

**DISCLOSURE IN THEORY AND PRACTICE**

**Address of**

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**before the**

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**of**

**CERTIFIED PUBLIC ACCOUNTANTS OF THE PACIFIC NORTHWEST**

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## DISCLOSURE IN THEORY AND PRACTICE

The letter from the president of the Oregon Society of Certified Public Accountants which I received last October was an irresistible piece of sales literature, or prospectus if you like, but strictly factual I am sure. I had not realized that the Pacific Northwest Conference was the senior regional meeting of CPAs in the nation. I can understand how Alaska qualifies for a Northwest Conference and I am pleased to see representatives of Hawaii here. You must have been on your toes to line up Hawaii too as Northwest! The SEC has had registrants served by accountants in Hawaii for many years, but I believe it is only in the last year that we have reviewed financial statements certified by accountants residing and practicing in Alaska. The centennial of the State of Oregon and the 50th year of achievement of the Oregon Society of CPAs make this meeting a memorable occasion. I appreciate this opportunity to participate in it.

A suggested topic for my discussion was "Accounting Theory, The SEC and The Independent Accountant." This appeared to be a broad subject, so it has been limited to "Disclosure in Theory and Practice" with the suggestion that examples from our day-to-day work would be of interest to you. I shall try to comply with these suggestions.<sup>1/</sup>

The SEC administers several statutes enacted by Congress for the protection of the interests of investors and the public. Perhaps the best known of these are the Securities Act of 1933 and the Securities

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<sup>1/</sup> The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

Exchange Act of 1934, the latter having established the Commission as a separate independent agency of the Federal government. These Acts, as well as the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, provide penalties for making false and misleading statements under prescribed conditions.<sup>2/</sup> With respect to the disclosure aspects of these Acts the Commission has said "It should be understood that the securities laws were designed to facilitate informed investment analyses and prudent and discriminating investment decisions by the investing public, and that it is the investor and not the Commission who must make the ultimate judgment of the worth of securities offered for sale. The Commission is powerless to pass upon the merits of securities; and assuming proper disclosure of the financial and other information essential to informed investment analysis, the Commission cannot bar the sale of securities which such analysis may show to be of little or no value."<sup>3/</sup>

The basic financial statements are prescribed by the statutes, but the form, extent of detail, classification, and accounting methods to be followed are specifically left to the determination of the Commission.<sup>4/</sup> Special powers of the Commission found in Section 19(a) of the 1933 Act include authority to define accounting and trade terms

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<sup>2/</sup> Securities Act of 1933, Sec. 11; Securities Exchange Act of 1934, Sec. 18; Public Utility Holding Company Act of 1935, Sec. 16; Investment Company Act of 1940, Sec. 34.

<sup>3/</sup> The Work of the Securities and Exchange Commission, p. v.

<sup>4/</sup> 1933 Act, Items 25 and 26 of Schedule A; 1934 Act, Sec. 13; 1935 Act, Secs. 5 and 15; 1940 Act, Secs. 30 and 31.

used in the Act and to prescribe the forms in which the required information shall be set forth and the methods to be followed in the preparation of accounts.<sup>5/</sup>

These powers have been applied in the adoption of the instructions as to financial statements found in the forms for registration and reporting and in Regulation S-X which prescribes the form and content of the financial statements to be filed under the several Acts. Rules of general application specify that the "financial statements may be filed in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto" and that items not material need not be separately set forth in the manner prescribed. However, "the information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."<sup>6/</sup>

Within the limits of the provisions of the statutes and the rules adopted thereunder after exposure to public comment, we try to solve our disclosure problems in a manner consistent with accepted accounting procedures and the disclosure philosophy of the statutes.

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<sup>5/</sup> House Report No. 85, 73d Congress, 1st Session, p. 25.

<sup>6/</sup> Regulation S-X, Rules 3-01, 3-02, 3-06.

## Independence

First of all, a vital safeguard in securing full disclosure is that a professional accountant who is independent of his client review and furnish his opinion on the statements. The concept of independence was well developed and the value of a review by an independent accountant was recognized before the establishment of the Commission. The Securities Act of 1933 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."<sup>7/</sup> The Securities Exchange Act, the Investment Company Act, and the Holding Company Act permit the Commission to require that such statements be accompanied by a certificate of an independent public accountant,<sup>8/</sup> and with minor exceptions the Commission's rules do require certification. The Commission's standards of independence are stated in Rule 2-01 of Regulation S-X. The Commission's experience in this area is reported in a number of Accounting Series releases,<sup>9/</sup> the most recent one being Accounting Series Release No. 81, issued December 11, 1958. Our independence requirements have fostered the growth of accountant-client relationships which, I believe, have strengthened the protection afforded investors by independent audits.

