"RECENT DEVELOPMENT IN ACCOUNTING"

Address

of

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The New Registrant

One advantage of a broad topic like that assigned to me for this meeting is that it gives me a free hand in deciding what to talk about. For the past several years, such a topic inevitably resulted in a discussion of the accounting questions raised by war conditions. Today, however, is a period of transition and it is certain of the transitional problems that I want to discuss. The economic conditions prevalent in this transition period are such to bring about very large number of new registrations.

In many cases, companies were taking advantage of current low interest and dividend rates to refinance their bond issues or to refund high-dividend preferreds. Many more were seeking new capital for the first time, or at least for the first time in many years. In still other cases, the owners of closely-held businesses were seeking to sell part or all of their holdings to the public. In these last two groups were a great many small or medium-sized concerns in which there had never before been any major investment by the general public. Since a large percentage of our day-to-day accounting problems currently concern this type of case, I thought it might be interesting to outline for your consideration some typical accounting questions which such cases present. I can also assure you that in addition to their own special problems the mine-run of such cases will include illustrations

of nearly all of the major accounting problems arising in any of our work.

Perhaps it would first be well to describe the typical case. We may call our subject The Turner Company, incorporated on July 1, 1946 to assemble the interests formerly controlled by Mr. Turner, his family and perhaps a few business associates. The business is of quite some years standing and was largely developed by the efforts of Mr. Turner. It is an enterprise consisting of around $7,000,000 in assets — though in the general run of such cases total assets will vary from 1 or 2 to 20 millions. There may be quite a sizeable number of small stockholders — employees, relatives, friends and their assigns, or perhaps a sizeable group of local investors as a result of a public sale of securities many years ago — but by far the majority ownership rests in the Turner family. In some cases, the enterprise may have consisted of several corporations and perhaps one or more partnerships whose operations were more or less closely integrated. The business may be the manufacture of any one of a variety of products, or it may be that of a group of small department or specialty stores. A second sub-class of these cases consists of businesses that were organized and developed as private enterprises to satisfy war requirements and now are proposing to enter peacetime production.

As closely held or even solely owned businesses, the companies ordinarily did not publish financial data, except perhaps for the particular use of bank creditors. Moreover, with management and investment in the same hands, the entire accounting system was developed to serve whatever particular interests the owner-managers considered

necessary or desirable. Even where a fairly substantial amount of non-management ownership existed, financial data prepared for and made generally available to such persons usually comprised no more than a very abbreviated annual report — of which more later. Usually the business had retained the services of a public accountant but ordinarily for somewhat specialized work, plus an annual examination which may have been specifically limited in scope.

Unless the enterprise had for some time consisted of a single corporation, with or without direct subsidiaries, the first accounting question raised would ordinarily be: "what financial statements truly reflect the financial history and condition of the business?" The variety of particular situations is such that no short answer can be given. However, the solutions to some fairly typical cases may serve as satisfactory guides.

If the preexisting business was conducted as a partnership, partnership income statements for the necessary period will usually be satisfactory, if certain modifications or adjustments are made. Since the business is now to be conducted in corporate form, it will be necessary to reconsider the nature and treatment of partnership salary, expense and drawing accounts to determine whether the portion of such items charged against income was in fact a fair statement of management costs. If not, there should be shown, in an appropriate manner, an

estimate of such costs on a corporate basis. Usually, such estimates can be made rather accurately on the basis of the employment contracts which the former partners have entered into with the new corporation.

The second major adjustment of the partnership income results from the changed tax status of the enterprise. Obviously, to show the partnership income as "enterprise income" without allowance for the taxes that would have to be paid by a corporation might be most misleading.

The necessity for such adjustments has raised an interesting question as to whether the certifying accountant can include the adjustments within the scope of his opinion. The solution has not been uniform. In some instances, the accountant, because of long familiarity with the business, because of the simplicity of the tax problem, or because of other factual circumstances has felt able to take responsibility for the adjustments and to state that the adjusted net income fairly reflects the operations of the business. In other cases, the accountant has not felt able to include such adjustments in his general certificate, either because of their nature as estimates or because of factual complexities. Nor have we pressed him to do so.

