

Address by

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I feel as much at ease discussing accounting problems with men trained in accounting as I would discussing fissionable materials with a group of nuclear physicists.

True, nine months at the Commission plus twenty-five years at the Bar, along with a few imperfect memories of a one semester college course in accounting have taught me a little of your vocabulary and have given me a fingernail-type grasp of a few of your concepts. But my humility is increased by my appreciation of the classical couplet:

"A little knowledge is a dangerous thing,
Drink deep or taste not the Pierian spring."

You can understand therefore the reason why I am not going to conduct a technical discussion. I would like, however, to philosophize with you a little while about the Commission's role in the matter of corporate accounting.

The effectiveness of both the disclosure provisions and the regulatory provisions of the statutes administered by the Securities and Exchange Commission is based primarily on the accuracy of financial information and the presentation of that information in accordance with sound accounting principles. Let's be frank about it. The text of the description of a business, its history, its property, its transactions with affiliated persons, information as to remuneration - textual material of that type - may help to sell securities, may help to insulate issuers and underwriters from liability, may give an indication as to the integrity and philosophy of that management, may round out an understanding of the enterprise and of the character of its management and may post a few warning signals as to future pitfalls.

Basically, however, 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.

As you know, the principal mission of the SEC has been to promote adequate disclosure of facts to investors. Whatever you may think of the work of the Commission in particular cases there can be no doubt in the mind of any

reasonable man that the overall effect of some twenty years of Federal securities regulation has been to raise materially standards of disclosure. Many of you remember two comments made in 1926 in William Z. Ripley's book "Main Street and Wall Street". He pointed out that the sudden advent of wide-spread ownership of corporations since World War I had created entirely new circumstances and conditions in the business world and he said:

"Our American business affairs, in so far as they have assumed the corporate form through this recent growth in public ownership, are still too largely carried on in twilight."

He said also:

"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."

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 with respect to accounting matters. At the risk of being a little boring, I want to enumerate those powers as enunciated in the various Acts administered by the Commission.

The Securities Act of 1933, Section 19(a) provides:

"Among other things, the Commission shall have authority, for the purposes of this title, to prescribe * * * the items or details to be shown in the balance sheet and earning 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, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer * * *."

Section 13(b) of the Securities Exchange Act of 1934 provides the same thing in practically the same words.

Section 15(1) of the Public Utility Holding Company Act provides:

"The Commission, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors or consumers may prescribe for persons subject to

the provisions of subsection (a), (b), (c), or (d) of this section uniform methods for keeping accounts required under any provision of this section, including, among other things, the manner in which the cost of all assets, whenever determinable, shall be shown, the methods of classifying and segregating accounts, and the manner in which cost-accounting procedures shall be maintained."

Section 31(c) of the Investment Company Act of 1940 provides as follows:

"The Commission may, in the public interest or for the protection of investors, issue rules and regulations providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements required pursuant to this title."

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

The so-called S-X rules are basically rules prescribing the form and content of financial statements and of the certification thereof. There are some accounting series releases which state the Commission's position with respect to certain practices of accounting but by and large, the Commission looks to the standard of general acceptability of the accounting principles followed in a particular report or registration statement in determining whether or not such report or statement should be accepted without comment. 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."

The application of the principles 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. The staff might well take the position that the preponderance of authority is the other way. What is authoritative support?

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 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. These results must be judged from the standpoint of society as a whole - not merely from that of any one group of interested persons.

"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 and there is no thought now that it should be revived. If it should be carried out I am afraid that it would be necessary for industry and the nation's economy to stand still and keep still so that it would always fit into our accounting pattern. No thanks! 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 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 again 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 we have adopted a rule permitting disclosure treatment. 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 the 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.

of American accounting. Corporate officers know and appreciate the value of sound accounting as an indispensable tool of management. The Securities and Exchange Commission and the Acts administered by it have contributed 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, they have not materially slowed down the process of capital formation nor have they resulted in a wave of law suits. As controllers your name goes on a registration statement under the Securities Act. The Form S-1, as you know, calls for the signature of the issuer's controller or principal accounting officer. The liabilities of Section 11 of the Securities Act are imposed upon every person who signs the registration statement. On matters of accounting, therefore, the controller cannot avoid being "it". It would be hard to argue that this liability 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.

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