COMMENTS ON FINANCIAL STATEMENTS
FILED WITH THE SECURITIES AND EXCHANGE COMMISSION

Address of

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. The title I have chosen for my remarks today is "Comments on Financial Statements Filed with the Securities and Exchange Commission".* This is broad enough to cover, in part at least, the three suggestions made in the invitation to participate in these proceedings. These suggestions were: "What can the public accountant do to further improve financial reporting to the S.E.C.?"; "Some current accounting problems with particular emphasis on 'pooling of interests accounting'"; and "A discussion of common deficiencies in financial statements submitted to the S.E.C." A survey of the literature produced by my predecessors in office reveals that all of these subjects have been discussed from time to time either when in official or in alumni status. Current accounting problems and common deficiencies have been popular recurring subjects since Mr. Carman G. Blough's official release No. 7 in the Commission's Accounting Series, published in May 1938, listed many commonly cited deficiencies in financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. Experienced practitioners should not need the advice this release contains, but the unitiated should find it quite helpful. A similar study of deficiencies

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was reported[1] upon by Mr. William W. Werntz in 1941, which was soon after the adoption of the Commission's Regulation S-X governing the form and content of financial statements for inclusion in most filings in the Commission except those of brokers or dealers in securities. A similar survey was made again in 1947 and was reported upon by Mr. Earle C. King soon after he became chief accountant of the Commission.[2] Changing conditions, the increase in volume of our work and the resulting increase in the number of registrants and their independent accountants, make it appropriate to consider some of the recurring comments we find it necessary to make with respect to the financial statements being filed with the Commission today.

The principal Acts administered by the Commission are the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. The statements required in the Commission's forms prescribed under these Acts are the conventional balance sheets, income and surplus statements and certain supporting schedules. The registration forms for new issues of securities usually require three-year income and surplus statements and in the prospectus

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1/ Current Deficiencies in Financial Statements, The Accounting Review, Vol. XVI, No. 4, December 1941; The Journal of Accountancy, January 1942, pp. 25-34.

2/ What the S.E.C. Requires in Financial Statements Filed with the Commission, The Journal of Accountancy, November 1947, pp. 377-384.

to be delivered to the investor a summary of earnings for an appropriate period, usually not less than five years.

The form and content of the required financial statements are set forth in Regulation S-X. This regulation does not purport to define accounting principles. It describes the extent of the detailed information required in conventional terminology and present accounting practice. It was worked out with the advice and cooperation of the accounting profession, and is under constant revision in the same spirit of cooperation.

The Securities Act provides that the financial statements required to be made available to the public through filing with the Commission shall be certified by "an independent public or certified accountant." The other three statutes permit the Commission to require that such statements be accompanied by a certificate of an independent public accountant, and the Commission's rules require, with minor exceptions, that they be certified.

Staff consideration of financial statements to be filed with the Commission may be obtained at various stages in the processing of the filing. Questions may be answered by telephone or letter or in conference prior to the filing of material. These usually involve interpretations of the instructions as to the financial statements required by the various forms and matters of accounting principles where it is recognized that controversial issues may be present.

After filing the registration statement, application, proxy statement or report, the staff examines the material and issues a letter of comment which contains, when necessary, suggestions for changes in the financial statements included in the filing; requests for additional information in support of the accounting reflected in the statements; or in the case of annual and other periodic reports we may suggest that changes in presentation or more precise compliance with our regulations be followed in future filings. This latter course is taken when the form of the financial statements could be improved or the failures to comply completely with the instructions are of relatively minor significance and do not result in a misleading report of income or loss or misleading classification of accounts in the balance sheets and income statements.

Following receipt of the letter of comments the registrant may feel that the questions raised warrant reconsideration either in light of additional information which may be furnished or because of the controversial or unique nature of the problem. Such reconsideration may be by telephone, study of material furnished by letter, or in conferences. Conferences, whether before or after a filing, may include representatives of the registrant, underwriters, counsel for both of these, and a representative of the accountants who are to certify the financial statements. On strictly

accounting matters it is essential that a complete understanding be reached with representatives of the registrant who are responsible for the financial statements and with the accountants who are to express their independent opinion with respect to them.

A paragraph from the Commission's annual report to Congress for the fiscal year ended June 30, 1956, is pertinent at this point: "It is not the function of the staff of the Commission to prepare or rewrite registration statements. The members of the staff are ready to assist registrants when it appears that a bona fide effort has been made to prepare a registration statement meeting the standards of the Act and are as helpful as possible in suggesting whatever may be needed by way of additional information if the registration statement as filed is not entirely complete. But the Commission's policy, in the public interest and for the protection of investors, is immediately to commence stop-order proceedings in those cases in which the issuer and underwriter refuse to comply with, or ignore, the disclosure standards of the law or where the registration statement appears on its face to be false and misleading."