If the preexisting enterprise was conducted through the medium of one or more separate corporations owned, however, by one or a small group of people, the "enterprise" now offering securities to the public

is in reality the group of old companies. Ordinarily, the most meaningful income statement covering past years would be one which combined the operations of the several component parts of the enterprise, since such companies have now become subsidiaries of the registrant or their assets and business directly acquired by it. In preparing such a statement much the same approach would be used as in preparing a group statement of subsidiaries of a corporation — that is, intercompany transactions and profits would ordinarily be eliminated. No special accounting problems are usually encountered in the consolidation process if as is usually true the several parts are in the same or related lines of business.

It sometimes happens, however, that the several parts of the "enterprise" were conducted by companies having different fiscal dates. Under our rules, a subsidiary's fiscal year statements may be consolidated with those of its parent only if the fiscal dates are within 93 days of each other. Where the gap is greater, it is necessary either to prepare 12 months, non-fiscal year statements that fall within the 93 day limits, or to furnish separate statements. Comparable procedures are applicable to this class of cases, where the statements of related companies are being combined.

In some instances, the nature of the operations and the state of the records may be such that the company and its certifying accountants

will wish and feel able to recast the accounts of certain of the companies so as to obtain 12 months statements comparable to the fiscal years of the other concerns. If this is not possible, it is necessary, of course, to group the companies in the most informative manner possible. It has proved generally advisable in such cases to discuss the problem with the staff well in advance of filing so as to agree upon a solution that will at once be the most practicable and least costly. Incidentally, this administrative device of pre-filing conferences and correspondence is one that has proved an extremely useful and efficient way of handling all kinds of complex and unusual accounting questions. Since it saves time and embarrassment for all concerned, it should, I think, be utilized even more than it now is.

In one or two cases, the preexisting enterprise included certain operations which were not to be carried on in the new publicly-owned business. In one case, for example, the controlling family had caused the corporation to act as a medium through which the family made investments in securities. However, all such activities were of course to be discontinued and the investments liquidated before the public offering. Clearly, the results of such trading and investment transactions had to be segregated from the manufacturing operations so that the investor might see clearly the earnings of the manufacturing enterprise in which it was going to invest. In another case, the public

sale had been preceded by a major revision of the financial structure of the company. A large and lucrative outside investment had been disposed of with the result not only of losing the income thereon but of increasing the cost of short-term borrowings for which such securities had formerly served as collateral. These and other major changes in the asset and liability structure of the company led the Commission to make this statement:

> "—— Profit and loss statements are required in the registration statement as an indication to prospective investors of the registrant's earning power. The nine-years' profit and loss statement contained in this registration statement reflected the results of operations during a period when the registrant had maintained continuously a financial status substantially equivalent to that existing immediately prior to this financing. By reason of the changes effected —— that financial status bears little resemblance to that which obtains presently. Where such changes will have a material effect on prospective earnings, the omission to disclose those changes and their effect with relation to the profit and loss statements is as misleading as if the registrant's past earnings had been misrepresented."

Largely as a result of the war, certain somewhat similar problems may arise in deciding what statements should be used to portray the history of the enterprise in which the public is being asked to invest. In certain cases the entire operating history of the concern falls within the war period. Moreover, the proposed post-war activities of the concern may be but remotely if at all comparable to the war business done. In such cases, the firm is doubtless counting on its experience

and technical ability to enable it to participate profitably in the post-war markets. Its war record may be evidence of that ability, but even so it can scarcely be considered indicative of its post-war earnings outlook. Accordingly, in one or two clear-cut examples of this situation we have not permitted the customary use of certified annual income statements for the war period, but instead have permitted only limited reference to such earnings as an historical item of interest in determining how the company reached its present financial condition. In essence, the enterprise is thus treated as a new venture with no past earnings record of any kind.

