

ADDRESS

of

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*Commissioner, Securities and Exchange Commission*

Before the

MILWAUKEE CHAPTER

WISCONSIN SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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To introduce my talk this evening let me say, what at least some of you know, that I am not an accountant. I cannot bring you a message with any such authority as might attach to the statements of one who professes competency in the science of accounting. What knowledge of accounting I have has been obtained by exposure to accounting discussions and to the necessity of forming unprofessional judgements rather than by consistent and organized study of the subject.

A layman who voices his opinions on any technical subject or with reference to the application of standards by the members of a profession is always in danger of getting beyond his depth and of merely exposing his ignorance where he is most vocal in criticism. What I have to say this evening may offer no exception, but whether or not you think that what I say in criticism is sound, the relationship between your profession and the administration of the securities legislation is such that you are entitled to have that criticism expressed, even though you may not admit that it is valid.

I might limit myself to a presentation of specific instances which have been considered by the Commission in connection with the application of the program for regulation of the sale of securities -- and before I am through I plan to bring to your attention a number of such instances in the hope that I may leave with you some understanding of the Commission's attitude and of the philosophy - if such it may be called - of its approach to these accounting problems. But I think I should attempt to do more than this. I think I should discuss with you some of the difficulties which seem to be fundamental.

The Commission, as you know, has not adopted general regulations governing accounting methods. Rather it has sought to attack each problem as it is presented in an individual case. In this way, case by case, the Commission has been sorting out what seem to it improper accounting practices, securing correction of statements, and criticising methods reflected in statements. This, I think, constitutes a movement in the right direction. Some of the leading accountants of the country report that already there has been a considerable improvement and have urged the Commission to continue this policy of handling each problem as it arises in a particular case as opposed to adopting a set of general accounting rules. Many accountants, on the other hand, have favored the formulation of general rules -- feeling that such rules would be helpful to them and their clients.

Section 19(a) of the Securities Act empowers the Commission to prescribe the items or details to be shown in the balance sheet and earnings statement, and 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 and as to certain other accounting matters. A similar provision in the Securities Exchange Act is contained in Section 13(b). Up to the present the Commission has not issued rules covering these matters but has tried to stake out its path by its handling of individual cases.

Whether it may become necessary to resort to general rules, I do not know. It seems to me that whether or not that will become necessary depends largely upon the members of your profession.

I have often heard it said that accounting is not an exact science -- that general rules and practices must be adapted to special cases, and that to attempt to force accounting principles and forms of statement into an unvariable course and form would retard progress and in many cases unfairly picture business results. It is not my purpose to deny that there are dangers such as those indicated, but no layman can examine the hundreds of statements which have been filed with the Commission without being impressed with the lack of general acceptance of uniform principles in respects where it would seem to him that fundamentals of accounting principle are involved. If an analogy may be drawn between accounting and engineering -- it is as if engineers had no agreement on the required strength of foundations, structural steel requirements for skyscrapers, or efficient design for power plants.

I think that a governmental agency should frame rules to govern the exercise of professional functions only when the need for such rules has been shown to be of real public importance. Mere preference of the administrative agency for one method or form is not a sufficient reason for taking the formulation of principles and practices out of the hands of the members of a profession, and where the profession gives evidence of its capacity and willingness to develop and apply proper methods without evasion or undue delay, it should be encouraged to take on the responsibility. If the profession fails in its public duty to recognize and apply adequate standards, I believe the agency whose duty it is to administer laws such as the Securities Act must eventually move in.

It would be unfair not to acknowledge the influence which the accounting profession has had in the improvement of conditions within its scope, but it would be fatuous to assume that because the profession exists there is no occasion to be critical of results produced and no need of taking stock of what remains to be done.

It seems to me that we are coming to have a different conception of the functions and responsibilities of public accountants. Perhaps it would be better to say that our conception of the function of the public accountant is becoming clearer.

Only a small part of what should be the public accountant's responsibility has been performed when he reviews the accounts of a company for the purpose of assuring its management that it has accurate figures of financial results and status. By no means has the complete responsibility been met when reports, adequate for their purposes, are made to underwriters of securities who stand between the enterprise and those investors whose funds give it life.