In keeping with this policy, accountants and registrants who are embarking on a first experience with the Commission should become acquainted with pertinent sections of the law, general regulations, the form on which the filing is to be

made and of course Regulation S-X. We have had cases where it was necessary to issue only one accounting comment: furnish revised financial statements complying with the regulations!

We have had a number of cases in the last few years which emphasize the necessity for practicing public accountants to be familiar with the Commission's rules on independence. These cases show that frequently closely held corporations unexpectedly find it necessary or desirable to sell securities to the public in interstate commerce, thus becoming subject to the registration requirements of the Securities Act of 1933, and that companies whose securities have been traded on the over-the-counter market desire to list on a national securities exchange, thus becoming subject to the financial reporting requirements of the Securities Exchange Act of 1934. Other companies may come under the jurisdiction of the Commission by making public offerings of their securities under Regulation A, which prescribes the simplified filing procedures for issues not in excess of $300,000. In the event that an accountant's certificate is used in any of these circumstances, the Commission's tests of independence are applicable and compliance with generally accepted accounting and auditing standards is subject to our scrutiny.

The rule on independence for qualification of accountants practicing before the Commission is stated as follows:

> "(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer or employee.
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> "(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission." 3/

In order for an accountant to be independent under the Commission's rules, he is prohibited from having any financial interest in the registrant or its affiliates. On the other hand, the rules of the American Institute of Certified Public Accountants merely require disclosure of a substantial interest of the accountant if he renders an opinion on financial statements which are used as a basis of credit and prohibit ownership of a substantial interest in an enterprise financed in whole or in part by public distribution of securities. These two conflicting standards of independence often cause confusion. It has been urged by some accountants that independence is a state of mind -- the accountant's conscience -- and that standards of professional work should not be affected

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3/ Regulation S-X, Rule 2-01.

by his financial interest in the registrant. However, the objective tests of independence to which certifying accountants are held by the rules of the Commission have been adopted for the purpose of avoiding both the opportunity for, and the appearance of, bias and prejudice, or the possibility of undue influence on the part of a client.

Public accountants whose practice involves the rendering of certificates based upon audits should be mindful that their clients may come under the jurisdiction of the Commission. This may require certification of income statements for at least three years, and in some cases the client may desire certified summaries of earnings for five or more years. Serious personal embarrassment to the accountant and added expense for the client can be avoided if the accountant is sufficiently foresighted to disengage himself from any entangling relationships with his clients. With present day interest in developing services to management, care should be taken to maintain a clear distinction between the giving of advice to management and the making of decisions for management.

In addition, the fact of coming under the Commission's jurisdiction for the first time may require an extension of the audit program. Extension of auditing procedures to require confirmation of receivables and observation of inventory-taking was adopted by the profession as a result

of the McKesson affair. Our experience indicates that these procedures have frequently been omitted by companies attempting to register for the first time. Acquiescence in the client's desire to reduce auditing costs while the company is closely held and not seeking public financing may be a disservice in the long run.

During the process of clarifying the accountant's status with respect to our rules on independence and his compliance with generally accepted auditing standards, it is our practice to request letters from the certifying accountants stating the facts upon which they rely.

The accountants' certificate is a subject for comment perhaps more frequently than it should be. The standard short form of certificate meets the requirements of Rule 2-02 of Regulation S-X in most cases. When more than one accountant is relied upon, it is sometimes necessary to issue a reminder that certificates and consents of all the accountants are required. It is frequently necessary to call attention to the requirement that certificates be manually signed and accurate in all particulars, such as specifying dates and statements covered. If the principal accountant assumes full responsibility for the work done by other accountants on divisions or subsidiaries of the registrant, his certificate should be clear on the matter as required by Rule 2-05. Whether or not the principal accountant assumes the

responsibility for the work of the other accountant, he does, of course, assume responsibility as a part of his audit of the parent company for the propriety and consistency of the accounting principles and practices followed by the subsidiary and for the adequacy of the audit program and standing of the other accountants. Certification by accountants of recognized standing known to the principal accountant presumably would require minimum or no inquiries; however, upon first contact with unknown accountants appropriate inquiries must be made.

Ambiguous opinions have also caused some trouble over the years. The phrase "subject to" is mentioned in Accounting Series Release 7 to which I referred at the outset. These words are rarely acceptable. If an exception is intended, it should be clearly stated. If an explanation is being highlighted, the wording should be clear that no exception is being taken. "Subject to" may be used with reference to some problem which cannot be resolved, such as the effect of pending court or regulatory agency proceedings fully explained in the certificate or in a note to the financial statements to which reference is made. Before leaving the certificate it may be well to reemphasize that anything the accountant wants to say about the financial statements or his audit should be said in the certificate. The financial statements, including the notes, are considered to be those of the management, hence the notes should not contain language written from the point of view of the auditor -- such as references by him to management or explanations of auditing procedures employed.