In another case, a privately-owned company engaged in war work had failed to take inventories at the fiscal dates falling within the war period. Moreover, a current audit indicated that its methods of production and its records were such as did not provide it with reasonably reliable book records of inventories for those years. The certifying accountants accordingly found themselves, even after exhaustive efforts in that direction, unable to express an opinion as to the net income of the concern by years although they were able to speak with respect both to the most recent balance sheet and to the entire four year period of earnings, considered as a whole, since reliable physical inventories had been taken at the beginning and end of the four year period. In view of the specially unusual circumstances

the unusual suggestion was made that there be furnished only a single income statement covering the four-year period plus year-by-year data as to the principal figures not affected by the failure to take inventories — that is, such items as sales, selling and administrative expense, other income, interest, and so on. It might be added that even where the niceties of accounting and auditing procedures were observed all through the war, there is much to be said for largely disregarding any trends disclosed by the year-by-year results reported during that period. So many uncertainties then existed, increase in volume was often so great, and so many special charges and credits fell fortuitously into one year or the other, that the apparently precise final net income by years was often only the roughest sort of estimate. Indeed, it has been suggested, and I think wisely, that in a great many cases there ought to be prepared, now that the war period is over, a combined income statement as a sort of final report covering the whole of war operations.

There are certain other auditing questions that have arisen in this field. In some instances, it appears that no physical inventory was taken as of the close of the period covered by the certified statements, and that inventory-taking during the period was a rather sketchy process. Obviously, in such cases, the certifying accountants were not able to employ normal audit procedures as to inventories. In addition, an exception was sometimes taken in the certificate not only as to the auditing procedures but also as to the presentation made being fair,

so far as inventories were concerned. Where the inventories involved were substantial in amount, we have felt that the failure to have reliable closing inventories, and the inability of the accountants to employ usual procedures were fatal deficiencies in the statements. In short, we do not see how a reliable presentation of the company's financial affairs can be obtained without reliable inventories, and we felt that the inclusion in the certificate of general exceptions as to the inventory resulted in the statements being not in fact certified.

Somewhat similarly, there are cases in which the accountant had been engaged in previous years to make audits of a specifically limited nature. Occasionally, the accountant will not seek to certify statements covering those years, with only minor additional work generally of a tying-in nature. The test in such cases has uniformly been this — has the accountant now performed such an examination of the years under review as to enable him to express his opinion as to the statements being filed. While he need not, of course, repeat work previously done, he must measure his past work not in terms of his then engagement, but instead in terms of generally recognized standards. He must be sure he has, in all, done at least as much as he would have done if he were now being called in for the first time to expressan opinion as to the statements being filed.

Where the preexisting business is one of long standing, it is also customary to include in the prospectus, as part of the history of the business, a summary of its earnings record going back far enough

to cover the more recent pre-war period, usually, in all, about ten years. This summary is not, however, a part of the formal financial data, although it consists in principle of a condensed earnings record showing major categories,such as in the case of a manufacturing business, sales, cost of sales, principal other expenses, or other income, taxes, and net income before and after taxes. It is not required by our rules to be certified. However, it frequently happens that the registrant or its underwriters wish to have the certifying accountant express an opinion as to the fairness of the presentation. Of course, so far as the summary is drawn from the certified statements included in the registration statement, no problem exists. As to prior years, however, we do not consider it proper for the accountant to express an opinion unless as to such years he has made an audit or examination comparable in scope to that undertaken as a basis for certifying the 3-year financial statements. Nor would we consider it proper for him to express merely a limited opinion to the effect that the summary correctly reflects the operations shown by the company's records or in previously published statements, since such an opinion obviously by-passes the heart of the matter.

Before leaving this area of general problems, I want to refer rather briefly to one peculiarly difficult and delicate question that sometimes arises in this class of cases — the question of the independence of the accountant. As I pointed out earlier, these closely

held businesses generally have availed themselves of the services of a public accountant for special work, such as taxes, and for general audit work often on a limited basis. In many cases, the relationship is much closer. The owners have frequently chosen the accountant because of a high personal regard for his ability, integrity and impartiality growing out of a long standing business or personal friendship. Particularly because of the trust and confidence placed in him, he may have been asked to undertake somewhat extraneous assignments of a truly managerial nature, as for example, to be a director of the company. Or he may have gradually come to have supervisory control of the accounting department. In some cases, he may even have been asked to undertake obligations of a highly personal nature, as for example, to be a trustee of a fund set up for the owner's family, perhaps having the stock of the company as an important asset. Yet when the time comes to make a public offering, the existence of such relationships, that arose only because of the management's high opinion of the accountant's integrity and ability, raises doubt as to whether he can be regarded as an independent public accountant, within the meaning of that term as used in the Securities Acts. The point is, of course, that the public investor has not had such acquaintance with the accountant and the management, or such intimate knowledge of the affairs of the company, as to be in a position to be satisfied that, or even judge intelligently, whether the accountant has, or is likely to have, done his work objectively and impartially.