In the light of our securities laws, the accountant has a responsibility for financial information which is important to the formation of an opinion as to whether a security should be bought or sold. The success of the application of the basic principle underlying the Securities Act, that complete and fair disclosure of all material facts should be made, is dependent on no one more than on the accountant.

Granted that many people are unable to read statements and certificates intelligently, it seems to me that the aim of the accounting profession should be to make those statements and certificates as clear and unambiguous as their technical nature permits. Financial statements which conform to convention and custom are not adequate if, in fact, they serve to conceal or fail to bring to light financial conditions or results which an intelligent investor needs to know in order to form a judgement. Certificates are not adequate if they evade expression of opinion regarding accounting practices which are not sound. I question how far an accountant may, in good conscience, resort to a multitude of notes attached to statements to explain unsound, questionable, or irregular practices where clarity of statement and of opinion would be better obtained by showing as a part of the statements themselves, the adjustments necessary to bring those statements into accord with sound practice.

Experience with statements which have been filed under the Securities Act clearly indicates to me that the profession has a long way to go to meet its full responsibility. In saying this I am not ignoring the many excellent statements and certificates which have been furnished, nor do I want to be understood as charging the profession generally with having failed, nor of failing to recognize that many of its members have conscientiously faced their duty in its broadest sense.

Nevertheless, I stand on the statement that the profession, by and large, has a long way to go. I think there are three or four principal reasons why this is so.

In the first place, the accounting profession is highly competitive. Competition exists not only within the ranks of those who have the status of certified accountants. There is a large body of practitioners as well who are not certified, which group shades down into a class who profess competency in accounting but whose qualifications make their use of any claim to be accountants altogether improper. Even under the Securities Act we have had experience with statements submitted on the authority of practicing accountants which showed on their face the utter incompetence of those who prepared them.

Accountancy has not yet reached the point which the legal and medical professions have attained, in which the practitioner must meet standards of professional knowledge before he may undertake to practice. For example, under the Securities Act, a public accountant has the same status as a certified public accountant. If he is an accountant in public practice and is independent of the issuer, he may certify financial statements with all the authority of the best firm of certified accountants in the country. Apparently the only determinations which the Commission may make as to his qualifications are that he is independent, that he is in public practice, and that he is an accountant. Who is, in fact, an accountant is not always easy to determine. Probably the test would have to be sufficiently easy so that individuals lacking a great deal in true professional qualifications would come within the term.

What seems to me to be a second reason why accounting has not come closer to its goal is the fact that traditionally the services of American

public accountants have been rendered to the management as distinguished from the investors. I do not mean that their work has not in a great many cases been of service to investors, but generally they have been the representatives of management rather than representatives of the investors, charged with the responsibility of reporting on what the management has accomplished. It may be very difficult to change this traditional relationship. Where large numbers of security holders are widely scattered, the proxy system of corporate government makes it questionable whether the selection of auditors by the stockholders would bring about their genuine independence of management. No single means of securing this independence seems available. Its gradual accomplishment is probably a matter of the stimulation of professional consciousness, of continual effort from within to raise the standards of the profession, and of pressure by public authority for the maintenance of high standards.

I have just indicated that the public accountant, though retained by management, has a responsibility to investors and to the public generally. I do not think that statement lays me open to the charge of being an idealist. It rests on a very sound business base. One of the most important assets of the public accountant, it seems to me, is his reputation for independence. There is a measure of public confidence that, although he is paid by the management, his first loyalty will be to the standards of his profession and to those who read the statements he prepares. Responsible accounting firms have worked consistently and unceasingly to build and protect this asset of reputation and public confidence. It seems clear that the public accountant who compromises his independence, whether by subservience to management or otherwise, not only injures his own reputation but weakens public confidence in the independence of accountants as a class, and to that extent destroys one of the chief assets of the profession.

What seems to me to be a third reason why accountancy has not more nearly fulfilled its possibilities is the tendency to rely on precedent and authority rather than on the scientific method. The competitive nature of the profession and its traditional affiliation with management makes the acceptance of precedent dangerous. Perhaps when I come to a recital of a few of the specific problems which we have met, this danger will appear more clearly. Accounting authority also seems to me to be surprisingly lacking in critical analysis. As problems are presented to us, we usually make a study of the accounting authorities. Results have been disappointing, first, because there seems to be a complete lack of literature on many problems, and, second, because the authorities, even though often differing among themselves, seem too much inclined to state a rule without giving the reader the benefit of the reasoning on which the conclusion is based. The field for research in accounting seems to me to be a huge one. Practicing accountants should have a part in this research and colleges and universities should have a place in it comparable to that which they occupy in other fields.