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<sup>7/</sup> Sec. 10(a)(1) (Schedule A, pars. 25, 26).

<sup>8/</sup> Securities Exchange Act, Secs. 13(a)(2), 15(d); Investment Company Act, Sec. 30(e); Holding Company Act, Sec. 14.

<sup>9/</sup> See Releases 22, 37, 47 and 81.

The independent status of the certifying accountant is perhaps the most important accounting matter in any filing with the Commission. Experienced practitioners are well aware of this. It should have first attention by the sponsors of a new registrant with the Commission, particularly if the parties involved are unfamiliar with our rules. Discovery after a filing has been made that the certifying accountant is not independent under our rules can result in a substantial delay and interference with well-laid plans as an audit by new accountants will be necessary. Determination of the accountant's status before undertaking the engagement may avoid embarrassment and expense.

#### Disclosure Applied to Financial Statements

Once the question of the independence of the certifying accountant in a new filing is settled satisfactorily, there may be problems of how and to what extent certain transactions should be disclosed. Early contact with the staff when questions of independence or disclosure arise is recommended. Staff considerations of financial statements required to be filed with the Commission may be obtained by telephone or letter or in conference prior to the filing of material. In complicated cases, such as a merger of several companies with different fiscal years, a pre-filing conference may result in a solution which will save valuable space in the prospectus or other document. Experienced practitioners usually know when they have a controversial matter of accounting principle. A discussion before filing may avoid later delaying correspondence or conferences when time is vital to the success of an offering.

The development of the meaning of disclosure as applied to financial statements filed with the Commission is marked by two events which should receive some attention before proceeding with a discussion of more recent problems. In October 1934 Northern States Power Company filed a registration statement which disclosed that subsidiaries of the company had written up properties on the basis of an appraisal in excess of \$8,000,000 with a corresponding increase in the investment account on the parent's books. This was done in 1924 and in that year and in 1925 the parent company charged unamortized debt discount and expense to capital surplus in the full amount of the appraisal. The staff took exception to this accounting and so did the accountant in a revised certificate accompanying an amendment which explained in a footnote the effect of the accounting. The registration statement was permitted to become effective in this form, but the divided opinion of the Commission was published in a release issued November 21, 1934.<sup>10/</sup> The release stated that three Commissioners thought that the circumstances were sufficiently disclosed by the amendment but the other two Commissioners thought that adequate disclosure and treatment required restatement of the affected financial statements and that an explanation should be made as to the company's past accounting practices. This action meant that the majority of the Commission at that time would accept incorrect financial statements rather than require restatement of them provided

the footnotes and accountant's certificate provided an explanation of the improper accounting. The minority were not satisfied with this solution of the disclosure problem. Further official discussion of the problem was promised but did not appear until April 25, 1938, when Accounting Series Release No. 4 was issued.

The Accounting Series was announced on April 1, 1937, with an opinion of the Chief Accountant on the treatment of losses resulting from revaluation of assets--that they should not be charged to capital surplus. This release incorporated in the series a previous release<sup>11/</sup> on treatment of Federal income and excess profits taxes and surtax on undistributed profits and announced that these releases initiated "a program for publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions." Release No. 2 was the first of several on the independence of accountants, and No. 3 dealt with the treatment of investments in subsidiaries in consolidated statements, a question undergoing reexamination today. So we have three releases involving accounting policy, in addition to the Commission's formal opinions on proceedings involving hearings, before the publication of its "administrative policy on financial statements" as Accounting Series Release No. 4. This release says that

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the

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11/ Securities Act of 1933 Release No. 1210, January 6, 1937.



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 first comment I find on this policy was expressed by Commissioner Mathews in his paper before the Institute on Accounting of The Ohio State University on May 20, 1938. The paper discusses the practice of the several professions before the Commission and contains a frank appraisal of the status of accountants at that time and concludes that

"The Commission will assert its influence and exercise its authority to hasten the general acceptance of those principles which have definitely proved their merit, but, because of environmental factors, have not been adopted, and will likewise seek to quicken the abandonment of practices identified with the body of accepted rules and principles which are nevertheless frowned upon by the better thought in accounting.