A finding by this Commission that an accountant is not independent because of such relationships should not by any means necessarily be construed as a reflection either on his integrity or ability (unless, of course, other circumstances are found to exist) but rather as holding that he has through such relationships become so closely connected with the management that he cannot be classed as "independent" within the statutory concept.

I have also observed in this class of cases evidence that on the occasion of a first public offering there is some disposition to pass over the local accountants previously engaged and seek to employ the services of a new, usually larger, firm either because of a belief that only such larger firms are equipped to handle registration work or for other reasons. There is this that I can say: some of the finest registration work we have seen has been done by the regular local accountants of this kind of company. In some instances, indeed, the successor firm has sought to adopt as its own the work done by the old accountants with no more than a perhaps thorough review of the working papers plus some cursory field checking. Such an examination is clearly not an audit of such character as to entitle the successor firm to express its own opinion as to the statements. A modification of this practice is to have certificates signed by both firms — that of the successor merely expressing an opinion as to whether generally accepted accounting principles have been followed. In a recent case of this

kind, we asked for the deletion of the purported certificate of the successor firm as being misleading and improper under the circumstances.

One of the first questions of accounting theory that arises in this sort of case is as to the amount at which the assets of the enterprise are to be set up on the new balance sheet. In some instances, the claim has been advanced that assets — particularly plant and equipment — ought, on the occasion of a first public offering, to be written up to what is labelled as fair value. If the "enterprise," as distinguished from its form of organization, is substantially the same business as existed before the proposed sale to the public, and if it has followed accepted accounting practices in the past, there will rarely exist, in my opinion, any sound reason for increasing the amounts at which assets are carried. Under the circumstances described — i.e., a continuing <u>business enterprise</u> — I can <u>see</u> no more merit in such revaluations than in the case of any going concern. And I may add that in common with most accountants I am opposed to the idea that it is appropriate for a going concern to depart from cost as the basis of its general financial records merely because replacement costs have risen — even if rather materially. In cases such as we are considering there are, of course, added difficulties. Any such upward revaluation necessarily entails future increases in depreciation charges — and ordinarily no increase in tax deductions. To that extent, at least, the procedure makes the prior earnings record unreliable and unfairly optimistic as an indicator of future earnings. Such problems are, of

course, in addition to all of the well-known uncertainties and evils that beset proposals to supplant objective arm's length costs with higher and purely subjective appraisal figures unsubstantiated by any competitive bargaining process.

Proposals to reflect appraisals in the statements of companies of this character are sometimes sought to be justified by drawing an analogy to the procedure of quasi-reorganisation by saying that the company is making a "new start." I think such analogies fail of conviction because of fundamental differences in environmental circumstances. Quasi-reorganizations were developed as a procedural device to care for concerns that had sunk and lost, presumably irretrievably, a substantial portion of their capital. They are the accounting equivalent of the legal processes of bankruptcy and receivership and creditors' committees. None of these atmospheric aspects are present in the case of a profitable going concern offering to sell securities to the public. To insert additional values in a balance sheet is not to me the converse of admitting by quasi-reorganisation, receivership or bankruptcy that some of the money heretofore expended has been sunk and lost.

There are classes of cases, of course, where revaluation of the assets seems warranted. If the old business was acquired for cash or its equivalent by wholly new owners, there may be much to be gained by allocating the cash cost among the assets acquired on the basis of a soundly conducted appraisal. Where formerly separate and unaffiliated

businesses are being brought together under such conditions that a wholly new enterprise is being launched, the same may be true. And there may be other cases. But I have not yet been convinced there is a sound basis for agreeing to such treatment forthe cases we are considering — where the owners of a continuing, going concern are merely selling part of their shares to the public or are seeking to obtain new capital from the public by the sale of additional securities.