The place which the Securities and Exchange Commission should take in this research program has so far not been clearly marked. Up to the present the Commission has developed its views largely by the case method. In a few instances resort has been had to stop orders to suspend the

effectiveness of registration statements where accounting practices were clearly in violation of sound principles and erroneous in their portrayal of condition and results. How far the Commission must take the lead in requiring the application of certain principles is a question about which there may be great differences of opinion. Much will depend upon what is accomplished in other ways, but unless the profession of accountancy moves forward consistently to develop principles and presentations with a view to meeting the investors' needs, the Commission may find it impossible to fulfil its responsibility in the program of securities sales regulation without going much further than it has in imposing requirements.

A business enterprise which asks the public to furnish it with capital or whose securities are widely held and actively traded surely owes an obligation to investors to furnish them with clear statements prepared in accordance with sound principles. The accountant who certifies the statements should have an obligation to tell investors clearly and unequivocally what his opinion is of the statements and of the accounting principles and practices which they represent. The instructions for registration forms which the Commission has prescribed provide that the accountant's certificate shall state his opinion of the results and of the principles upon which they are based. Yet one of the most difficult undertakings of the Commission in the field of accounting has been to secure certificates which stated such opinion clearly so that it could be understood by the investor.

Accountants have frequently told me that, when, in their certificates, they certify "subject to the foregoing comments", they mean to direct attention to the fact that the certificate would or might be misleading without the comments and should constitute notice to the reader that, to an extent, the statements reflect improper or questionable practices.

Generally, however, they will not make a direct statement that the practices were improper or questionable. Sometimes they obviously do not mean that all of the matters commented on are subject to criticism. Frequently the comments will relate in part to practices which are questionable or improper and in part to procedures which are proper but need elucidation.

Such certificates do not clearly state the opinion of the accountant. Perhaps they would serve the purpose of the management or of the analyst, but if the reliance of the Securities Act upon presentation of pertinent facts to the public is to be justified, surely a clear statement of expert opinion is called for. Perhaps the explanation for the failure to meet the simple test of clarity and definiteness may be found partly in the lack of a general recognition of what are correct principles and partly in the historical development of the relation between the accountant and the management.

A fourth difficulty seems to me to arise from the fact that financial statements often contain figures for which the accountant is not willing to take responsibility and which he feels unable to criticize. An example is the provision for depreciation on a large and complicated property and the reserve for depreciation which appears in the balance sheet. Here the general practices seem to fall into three classes: First, a disclaimer of any responsibility for the figures; second, a modification of the first, which uses the phrase "subject to the adequacy of the provision for depreciation"; and, third, a statement of management's practice and whether or not it purports to represent a provision on a life and age basis.

It must be admitted that the accountant may not be in a position to certify to the adequacy or correctness of the depreciation accounting. There are a great many cases, however, where the provision has so patently been insufficient that it is questionable whether the accountant is not called on for the expression of an opinion. A difficulty here is that the practice in such cases of giving an opinion to the effect that proper standards have not been applied might lead to misunderstanding of the certificate in cases that are more nearly borderline, and where the determination is clearly beyond the province of the accountant.

This may well prove to be one of the classes of cases as to which the Commission should prescribe standards under Section 19 of the Securities Act.

It has been suggested that you would be interested in having me outline a few of the specific problems which have arisen in the administration of the Securities Act and indicate how they were handled. It will, of course, be impossible to present anything comprehensive within the limits of this paper and of your patience, but a review of a few cases may emphasize some of the respects in which it has seemed to us that accounting statements have failed, as originally submitted, to present a proper picture of the business. Some of the more flagrant cases have been discussed in stop order opinions but those which follow are cases where amendments have been worked out informally.

The first case that I will mention arose in connection with the registration of a bond issue of a large public utility.