"A recent action of the Commission will serve to illustrate this attitude and approach. Many of you are familiar with the complaints originating in the accounting profession against the use of footnotes to financial statements to explain the use of improper accounting procedures or to correct the effect of statements in the financial statements themselves. Perhaps the growing opposition to the use of footnotes for such a purpose would eventually evolve or develop into a rule of accounting prohibiting and

condemning the practice. It would occur, however, only after a long struggle by practitioners against the factors which have in the past on so many occasions tied their hands."

Editorial comment by the Journal of Accountancy recognized the statement of policy as an intention of the Commission to assume more responsibility for settling differences of opinion "than formerly because instead of accepting 'full disclosure,' it must decide which party to a controversy is right.<sup>12/</sup>

#### Regulation S-X and The Income Statement

The Commission's Regulation S-X which prescribes the form and content of financial statements required to be filed under the several Acts was published February 21, 1940.<sup>13/</sup> Prior to this each of the forms for filing included instructions as to the form and content of the financial statements. Between the publication dates of the statement of accounting policy and Regulation S-X seven Accounting Series releases were published. These included opinions that dividends on treasury stock should not be treated as income, that proceeds of treasury stock in excess of cost do not result in corporate profits or in earned surplus, that surplus by appraisal of properties in excess of cost should be eliminated from the balance sheet of a promotional company, and one listed many of the commonly cited deficiencies in financial statements with a clear invitation for accountants to use more care in the preparation of material for filing. Three releases

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<sup>12/</sup> The Journal of Accountancy, June 1938, p. 464.

<sup>13/</sup> Accounting Series Release No. 12.

dealt respectively with the presentation of stock having preferences in involuntary liquidation in excess of par or stated value, treatment of unamortized bond discount and expense applicable to bonds retired prior to maturity with proceeds from sale of capital stock, and the propriety of including in consolidation with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies, or whose assets and operations are endangered by war conditions prevailing abroad. All of these releases and many of those published subsequently represent the application of the policy announced in Release No. 4. Most of these constitute currently effective guides.

Throughout this development period and to the present time it has been Commission policy to seek the advice of those who would be affected by its regulations. This does not mean that in accounting or in other areas everyone can expect to be pleased with the result. As an example of how this works out in practice let me move on about ten years and consider the much debated subject of income and earned surplus which many of you will recognize as Accounting Research Bulletin No. 32 now found in Chapter 8 of the Restatement and Revision of Accounting Research Bulletins. The debate over the "all-inclusive" versus "current operating performance" concept of the income statement had gone on for some time. The staff of the Commission had made comprehensive studies of charges and credits to earned surplus<sup>14/</sup> and a

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<sup>14/</sup> William W. Werntz and Earle C. King, The New York Certified Public Accountant, September 1946.

conference on the subject attended by representatives of various interested organizations had been held at the Commission. As is done today, drafts of the proposed bulletin were discussed with the staff who expressed general agreement with the objective sought but took exception to certain of the proposed exclusions from the income statement. In a most commendable spirit of cooperation the editors of the Journal of Accountancy agreed to publish a letter of the Chief Accountant in the same issue with the new bulletin 32.<sup>15/</sup> After reciting his reasons for disagreeing with certain aspects of the bulletin he said, "Under these circumstances the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32."

About this time staff work was begun on a general revision of Regulation S-X. As a first step a draft was prepared in which new terminology recommended by many accountants and public relations men was tried out. The terms "reserves" and "earned surplus" were avoided. The idea was abandoned as being too cumbersome and probably too far ahead of the times. However, we do accept the newer terminology under the provisions of Rule 3-01. Under this rule we also encourage what some wit has called "cent-less" accounting, and figures to the nearest thousand dollars. In the first and subsequent Ford filings the summary of earnings and some other figures were presented to the nearest million dollars.

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<sup>15/</sup> The Journal of Accountancy, January 1948, p. 25.

Another preliminary step in the revision process was to review letters of comment for a substantial period, noting particularly comments cited under authority of Rule 3-06 to which I have referred. Specific provisions were made in the rules for recurring items identified in this review. The resulting first preliminary drafts were exposed to a limited number of persons including members of Institute committees. A revised draft was sent to approximately 600 persons in September 1949 and the official draft for comment published in the Federal Register went to more than 3000 persons in July 1950. These last two exposures drew comments from approximately 175 persons. The rule governing the income statement upholds the all-inclusive concept but with a provision that the Commission may permit exceptions.<sup>16/</sup> As adopted and now in effect the rule reflects the results of a compromise worked out between the staff and representatives of the Executive Committee of the Institute after their appearance before the Commission. This produced the well-known item 17, Special Items, which has served to bridge the gap between the "all-inclusive" and "operating performance" advocates.