Perhaps the next most frequent accounting issue found in this class of cases grows out of the point made earlier that the accounting records and reporting methods of concerns in which ownership and management rest in the same small group will very usually be of whatever nature seems most useful and desirable to the particular people involved. Because of their first-hand and intimate knowledge of the business they often appear to rely less on adequate accounts and records than on personal knowledge as to the status and progress of their business. They may, for example, have a conservative bent which in one case resulted in a 30% reserve for bad debts though actual losses were rare and which, in another case, resulted in nearly the whole of an efficient power plant being erected by way of charges against current income. Or they may have followed methods of accounting which are now generally disapproved — but which to the owners are familiar and well understood because of their first-hand knowledge of business. Equally important, they may have consistently just not treated their accounting and reporting functions as an important part of the business so that their records and statements are quite outdated. In many cases, all the

necessary data for excellent statements is in the records and has been summarized or presented in the form of detailed operating statements and reports for use by the management, but no modern and informative statements in a form suitable for investors have ever been drawn up.

Even where a substantial investment on the part of the public exists, it is frequently true that the available financial data as to these companies, prior to registration, is totally inadequate. A survey of some 160 companies prepared in connection with a pending report to Congress by the Commission indicated that the financial data regularly available to public stockholders in such companies and to the public generally is grossly inadequate in a majority of the cases. A sizable number failed to furnish all of the three fundamental statements: balance sheet, income account and surplus analysis. In more than half the cases the balance sheet was so condensed or otherwise lacking in informative detail as in our opinion to be materially deficient. In well over half the cases the income statement was either lacking entirely or so condensed as to be of only the most limited usefulness.

It is to be noted that some 85% of the statements covered in the survey were accompanied by certificates of public accountants. Three quarters of the certificates were about like those accompanying the full and rather detailed statements required to be filed with this Commission. Personally, in view of the measure of social and economic

responsibilities being shouldered by public accountants, I think it fair to ask this question. Is it any longer appropriate, if indeed it ever truly was, for an accountant when he knows statements are to be sent to public stockholders or made available to the general public to say with respect to a highly condensed balance sheet accompanied, if at all, by an even more condensed and incomplete income statement that such statements "present fairly the position of the company and the results of its operations." In any event, the Commission concluded in its report:[1] "Whatever an accountant's personal views may be about the necessity or desirability of disclosure, it is apparent that management policy is the factor which determines the nature of the annual report. The Commission's experience has been that, unless accountants can point to legal requirements of good accounting standards, they are often unwilling or unable to insist on a position contrary to that of the management on the extent of the disclosure which is desirable." Its further conclusion was that accountants need and should have the support of statutory or administrative requirements for good accounting. A similar finding as to the position of accountants in Great Britain was made by a committee of the Board of Trade which recently investigated the need for amendments to the British Companies Act.

1/ Report to Congress, Page 16.

I have pointed out that when companies enter the public capital markets for the first time it is often discovered that their past accounting has not been in accord with generally accepted accounting principles. In such cases, corrections of past practices ought to be made in preparing the statements and clearly described. For example, charges erroneously made to capital surplus may have to be reversed, and taken to earned surplus. Depreciation and maintenance policy and the treatment of additions and betterments may have to be overhauled. Occasionally, substantial, useful assets written off to income at construction, or later arbitrarily written down to $1, may have to be reinstated.

This latter possibility, which has occurred from time to time, has a particular present interest in view of the current discussion as to the treatment of fully amortized, but still useful, emergency facilities. Where circumstances warrant, our policy for quite some time has been to view this problem ~~also~~ as one of correction, not of "write-up," and we have raised no objection to the reinstatement in the accounts (with correlative adjustment of prior charge-offs) of such portion of the original cost of the facilities as seems reasonable under all the circumstances. By the phrase "all the circumstances" it is intended to give weight to such factors as excessive cost of construction during war periods, possible inadequate maintenance during the war, higher depreciation during the war due to overtime or continuous use, degree of adaptability to future use including the

question of over-capacity, the effect of the use of the facilities on the usability of the rest of the plant, and the fact that there will usually be no further deductions for tax purposes. All of these factors tend towards charging a good deal more than straight-line depreciation on a year-life basis to the war period. Indeed, as a rough rule of thumb it often seems that the balance of 30, 40 or 50% of cost unamortized at September 29, 1945, is not a bad guess as to the reasonable part of the cost to be retained for financial purposes and charged off against future operations. In no case, however, should such corrections be made and facilities reinstated unless the amount involved is a really substantial part of the total plant; unless the depreciation charge involved would be material in relation to total future plant costs; and unless there is a high degree of certainty in the prediction that the facilities can and will be efficiently used in conducting future operations. //