#### CASE NO. 1

Prior to 1924, the registrant followed the practice of amortizing debt discount and expense by charges against income over the life of the respective issues. In 1924, it wrote up its fixed capital and investment accounts approximately \$15,000,000, crediting about \$7,000,000 to a retirement reserve and about \$8,000,000 to capital surplus. During 1924 and 1925, it wrote off to capital surplus a total of approximately \$8,000,000, which was substantially all of its then unamortized debt discount and expense. The effect of this write-off was to relieve the income account prior to August 31, 1924 (the date of the balance sheet included in the registration statement) of amortization charges aggregating approximately \$5,000,000; the balance (approximately \$3,000,000) would have been charged to income subsequent to that date. The accountants commented upon these facts in their certificate and in the final paragraph took exception to the procedure followed.

Objection was raised to the method followed by the company and considerable discussion both within the Commission and between the Commission and representatives of the registrant and the accountants was had. Without commenting upon the effect upon the property account and the increase in the reserve by additions made other than from earnings, the procedure followed raised the following principal objections:

- (1) The earnings statements for the periods covered were overstated.
- (2) The earned surplus account was overstated.

- (3) Since the funded debt on which the discount was incurred was not yet due, the procedure would result in overstatements of earnings and earned surplus accounts in the future.
- (4) The procedure failed to disclose that a deficit would have existed in the earned surplus account.
- (5) It did not disclose the true interest burden of the company.
- (6) It, in effect, capitalized discount.
- (7) It understated the amount of the unamortized debt discount.

As finally amended, footnotes to the earnings statements, balance sheets and surplus schedules and more extensive comments in the certificate of the accountant fully revealed all of the facts involved. Any one reading the statement and taking into consideration the footnotes and comments of the accountant was put on notice of the fact that the company had followed incorrect accounting procedure and was given information necessary to determine the correct results that would have obtained had correct accounting procedures been followed. The company was not required to change its accounts or its accounting procedure.

The majority of the Commissioners thought the facts were sufficiently disclosed in the registration statement and prospectus as amended. Accordingly, the statement was permitted to become effective. Two of the Commissioners thought that adequate disclosure and treatment required that the balance sheets, the earnings statements, the earned surplus accounts and statements of dividends paid should be restated and should be accompanied by a description of the company's past accounting practices.

In considering the principles adopted in this case, it must be recognized that the Commission permitted this procedure to be followed only because it was possible to make, and the registrant had made, in the opinion of the majority of the Commission at that time, a disclosure that was sufficiently simple to make possible the reading of these statements without serious danger of misunderstanding.

#### **CASE NO. 2**

Shortly after that case, a holding company in the same system filed a registration statement. The financial data as originally presented by it included fifteen pages of notes pertaining to the balance sheet and profit and loss statement. The certificate of the accountants included numerous qualifications and exceptions. Because of this, it was practically impossible to determine with any degree of certainty either the company's financial condition or the results of its operations.

It appeared to the Commission that in this case adequate disclosure could not be made without some adjustment in the financial statements themselves. To overcome this condition, the various financial statements were amended to give effect to many of the adjustments referred to in the accountants' certificate and in the footnotes.



This was accomplished by showing on each such statement three columns, headed as follows:

Items	(1) Per Company's Books	(2) Footnote Adjustments	(3) Amounts if Adjusted as Explained in Footnotes
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Through the adjustments shown in Column (2) of the balance sheet, surplus was reduced from approximately \$139,000,000 to a deficit of approximately \$33,000,000 as at December 31, 1934. This reduction in surplus was offset on the balance sheet through the reduction of assets.

The final statements as drawn still had an extremely large number of footnotes and the accountants' certificate was long and complicated but we felt that it was considerably simpler and more understandable to the investor than it was before the statements were required to be changed.

The difference in treatment in these two cases was due largely to the fact that in the first case, the majority of the Commission felt that the information as presented was sufficiently revealing and the deviation from accepted principles of accounting was shown in a manner sufficiently easy to analyze that it was unnecessary to require further amendment of the statements; whereas, in the latter case, the information presented in supplementary notes and in the accountants' qualifications was so complicated that it was next to impossible to get any adequate understanding of the facts.

It is interesting to note that in a third case, that of the registration of an issue of another company in the same system, the entries which were the basis for criticism were reversed on the company's books after discussion with representatives of the Commission, so that the statements as presented caused no difficulty.

