4 naturally gives rise to the possibility of disagreement and uncertainty in respect of particular statements and particular problems. If a registrant makes a filing stating accounts on principles for which it claims there is substantial authoritative support, there can readily arise arguments as to whether the claim for support is well founded.

You cannot write rules to answer questions like that. The discussions will go on through the years because accounting is not a branch of mathematics like arithmetic or geometry.

It would be a mistake for the Commission to become too bureaucratically rigid in matters of accounting. I would like to associate myself with the thoughts expressed in the introduction to the Restatement and Revision of Accounting Research Bulletins, published in 1953 by the American Institute of Accountants. In fact, that introduction says a few things so well that I would like to repeat them, just in case there are those in this audience who customarily pass over the introduction to a book:

"The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced.

"The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet changes as they occur . . .

"Although uniformity is a worthwhile goal, it should not be pursued to the exclusion of other benefits. Changes of emphasis and objective as well as changes in conditions under which business operates have led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently diversity of practice may continue as new practices are adopted before old ones are completely discarded."

I understand that once upon a time about 18 years ago, a project was started at the Commission to have the staff prescribe a series of classifications of accounts for each of a number of industries. The project was not carried out. I believe we would all prefer the arguments.

It is not possible forever to clothe a growing boy in the same suit of clothes. If it is not practicable to have accounting principles rigidly formulated for SEC purposes, the occasional arguments and disagreements must go on. We must reconcile ourselves to suffering together from accountancy's growing pains.

Moreover, in the development of ideas - whether in accounting or anything else - the ultimate test of soundness is not brilliance or plausibility or even logic. The ideas which survive are those which become accepted because their application produces sound results in the multiplicity of particular situations which arise in a practical world.

This too the American Institute of Accountants recognized when it said:

"Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of opinions reached by the committee rests upon their general acceptability."

Justice Holmes expressed the same thought when he said "The life of the law is not logic but experience."

And so we must recognize the fluid character of the stuff we work with. I doubt that there is one among you who would think that we should have accounting principles cast rigid in a mold.

Since I have been a member of the Commission we have had a number of conferences with representatives of the accounting profession, both with controllers and with independent accountants. We receive indoctrination from our own Chief Accountant and his associates. We have been taught the importance of moving but not moving too fast. I hate to quote eighteenth century poetry lest it be thought that my thinking is running 200 years behind the times, but I suggest that in accounting it is well to obey the injunction

"Be not the first by whom the new is tried,
Nor yet the last to lay the old aside."

We have had discussions on accounting for stock options and the accounting problems raised by accelerated amortization.

On the former subject you may recall that Accounting Research Bulletin No. 37 of the American Institute of Accountants was revised in January 1953.

The Commission, in February 1953, because of observed conflict of opinion on the subject, published for comment a proposed amendment to Regulation S-X requiring accounting for compensation under employee stock options as prescribed by Bulletin 37 before revision. Extensive written and oral comment was considered by the Commission with the result that a conclusion was reached that the conflict in opinion on the subject was so great that it would be inappropriate to prescribe a procedure for determining the amount of cost, if any, of employee stock options to be reflected in profit and loss or income statements to be filed with the Commission. A revised proposal for amendment of Regulation S-X was then circulated which would provide for full disclosure of the terms of employee stock options and the method of accounting for compensation, if any, followed by the registrant. The rule requires that information be given as to the number of shares and their option price and fair value per share and in total at granting date, first date exercisable and when exercised. To avoid unduly lengthy notes the rule states that the information may be summarized as appropriate with respect to each of these categories. This solution of the problem drew very little comment and was adopted to be effective with respect to financial statements for any fiscal year ending on or after December 31, 1953. This requirement can be met in concise notes just as disclosures with respect to pension plans have been reduced from the earlier lengthy first efforts.

On the matter of amortization of emergency facilities, we have been pulled both ways by registrants, by the June 1953 Bulletin of the Controllers Institute and by Bulletin 42 of the American Institute of Accountants. We are accepting in respect of 1953 reports statements of accounts which amortize the portion of the cost of properties covered by certificates of necessity over the five year period as well as statements of accounts which depreciate the cost of such facilities over the probable useful life of the facilities but give recognition to the resulting reduction in income tax benefit after the close of the amortization period. The transitional stage of thinking on this subject exemplifies the process of getting an accounting principle generally accepted. The registrants in filing statements on either basis have been making adequate disclosures as to the method followed and the effect which would have been produced if the alternative method had been followed.