Another accounting question arising in these first filings is the past reserve practices of the company. Often the methods followed in the creation and use of reserves are found to have been, if I may say so, a bit unorthodox and have to be revised to comply with generally accepted practice. Currently, the issue — in common with a great many listed or registered companies — involves so-called war reserves. There have been indications that many companies, listed as well as unlisted, reduced reported war profits by lump-sum amounts described loosely and vaguely as provisions for war and post-war adjustments. It

now appears that there are those who are inclined to believe it will be satisfactory to charge directly to such blanket reserves all sorts of post-war costs, losses and expenses, with little, if any, discrimination between such divergent items as, on the one hand, separation pay that could rather clearly be foreseen at the time the reserve was established and could on some persuasive theories be treated as a direct cost of creating war material; and, on the other hand, losses due to strikes that occurred months after the cessation of all war business. You may have had occasion to note the policy adopted by the Commission last spring to deal with this problem for the current year. Under it we have required companies to state in statements filed with us clearly the policy followed in excluding items from the income account on the ground they were so-called "war expenses." In addition, companies are asked to segregate within the income account any substantial statistical figure immediately following "net income" the total expenses excluded from the income account because considered to be war expenses. This strict and rather striking disclosure policy was adopted because it seemed impossible to reach any generally agreed-upon conclusion as to what constituted "war expenses" or as to how they should best be treated during this transition period. This solution of full disclosure may not be practicable in flash reports of earnings since it does not guarantee that the full story will be told wherever the earnings report appears to cover that area. It will probably be necessary to arrive at some clear-cut understanding as to what, if any, expenses may be charged to these reserves. Personally, I am disposed to believe that by the end

of 1946 all war reserves ought to be disposed of either by return to surplus or income, as appropriate, or by clear-cut and specific earmarking if perchance there is still pending some definitely foreseeable loss that can be directly and closely associated with war operations. If this be done, the problem will be manageable and will be amenable to long recognized reserve accounting principles. To retain vaguely captioned reserves for the purpose of later absorbing some dimly seen future losses that can at best be but tenuously associated with actual war production will, in my opinion, so undermine the reality of income reports as to invite charges that earnings are being equalized.

No catalogue of recent developments in accounting would be complete without some attention being given to the "income vs surplus" question — and by that I mean whether there are circumstances under which particular charges and credits may be excluded from the income account and carried directly to earned surplus, or its alter ego a so-called surplus-reserve. In "The New York Certified Public Accountant" for September, 1946, there appear the results of an analysis we have made of practices in this field as evidenced by the statements filed with us by some 160 listed companies. Perhaps the cases summarized there will provide a common ground for argument, something which has not always been present in the past for the simple reason that each debater customarily has spoken from his own experience and study but has related only a part of his examples.

My own conclusions, from this study, are these:

(1) There now exist no generally agreed upon accounting criteria as to when an item may properly be excluded from the income statement. I do not say that practice is hit-or-miss, but that the effective considerations do not appear to have been accounting principles.

(2) Accountants have accepted the situation and have been willing to certify statements, either on the basis that they conform to their own views in the matter, or on the ground that in the absence of effective criteria they are unable to object.

(3) By a choice as between income and surplus, it is possible to vary reported earnings, within very wide limits.

(4) Practice in this field is so devoid of any unifying principle, as to be readily susceptible of misuse and misunderstanding to the very probable detriment of investors not expert in accounting matters.

In the past, there have been periods during which most companies carried nearly all items other than regular operating costs and expenses or income, through the surplus account. For a long time, there have been many who advocated and practiced the distribution of items between income and surplus, using as tests such various concepts as "abnormally large," "immaterial," "affecting the business of another year," "not related to regular operations," "extraordinary," "non-recurring," and a host of others. No wide-spread try-out has ever been given the policy