**CASE NO. 3**

In 1930 a public utility company operating electric, gas and traction properties made a revaluation of its electric and gas properties, as a result of which their value on its books was increased approximately \$8,200,000. This excess was carried to an account designated "Appraised Value in Excess of Book Value". The amount of this write-up was credited to "Capital Surplus - arising from revaluation of electric and gas properties".

During the years 1930 to 1935 inclusive, abandonments of traction property, amounting to something over \$2,100,000, were written off against the capital surplus so created. The accountant's certificate made no reference to this and expressed no opinion concerning the propriety of the write-off of abandoned traction property against surplus created by the write-up of electric and gas property.

The Commission was of the opinion that this procedure was sufficiently questionable to necessitate a specific expression of opinion by the accountant with respect to the practice.

Accordingly objection was raised to the statement as it had been presented. Considerable discussion took place as to whether the company should be required to carry the amount of the abandonment to earned surplus and restore the appraisal surplus to its original amount.

The accountants in the case supported the claims of the registrant that the procedure followed was in accordance with accepted accounting practice and expressed a willingness to so state in their certificate.

The upshot of the matter was that amendments were finally made to the registration statement which, among other things, gave complete information on the appraisal, stated how and by whom it was made, described how the results were set up, described the abandonments of property and explained how they were handled. Also, the certificate was restated in such a manner that the accountants clearly expressed their opinion of the procedure in question. The amended certificate as it related to this item read as follows:

"Losses on the complete abandonment of certain street railway operations have been charged against capital surplus arising from re-appraisal of assets. Neither the practice of the company nor general accounting practice calls for provision for such losses out of income or out of reserves created out of income, and in our opinion they are properly chargeable against any capital surplus, including surplus arising from reappraisal of properties assuming the correctness of such reappraisal (which being a question of valuation we, as accountants, cannot pass upon). In the absence of appraisal surplus, sound accounting practice would, in our opinion, have permitted the charge of the losses against a capital surplus created by reduction of capital or otherwise or, alternatively, they might have been charged against surplus earned prior to abandonment or over a period of years following abandonment; the extent to which the earned surplus on June 30, 1935 would have been reduced if the latter alternative had been followed cannot be stated. The earnings would not have been effected."

Here again, in my opinion, the procedure that was followed was in violation of good accounting practice. However, all the facts were clearly stated and the accountants expressed an opinion on the principle involved and seemed, at first reading, to do so with respect to the application of the principle in the particular case. Here again, full disclosure of the pertinent facts was the guiding principle in the settlement of the case. The accountants' disclaimer of responsibility as to the genuineness of the surplus, of course, raises a question of whether they had really expressed an opinion on the particular entries concerned.

The distinction between this case and the first one I cited is that in this case the accountants upheld the practice of the registrant as being in accordance with accepted accounting practice whereas in the other the accountants took exception to the method adopted. We felt that neither case followed good accounting practice, but, since all the facts in the case were presented in such a manner that the investor would not be misled and since the accountants had expressed their opinions with regard to the procedures, the majority of the Commission felt the statement might be permitted to become effective.

CASE NO. 4

An industrial concern acquired certain patents through the issuance of its own capital stock late in 1926. These patents were carried into its accounts at the stated value of the capital stock issued for them. The book value of the patents on this basis was approximately \$1,200,000. From the date of their acquisition until June 30, 1933 a half million dollars of this cost was amortized. On that date the patents were appraised at \$2,400,000 and surplus arising from appreciation was created in the amount of about \$1,700,000.

During the period from the date of acquisition to September 30, 1936, the corporation was amortizing the appraised value of these patents. The amortization of cost was charged to income and the amortization of the appreciation was charged to surplus arising from their appreciation. By the close of September 1936, the operations of the company had resulted in a deficit in the earned surplus account so the stockholders approved a restatement of the capital stock from \$10.00 a share to \$1.00 a share, thereby creating approximately \$1,800,000 of capital surplus. The company then not only wrote off the unamortized portion of the cost of the patents against this capital surplus but it also transferred from capital surplus to earned surplus an amount sufficient to restore to earned surplus all that had been charged off through the income account in the form of amortization of patents since the date of their acquisition. In this manner, a deficit of approximately \$470,000 was changed to an earned surplus balance of nearly \$400,000.