We have had several discussions - some practical and some academic - on departures from cost in the handling of depreciation. On this subject we have recently declined a formal application to adopt a requirement that economic depreciation (based on replacement at current prices) be reflected either in the accounts or by other appropriate disclosures.

We have been importuned to greater liberality in balance sheet treatment of assets acquired as a result of a fortunate purchase, but we shall continue to be practically deaf to the persuasion of appraisals.

There are a number of accounting statements filed with the Commission which reflect balance sheet write-ups. Usually the write-up is concurrent with the decision to make a public offering of securities. I think that it is perfectly obvious why it is not in the public interest for us to allow such statements to pass without comment. I call your attention again to Section 19(a) of the Securities Act of 1933 which vests in the Commission authority to prescribe the methods to be followed in the preparation of accounts and in the appraisal or valuation of assets and liabilities.

A somewhat analogous problem is the capitalization just prior to a public offering, of items which for many years prior thereto had been charged to expense not only for tax purposes but

in stating the corporate accounts for internal purposes. I think you will agree that the Commission is correct in taking a tough adverse attitude on this practice.

The Commission has also had a considerable number of accounting questions arise in connection with administration of its so-called Regulation A. Regulation A, extensively amended in March 1933, has to do with certain offerings up to \$300,000 which are entitled to exemption under Section 3(b) of the Securities Act. Regulation A as formerly in effect did not require financial statements nor the use of an offering circular - although such statements and offering literature, if used, were reviewed by a regional office of the Commission. Under the new regulation an offering circular including financial information is required if the amount of securities exceeds \$50,000.

Since the rule does not require that these financial statements be certified, many problems arising in the examination of financial statements included in offering circulars stem from the fact that the statements have been prepared by persons unskilled in such work.

I respectfully suggest that the required use of financial statements in connection with offerings under Regulation A will have the effect of encouraging a wider use of generally accepted accounting principles since in the Commission's processing of offering literature such statements are required to be brought into conformity with such principles.

We have had questions arise with respect to the independence of accountants, particularly in some of the nation's smaller communities, where the application of ideal standards creates practical problems which would not arise in larger centers. We have had discussions as to the responsibility of the independent accountant to insist, over his client's objection, upon employing adequate auditing procedures.

We have had several problems in respect of foreign issuers. Nice questions are frequently posed by the arithmetical impossibility of converting the result achieved by one method of accounting into the result which would have been achieved by the

application of another. An overall policy question is presented to us in the matter of accounts and other disclosures by foreign issuers. The national interest in encouraging American investment abroad would naturally suggest removal of needless barriers to the access of foreign issuers to American capital markets. On the other hand, if foreign standards of disclosure and accounting are not up to our standards, it might well be that lowering our standards for foreign issuers might result in a general lowering which would be adverse to the public interest. It is hard to conceive of an aggressive, two-fisted American corporate executive consenting to less than "most favored nation" treatment from an American regulatory commission.

From this partial list of accounting problems that the Commission has discussed within the last year, you would think that some degree of turmoil exists but when one considers the vast complex presented by the accounting problems of American industry, it is almost a miracle that the areas of controversy are so small.

Private organizations like your own, like the Controllers Institute and like the American Institute of Accountants have had a great deal to do with the achievement of the high standard of American accounting. I think that all will agree that the achievement, however, is not one which should be viewed in the past tense. It is a process which by the very nature of things must be continuous. The results of your work are an indispensable tool of management but they are also indispensable in the administration of laws designed to protect investors. I think it fair to say that your work and our work have contributed greatly to the development of better and more informative corporate accounting and reporting.

The discipline of legal liability has been imposed upon issuers, officers, directors, controlling stockholders, underwriters and experts. At the time the Securities Act was adopted there was strong protest to the effect that the imposition of such liability would deter capital formation. While the liability provisions have restrained exuberance in the presentation of material, the process of capital formation has gone on. Nor have the liability provisions generated a wave of law suits.

Your name or the name of your firm goes on a registration statement. On matters of accounting, therefore, you are "it". It would be hard to argue that the liability imposed upon accountants by Section 11 of the Securities Act has not contributed to improved accounting standards and procedures.

The Commission has loaned both moral and legal support to those who have helped to develop better and more informative corporate accounting practices. It has goaded a good many stragglers into falling in line. I cannot see, in view of the categorical language of the statutes which it administers, how the Commission can do otherwise.

Our political democracy and our free press both testify to a belief that an organization of people does best when the people who compose it know the facts. The full disclosure concepts of the several securities laws were received in the beginning with grave misgivings. But who can urge today that the duty to disclose has either seriously interfered with the raising of capital or hampered management in developing the economic potential of the enterprise it administers.

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