I have taken some time on the matter of the income statement because of its importance and because it is still the source of a large number of comments on financial statements. Many of these are caused by a slavish adherence to advice found in many textbooks that prior year items no matter how insignificant must go directly to earned surplus. The black print in paragraph 11 of Chapter 8 in

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<sup>16/</sup> Regulation S-X, Rule 5-03; see also Accounting Series Release No. 70.

Research Bulletin 43, when qualified only by exception (a), and our interpretation of Rule 5-03 of Regulation S-X are in agreement on this point that only material items of this type should go directly to surplus. The airlines and some hotel and real estate operators present what might be called regularly recurring non-recurring extraordinary items in the nature of substantial gains (usually) or losses on the disposal of or trading of equipment or property; segregation of these items in the income statement after results from operations but before arriving at net income is an accepted procedure.

#### Employment Costs

Accounting for employment costs is a continuing problem with considerable difference of opinion as to the solution in accounting theory as well as the degree of disclosure in practice. Problems have arisen, and some persist despite efforts at a solution, in the accounting and reporting for pensions and deferred compensation plans.

The Institute's bulletins have not dealt with the deferred compensation problem. In fact Bulletin No. 47 on Accounting for Costs of Pension Plans states specifically that "It does not include profit-sharing plans or deferred-compensation contracts with individuals." As a matter of principle it appears to us that in most cases deferred compensation should be provided for prior to retirement and assumption of a status as consultants and advisors. The amounts involved are not material in most cases, perhaps, but this should not be used as a reason for omitting proper accruals.

The business recession of 1958 set the stage for difficulties under Bulletin 47 dealing with the accounting for pension costs. With net incomes staggering from decreased business activity, corporate managements exerted great pressures to reduce costs for both those requiring cash expenditures and book accruals. The revenue deduction for pension costs varies widely, depending upon the assumptions made by the actuary. The determination of a fair amount for pension costs under a systematic plan is in the controversial area of securing the data on which the accounting is to be based.

The case of the financial report of United States Steel Corporation for 1958 indicates current controversy on what the generally accepted accounting principle should be.<sup>17/</sup> The corporation made a charge to income of \$144 million for pension costs in 1958 compared with \$265 million for 1957. The certifying accountants state that the charge, while not equal to the current service costs accrued during the year, is more than sufficient when added to current service costs accrued in prior years to equal all current service costs accrued since the adoption of the plan in 1950. The certifying accountants in this case noted in their certificate a change in the company's determination of the amount of cash paid to the trustee, disclosed the effect on net income and that the payments for the current and prior years were not comparable, but concluded in their opinion that generally accepted accounting principles were consistently applied for the five years. Other accountants have indicated that they would

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<sup>17/</sup> See "News Report," Journal of Accountancy, April 1959, p. 8.

take an exception to such action since they did not consider that a generally accepted accounting principle had been followed when a charge to income is not made for the full amount of the current service costs accrued. A third group has indicated that under Bulletin 47 no explanation need be given in the certificate as long as footnote disclosure sufficient for statement comparability is made. This is a subject which requires further study as to what constitutes a generally accepted accounting principle.

Representatives of the profession are well aware that progress in this area must be made. Often it is urged that experience is necessary in dealing with a new problem before a sound principle can be derived. There is merit in this approach, but in the meantime good financial reporting and fair disclosure require that the items be handled within the existing framework of generally accepted accounting principles.

### Inventories

Before leaving the general subject of income statement problems we should recognize that inventories continue to cause trouble of various kinds. In the realm of theory LIFO looms large. Ten years ago we were close to agreement that an alternative valuation should be disclosed in a footnote or otherwise when LIFO was used in the accounts. Although some companies have volunteered this information with varying degrees of clarity, others resisted on the grounds of cost to develop the information, feared effect on their tax status or the alleged misleading nature of the figures that would be produced.



The Libby, McNeill & Libby proxy contest of several years ago demonstrates that the subject can be used to confuse the uninformed.<sup>18/</sup> Recently there seems to be a renewed interest in the subject prompted, it appears, by a desire to gain the benefits of more current values for balance sheet purposes and still retain the advantages in determining income. More uniform disclosure in this matter should be encouraged, but we are not ready to accept a balance sheet adjustment to the LIFO inventories net of tax effect reflected as an increase in working capital and stockholders' equity. We have not objected to parenthetical disclosure, however, in the face of the balance sheet.