When this company filed a registration statement in December 1936, it included profit and loss statements for three years and nine months ended September 30, 1936, in which no deduction was made for the amortization of these patents. It also submitted a balance sheet as of September 30, 1936, in which earned surplus was shown at this written-up value of nearly \$400,000. These statements were certified.

We considered it improper to show net income for the years in question without including deductions to provide for amortization attributable to those years. We are also in agreement with the generally accepted principle that capital surplus should not be used to relieve the income account of charges that would otherwise be made thereagainst. While there may be justification for using capital surplus to wipe out a deficit in the earned surplus account, we could hardly subscribe to its use to create earned surplus.

An asset should not, it seems to me, be written off to capital surplus when its consumption is part of the cost of operations and generally accepted accounting practice would amortize it by charges to income and particularly is this true when earned surplus exists. Statements drawn in conformity with such a procedure without extensive explanation and qualification would, in my opinion, be misleading. A company cannot honestly state that it has a surplus arising from earnings when expenses of doing business during prior periods have been charged to capital surplus in an amount so great that the earned surplus would have been completely wiped out had operations been properly charged. In saying this I recognize that there may be cases substantially amounting to reorganization where it will be proper to accumulate earned surplus from the date of such reorganization notwithstanding the fact that losses attributable to prior periods may have been wiped out against capital surplus.

Pursuant to our letter of deficiencies and after conferences with our staff, the registrant amended its statements. In the amended profit and loss statements, net income was shown before amortization of patents from which was deducted the amortization of patents, thereby arriving at a net income figure after amortization.

Possibly this treatment might be criticized on the ground that the amortization should have been included as part of the cost of goods but since the information was clearly set forth and a resulting net profit was arrived at after the deduction of amortization, we concluded that the facts in the case had been sufficiently revealed. In the balance sheet, the earned surplus was wiped out but a sufficient amount was transferred from capital surplus to leave no deficit in the earned surplus account. Full explanation of all the facts relating to the patent situation was contained in footnotes.

*CASE NO. 5*

In this case, there was included in the registrant's balance sheet approximately \$302,000 for patents from which was deducted a reserve for amortization of about \$296,000, leaving roughly \$6,000. The following footnote appeared in the schedule relating to intangible assets:

"There is included in the above reserve for amortization of patents \$294,816.37 applicable to patents covering chain manufacture which were fully amortized prior to June 30, 1932."

It developed that a substantial part of these patents had expired and we questioned the propriety of showing them in the balance sheet, expressing the opinion that the expired patents should have been written off against the reserve. It seemed to us that the balance sheet should reflect only the unexpired patents and the reserve applicable to them. Inasmuch as the expired patents had no further value as patents at the date of the balance sheet, their inclusion seemed to be misleading.

The registrant objected to amending the financial statements, claiming that, although the patents had expired, there was still a substantial carry-over of value to the company from having had them. This, they felt, entitled them to show what the patents had previously been worth. An amendment to the balance sheet was submitted to include a footnote reading as follows:

"There is included in the above reserve for amortization of patents \$294,816.37 applicable to patents covering chain manufacture which were fully amortized prior to June 30, 1932. However, a relatively small portion of this amount is applicable to patents which have not run the limitations of statute, and the segregation of this portion so applicable has never been made upon the books of the Company and would now be impracticable. Patents which have not been heretofore wholly amortized are being amortized over the life thereof. Patents are the only intangible asset shown on the books of the Company."

In view of the fact that the amount involved was relatively small, the net balance carried into the asset account was correct and the footnote clearly revealed the facts as to the expiration of the patents, we felt that the statement as amended was not materially misleading. Accordingly, further request for amendment was waived. However, it seems to me that when the patents have been fully amortized and have expired, they should be written off against the reserve so as to remove from the balance sheet both the asset and the reserve.

*CASE NO. 6*

Some years ago, a company acquired a subsidiary by purchasing its capital stock at a price considerably greater than its value as shown by the books of the subsidiary. The subsidiary owned very profitable patents carried on its books at a nominal amount.