Some of our suggestions which we believe are most helpful are best made in conference before filing. These are concerned with multi-company problems and improvement in the layout of the statements. Examples are columnar presentation of registrant and consolidated statements when both are required, group statements, recasting to common fiscal periods, integration of notes, use of income statements for the summary of earnings and other devices for reducing the length of the prospectus with better presentation of material and a reduction in printing and mailing costs. In this connection we apply the provisions of Rules 3-01 to 3-05 of Regulation S-X relating to form, order, and terminology; immaterial items; inapplicable captions; combining of notes and grouping of subsidiaries and the provision of the various forms permitting deviations from specific instructions when appropriate. Occasionally, however, registrants and their accountants are overzealous in relying on these rules, particularly as to what is material. Often, a suggestion is made to restore information to a form given in prior filings. This may be the right place to mention that publication of financial statements in a report to stockholders or elsewhere prior to filing them with the Commission does not preclude comment and a request for correction of the statements if such action appears to us to be necessary in the circumstances.

The financial statements included in reports to stockholders and those prepared for filing with the Commission are

substantially the same for many corporations. A common exception is that our rules require more disclosure in foot-notes than is customary in reports to stockholders. Comments with respect to these notes are common. Additional information frequently must be requested with respect to methods of pricing inventories, classification of plant assets, methods followed in measuring depreciation, depletion and amortization and methods of accounting for maintenance and repairs and the recording of disposition of assets. Notes relating to pensions, stock options, income taxes and restrictions on surplus frequently require expansion to meet the requirements of the rules.

Adequate disclosure of these matters is essential to an understanding of the financial statements. This is particularly true when the accounting for significant items affecting the determination of income is treated differently for corporate reporting purposes and for income taxes. A number of cases have come to our attention in which sum-of-the-years-digits or declining balance depreciation has been claimed for tax purposes but straight line depreciation has been continued on the books without any adjustment for deferred taxes. The improvement in earnings resulting from this practice has been so large in some cases that amendment of the statements to include an additional amount equal to the tax benefit has been required on the grounds that failure to

do so would make the statements seriously misleading. We have encountered very flexible concepts of materiality in some instances. In those cases in which the accelerated depreciation methods correspond with operating realities it appears that the books should reflect the basis used for the tax returns. Practice seems to vary by industries and has been influenced in the regulated industries by the position taken by the federal or state commissions having primary accounting jurisdiction.

Problems raised in connection with proposed business combinations are usually the subject of a prefiling conference on proxy material in which the proposal is to be placed before stockholders for approval or on drafts of a registration statement covering an offer of exchange of shares. In clear cut cases these discussions may cover questions of presentation of financial data rather than of principle. Usually the parties involved know when they have a marginal case and arrange a discussion before printing rather than risk a conflict in views which might require reprinting to reflect, for example, "acquisition accounting" rather than a "pooling of interests" solution. Such a result may arise in a situation when factors favoring a "pooling of interests" solution have been deemed by the registrant to outweigh adverse evidence but we are more impressed with the latter. The evidence is fairly clear at times that the result desired

carries more weight with the registrant than the facts brought forward in support.

The concept of "pooling of interests" accounting (which avoids the booking of goodwill as would be required in many "purchase" transactions and permits the combining of earned surplus of the constituent companies rather than "acquisition accounting") has been recognized by the Commission for about fifteen years. At first this accounting was deemed appropriate when the corporations to be combined were of about equal size and were engaged in similar or complementary businesses. This latter test is now outmoded with the emphasis on diversification in corporate mergers.

In 1945 the Commission considered a merger proposal in which all factors other than size clearly supported a pooling of interests solution. The result was that goodwill was not recorded and the earned surplus of both companies was carried forward. In this case the assets and common stock equity of the smaller company were less than one-fifth and one-third respectively of the larger. From this point on, relative size was considered to be less important than other factors in considering whether a business combination was a pooling of interests or not.

The significant next step in the case by case consideration of the problem by the Commission was raised in a proposed merger involving the possibility that a minority interest

would remain after an exchange offer and the smaller company would continue as a subsidiary. It was concluded that in these circumstances it would be inappropriate to treat the transaction as a "pooling of interests" and therefore the earned surplus of the acquired company could not be combined with that of the registrant. On a purchase basis goodwill would have been negligible.