Another inventory problem arises when one company buys another at a substantial discount from underlying book value, resulting in an allocation of this discount to various balance sheet items including inventories. When the inventories are sold in normal course soon after acquisition an unusual non-recurring profit may be realized. We have had several cases in which this was so significant that the non-recurring gain was removed from gross profit and reported below with a clear explanation of the source of the gain.

#### Principles of Consolidation

In the area of consolidated statements there remain many unresolved problems. One question which gives us considerable difficulty is when may a subsidiary be omitted from consolidation with the parent company. We have generally taken the view that the investor can most

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<sup>18/</sup> SEC v. May, 134 F. Supp. 247 (1955) Aff'd, 229 F.2d 123 (1956).

readily appraise the financial condition of a company and of his investment in the company if all majority-owned subsidiaries are consolidated. There are a number of definite exceptions to this rule. But the inclusion of profitable subsidiaries and exclusion of the unprofitable, as was urged upon us recently on the grounds that the excluded subsidiaries were not significant, is not one of the exceptions. Our rules do not permit an industrial or commercial company to consolidate a bank or a life insurance company due to the complete dissimilarity of operations and because the latter's resources would not be available to the parent companies. It may be misleading to consolidate foreign subsidiaries where rigid foreign exchange controls are employed or where a devaluation of the currency has recently been experienced or is imminent. Recently a financial writer criticized this practice on the grounds that an element in determining the strength of the company was concealed. When subsidiaries are excluded from consolidation for valid reasons our rules require that the parent's equity in the underlying assets and earnings be disclosed in footnotes.

However, where an operating function of a company is separated from the parent and performed by a subsidiary, ordinarily such subsidiary should be included in the consolidated statement. The real estate subsidiary, normally heavy with debt, is an example. Omitting the real estate subsidiary and its debt from consolidation results in a "clean balance sheet" but does not disclose the impact of the debt

on the consolidation. On the other hand, where the subsidiary is consolidated the reader is properly informed as to the debt for which the parent company's rental payments are usually collateral.

A similar question is raised when a property used by the registrant is acquired subject to a mortgage. In a recent utility filing it was urged that the net equity should be shown among the assets by disclosing cost of the building and deducting the reserve for depreciation and the balance due on the mortgage. Operations of the building were included in the company and consolidated income statements. Under these circumstances we insisted that the building be shown under property and the mortgage payable as a separate item among the liabilities with appropriate descriptions to disclose the status of ownership.

Some accountants and company representatives have contended that a finance subsidiary should not be consolidated, even where it is financing primarily sales of the parent, on the ground that the finance subsidiary's operations are of a banking nature and are too unlike the operations of the parent to make it advisable to consolidate. The typical finance company has a heavy debt/equity ratio, although the argument is made here that this should not be considered where the parent has no liability on the accounts. In my opinion, where the finance company is handling primarily the accounts of the parent and affiliates, it constitutes an integrated part of total operations and should be consolidated even though the parent is not subject to recourse on the accounts.

Often the buying or selling functions of a firm are performed by a subsidiary. The "buying subsidiary" acting in the capacity of purchasing agent for raw materials often carries a substantial part of the raw materials inventory for the combination and in order that the total resources of the combination be reported, the subsidiary should be consolidated. In addition, debt is customarily used extensively with the inventory pledged as collateral and this constitutes a further need for consolidation.

As an argument against consolidation of these companies their representatives often note that creditors of the buying subsidiaries or of the finance companies do not want consolidated statements. Their argument is that specific assets pledged as collateral for the debt are not segregated. Compliance with our requirements will produce this information.<sup>19/</sup> Presentation of separate subsidiary statements to the bankers, insurance companies and other credit grantors in need of such statements is not precluded.

Some industrial companies acquire or establish subsidiaries for the production of their raw materials. Where this stage of vertical integration is not common in the industry, some companies are reluctant to consolidate such subsidiaries and argue that their statements would no longer be comparable with those of other firms in the industry. With the possible rare exception it would appear that consolidation is in order.

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<sup>19/</sup> Regulation S-X, Rule 3-19(a).

Promotional Companies

The problem of accounting for assets received in exchange for stock in promotional companies occurred frequently in the early years of the Commission and led to the adoption of Article 5A of Regulation S-X in which no values are extended for assets so acquired. The problem of the donation back of shares issued in these circumstances was considered in an early decision <sup>20/</sup> in which the Commission discussed statutory law and court decisions and then said: "With the question of whether or not stock reacquired under these circumstances is true treasury stock and hence is to be regarded as fully paid and non-assessable, this Commission in this case has no concern; but under the standards of truthfulness demanded by the Securities Act, such an entry cannot be regarded as otherwise than untrue and misleading."