In the balance sheet of the parent filed as part of a recent registration statement, the investment in the subsidiary was carried at about \$10,000,000, which was about \$6,000,000 more than its book value, at the date of purchase. No provision was made for amortizing any part of the investment. In the balance sheet consolidating the affairs of the parent and the subsidiary, the excess of \$6,000,000 was carried under the heading "Patents, Patent Rights and Goodwill". No provision was made for writing off this excess to give effect to the expiration of the patents.

When the registration statement was examined, a deficiency was cited with respect to this procedure. In citing the deficiency, we were governed by the belief that the excess should not be designated as patents unless provision was made for its amortization to reflect the expiration of the patent rights. To us it seemed improper for the company to show in its consolidated balance sheet that it possessed patents without providing for their amortization in its consolidated profit and loss statement. We also felt that if a considerable portion of the value of the investment in the subsidiary was due to the value of the subsidiary's patents, as the registrant consistently maintained throughout its prospectus, such investment should be reduced in conformity with the expiration of the patents.

Had the value of the patents been reflected on the books of the subsidiary at the figures attributed to them in the acquisition of the subsidiary's stock, they would have been shown on the consolidated balance sheet in the same manner as they were in this case but would have been carried at an amortized figure and charges to income would have reflected the amortization in the consolidated profit and loss statement.

Representatives of the registrant contended that the value of the investment in the subsidiary was not actually decreasing and that, therefore, there should be no amortization of the excess cost. This continuation of excess earning power was due, they said, to several factors, among which were (1) improvements to the basic patents continued their usefulness indefinitely, and (2) contacts which the subsidiary had with certain large customers gave assurance of a continually profitable outlet for its products. They further stated that these factors were anticipated at the time the stock of the subsidiary was purchased and, accordingly, what had really been purchased for the excess was goodwill.

The responsibility for the truthfulness of the representations in the financial statements filed in connection with a registration of securities is that of the registrant and the accountant. We were in no position to determine whether this excess value was due to the expiring patents, as indicated by the caption of the account and reiterated elsewhere in the body of the statement, or whether it was due to goodwill, as was asserted in the course of the discussions relating to the deficiency memorandum. In our treatment of the deficiency, we did not undertake to determine whether the excess was paid for patents, for goodwill, or in part for both.

We did insist, however, that the treatment throughout should be consistent. We felt that if the position was taken that the excess was due in whole or in part to the value of the patents, it should be amortized and that this necessitated writing off the amount carried as patents in consolidation and writing down the investment as carried on the parent's books as the patents expired.

If, on the other hand, the excess had been paid for goodwill, it was not necessary that the excess be amortized. In such case, however, we felt the registrant should remove from its financial statements and prospectus all matter tending to indicate that this excess purchase price was paid because of the patents.

The registrant amended its financial statements and its prospectus by striking out the references to patents in support of the excess purchase price and labeled the item:

"Goodwill, being the investment of \_\_\_\_\_ Company in the capital stocks of subsidiaries consolidated in excess of the net assets exclusive of goodwill of such subsidiaries at dates of acquirement."

CASE NO. 7

During the years 1934 and 1935 a company engaged in the manufacture of aircraft was manufacturing three long-range multiple engine ships and, during each of those years, approximately a quarter of a million dollars of its expenses were deferred as representing experimental cost. It was anticipated that if the three ships were successful, the company would receive contracts for the manufacture of a substantial number of additional ships and the deferred experimental expense was to be written off as part of their costs.

In 1936, it was determined that no contracts for additional ships would be entered into. Accordingly, the company charged off the deferred expense against surplus. This procedure was, of course, in accordance with proper accounting practice. However, the registration statement which it filed in 1936 included profit and loss statements for the years 1933, 1934, and 1935 and for the seven months ended July 31, 1936. At the time of filing, the company was aware of the fact that its experimental expenses had been useful only in the construction of the three ships manufactured during 1934 and 1935 and had already made the charge to surplus. The facts relating to these expenses were given only in connection with the charge to surplus and no mention of it was made in connection with the profit and loss statements. It appeared to us, even though the charge was properly made to surplus, a retrospective statement of the actual results for 1934 and 1935, made after the loss had been ascertained, should clearly show what the results would have been if these losses had been charged to profit and loss at the time the expense was incurred.