Adhering to this interpretation that pooling of interests accounting was inapplicable when parties to a merger continued in a subsidiary relationship led to a reconsideration of Section C of Chapter 7 of Bulletin No. 43 which succeeded Bulletin 40 with only minor changes. Bulletin No. 48,[4] published in January of this year, omits the requirement of similar or complementary business and permits a pooling of interests when substantially all of the ownership interests in the constituent corporations continue and permits a subsidiary relationship to survive "if no significant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses." The revision retains the tests of continuity of ownership and of management or power to control the

4/ Issued by the Committee on Accounting Procedure of the American Institute of Accountants.

management and introduces a specific test of relative size. Although relative size may not necessarily be determinative, the bulletin says that "where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests."

As you would suspect, the first questions raised under Bulletin 48 were with regard to the size test and minority interests. The first cases involved combinations in which the smaller company fell in the range of 5% to 10% of the combined equity. No objection was raised to pooling of interests accounting in these cases when it appeared that a strong case had been made under the other tests. We have objected to pooling of interests when the equity of the smaller company would be less than 5%. On the minority interest question the words "substantially all" we construe as having the same meaning as in our definition of a totally-held subsidiary. This permits a minority of directors' qualifying shares and negligible amounts due to other causes.

The summary of earnings is generally considered to be one of the most important parts of the prospectus. As such it must be prepared with great care in order that it not be misleading. Effective and fair disclosure of the results of operations for interim periods is often troublesome,

particularly when a company's operations are subject to marked seasonal variation. In other situations the effect of declining sales on earnings must be clearly disclosed.

The staff, when examining the summary of earnings, makes appropriate inquiry with respect to all uncertified interim periods in such summaries to determine the existence of any unusual conditions affecting the propriety of the presentation and the necessity for the inclusion of an appropriate previous period. If it appears that a significant decline in earnings may have occurred, unaudited interim figures to the latest practicable date and for the same interim period in the previous year are requested.

In addition to inquiries as to the trend of the business since the date of the financial statements and requests for explanation of the results reported, it is often necessary to request that footnotes be clarified, that the basis of calculation of earnings per share be stated, that retroactive adjustments of the accounts be made in the years affected, that the order of the statement be changed to emphasize significant factors and all too often that information specified in the instructions be furnished.

Financial statements used in offering circulars under Regulation A are examined in the Commission's regional offices, and comments, if any, are sent from these offices. Although these financial statements are not required to be certified,

it is not unusual to find that they are. In such cases the same tests of independence are applied to the accountant as pertain in other filings with the Commission. We do not recognize two standards.

A common fault in financial statements furnished under Regulation A is excessive detail. This appears to be due in many cases to the use of material prepared for management with no effort made to edit and rearrange the material for the use of investors.

Common deficiencies in the content of the financial statements include the use of written up values of assets; improper accounting for deferred charges; improper classification of items, usually resulting in an overstatement of working capital; failure to disclose the pledging of assets; inadequate description of securities of the issuer; failure to disclose the basis of valuation of inventories and fixed assets; and failure to make appropriate accruals, especially in interim period statements. Many of these deficiencies appear in filings of small companies under the 1933 and 1934 Acts.

A discussion of this kind would not be complete without some reference to broker-dealers in securities. At June 30, 1956, there were 4,497 effective registrations of brokers and dealers, of which 1,274 were in New York City. Of the total, 1,471 were corporations, 1,306 were partnerships,

and 1,720 were sole proprietorships. Every registered broker-dealer is required to file with the Commission during each calendar year a report of financial condition. Under our present rules a substantial number of these reports are not required to be certified by independent accountants. A proposal to amend the rule to limit the exemption and to clarify the filing date for the reports is now out for comment.[5/] This release includes a revision of an earlier proposal upon which comments had been received. However, further action on the original proposal was delayed pending the publication by the American Institute of Accountants of a booklet entitled "Audits of Brokers or Dealers in Securities" which was issued by the Committee on Auditing Procedure after several years of study. This booklet, which should fill the need for an authoritative guide in this specialized field of auditing, describes the special accounting records used by brokers and dealers, and auditing procedures and forms of reports to be used in connection with the examination of their books and records.

The deficiencies which have been cited most frequently with regard to the reports of broker-dealers appear to be due to a lack of knowledge of stock brokerage techniques with respect to the maintenance of securities accounts. At

5/ Securities Exchange Act of 1934, Release No. 5515, May 10, 1957.

times deficiencies appear to arise from the failure of accountants to read the applicable rules and to comply with the instructions in the forms. The booklet to which I have referred was prepared by an Institute committee at the suggestion of the Commission's staff. It is hoped that it will receive wide circulation among accountants serving brokers and dealers and that the result will be improved reports filed with the Commission.

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