In another early case the Commission questioned the value of services rendered in exchange for stock and said: "Statutory provisions in the state of incorporation making values fixed by directors conclusive for certain purposes in the absence of fraud, cannot foreclose this Commission's inquiry as to the truthfulness of a statement that a corporation has received services of a certain value, reasonably determined, nor prevent such a statement from being tested for truth under the standards set by the Securities Act." <sup>21/</sup>

Situations similar to these are occurring today with a new generation of promoters and their professional advisers who may think

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20/ In the Matter of Unity Gold Corporation, 1 SEC 25 (1934).

21/ In the Matter of Brandy-Wine Brewing Company, 1 SEC 123 (1935).

that the circumstances are different or more likely they are not aware of the stop order cases in the first years of the Securities Act. An example is a case a year ago in which an old company was the vehicle for a new promotional uranium venture.<sup>22/</sup> Even the corporate name was misleading.

The financial statements were prepared in an effort to comply with Article 5A of Regulation S-X and were accompanied by a most revealing certificate. Significant facts revealed were that the company's records were destroyed by fire in 1939 and that the company had had no operations from that date to May 1, 1957. In these circumstances the accountant reported that he had inspected the properties and obtained engineering appraisals of the old tunnels, power house installations and water rights and set up his statement of assets using values so determined but as for new mining claims acquired for stock he assigned no dollar values. The prospectus as filed said that "The business intended to be carried on by the company is that of a public utility and the operation of the firm's mining properties." After the opinion in the proceeding was published a revised prospectus for the company under its new and more informative name became effective on August 13, 1958. This document stated that "This is an exploratory mining venture and no assurance can be given the prospective investor that commercial ore bodies will be discovered." As to the power plant and water rights the new prospectus said: "It is not the present intent of the management of the company to utilize the hydroelectric facilities or the

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<sup>22/</sup> In the Matter of The Fall River Power Company, S.A.Rel. 3932, June 4, 1958.

water rights at the present time as there is no evidence of any demand for the power." The statement of assets was revised to reflect this situation. In the statement furnished with the original filing the principal properties were set forth as follows:

Hydroelectric Power Plant -	
Appraised value on present day replacement costs - approximately	\$ 450,000
Water rights - appraised value	1,000,000
Mining claims - at necessary cost to patent	232,272
Claims from promoters in exchange for stock	969,395 shares
Development work on mining claims -	
Engineer's appraisal of present day costs per foot	<u>438,615</u>
Total dollars assigned to these items (including items assigned nominal values of \$1 each)	\$2,120,887
Recent cash items amounted to	<u>26,730</u>
Total dollar valuation	<u><u>\$2,147,617</u></u>

As revised nearly two years later the cash items extended at \$38,506 and all of the old properties were identified by descriptions and references to footnotes and one group was assigned a nominal value of \$1.00. All of these were shown as encumbered by a \$500,000 mortgage to the former owner who was to receive 90% of the first proceeds from the public offer up to the \$500,000. The Commission's opinion disclosed that this individual had acquired all of these old properties for about \$100,000 in 1944.

The desire to use appraisals as the basis for writing up assets is strong in sponsors of small companies with unimpressive earnings records. This situation is encountered frequently in exempt offerings under Regulation A. The standard pattern seems to be a restatement

upward of the fixed assets shortly before the offering. When we receive the material for review the balance sheet reflects the appraisal but the reported earnings do not include depreciation on the addition to the plant values. Removal of the write-up is requested. It is not unusual to find that the appraisal surplus has been capitalized by a stock dividend. Where this is legal under state law we request a restatement of the property at cost and the excess due to the appraisal must be shown as a deduction in the equity section of the balance sheet. In a recent case the write-up was limited to the exact amount of a 100% stock dividend but a note disclosed that this was conservative since the appraisal revealed an additional value of nearly that much more! All dollar amounts of this total appraisal were removed and book values per share calculated on the written-up values were deleted before the offering circular was acceptable.

If I have done nothing else this morning I hope I have made it clear that we recognize that we must first attempt to understand the business facts and then apply what we find to be the appropriate accounting principles. Accounting is still a matter of opinion and judgment, and good results depend upon the high standards of business ethics and professional conduct displayed by management and certifying accountants.

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