When this thought was conveyed to the registrant, the profit and loss accounts for 1934 and 1935 were completely restated and the surplus charge of 1934 was eliminated from the schedule of surplus.

This procedure was, we believe, the most satisfactory method of presenting the facts in this particular case. While our deficiency letter did not advise the company to do more than reveal the pertinent facts in the profit and loss statements, our staff suggested the desirability of a complete restatement. The registrant and its accountants promptly accepted the suggestion and went the whole way in the amendment.

#### CASE NO. 8

One of the companies registered under the 1934 Act had charged to surplus and credited to income substantial amounts of dividends on its own preferred stock held in its treasury. In 1934, the fiscal year covered by statements examined, this amounted to nearly a quarter of a million dollars.

We thought that the policy of showing the dividends on treasury stock as income was highly improper. By this procedure, a company with a substantial amount of treasury stock could, on the basis of an earned surplus at the beginning of a series of years during which no profits whatever were made, show net income in the profit and loss statement and pay dividends therefrom during such years. To show net income under such circumstances appeared to us to be highly misleading.

Pursuant to a deficiency memorandum with respect to this item, the company amended its statement by reducing the dividends charged to surplus to the amount paid to outside holders and by removing from income the dividend on the treasury stock.

#### CASE NO. 9

As of May 31, 1934, a company by an amendment to its certificate of incorporation restated and reduced the stated value of its common stock. The total reduction amounted to slightly more than \$2,200,000, of which nearly \$2,100,000 was carried to a reserve against investment in subsidiary companies and a little over \$100,000 was credited to capital surplus.

This company owned a number of subsidiary companies that had suffered substantial losses since the date they had been acquired. As a result, the consolidated balance sheet at the date of the restatement of capital carried a substantial deficit in the surplus account although the parent company had nearly a half million dollars of earned surplus on its own books.

By the use of the reserve for investments created by the restatement of the capital stock, the company was able, in drafting a consolidated balance sheet, to eliminate these subsidiary deficits against the reserve created by the reduction of the capital stock of the parent. Accordingly, the earned surplus of the parent was carried out as consolidated earned surplus and the deficit disappeared in the consolidated balance sheet.

As a result of this procedure in 1934 the earned surplus account as shown in the consolidated balance sheet as of February, 1936, filed as part of a registration statement, was stated at half a million dollars more than it would otherwise have shown.

The consolidated balance sheet is intended to present the joint condition of a parent and its subsidiaries in the manner in which it would appear if only one corporation existed. There seems to be no good reason why a consolidated group should create earned surplus through a restatement of capital stock when an individual corporation could not do so. Accordingly, it seemed improper for this company, in its registration statement, to show an earned surplus of nearly \$500,000 more than the consolidated net earnings after May 31, 1934, the date of the restatement; so we advised it that we considered the statements to be deficient in this respect.

As a result of this notice of deficiency, the parent company decided to adjust its accounts to take up the profits and losses of the subsidiaries from the date of their acquisition. The deficit which, on the revised basis, would have existed at the date of the restatement on May 31, 1934 was then wiped out by use of the reserve created by the restatement. The company then took up profits and losses of the subsidiaries from May 31, 1934 to the date of the balance sheet filed with the registration statement.

As a result of this procedure, the parent company now shows in its earned surplus account its own and its subsidiaries' profits and losses since the date of the restatement and its earned surplus account is dated to show that fact. The surplus on the consolidated balance sheet is, insofar as these factors are concerned, the same as on the balance sheet of the registrant itself.

What I have said may sound unduly critical of the work of the accounting profession. It would be most unfair to leave without acknowledging that a great deal of progress has been made and that a great deal of credit is due to members of the profession. I have the highest regard for the aims and standards of many accountants with whom I have come in contact. No profession is without its weaker members. Probably no profession has had to fight against greater odds to secure advancement of its standards. It seems to me that yours has a greater opportunity than ever and I must recognize improvement which is undeniably taking place. It would be pleasant to recount some of the evidence which we have seen of advancing standards. I have assumed, however, that you are more concerned with the other side of the picture. This paper has already reached such length that I am sure you will not object to my closing its presentation with merely a general acknowledgment of the progress which is being made and of our deep interest in having that progress continue.