

Library - 184

What the Securities and Exchange Commission
Desires in Financial Statements

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Before the

Second Annual Institute

The Georgia Society
of
Certified Public Accountants

and

The University of Georgia
College of Business Administration

At the

University of Georgia
Athens, Georgia

Friday, November 19, 1948

What the Securities and Exchange Commission Desires in Financial Statements

It seems desirable that before discussing the things that the Commission desires in financial statements some brief comment be made as to the reasons why we are interested in financial statements.

Accounting plays a very important part in the administration of most of the statutes which come within our purview. Complying with the Securities Act of 1933 more than two companies file registration statements covering the sale of securities every business day. These registrations, which in the course of a year embrace practically every type of business enterprise, old and new, large and small, contain financial statements generally covering a period of three years together with comparative earnings summaries, in most cases, for ten years. And once a company has filed a registration statement in connection with the sale of securities it is required to file financial reports annually thereafter as long as there are outstanding 2,000,000 or more of the securities of the issue registered. Approximately 500 companies are now filing such annual reports.

In addition there are presently listed on the various stock exchanges securities of more than 2,000 companies which are required to file annual financial reports with the Commission pursuant to the Securities Exchange Act of 1934. And the activities of more than 4,000 security brokers and dealers are subject to the supervision of the Commission under this same Act. Most of these broker-dealers are required to file annual statements of their financial condition.

The Public Utility Holding Company Act of 1935 requires the registration of public utility holding companies and, among other things, the geographic integration and simplification of holding company systems, and the simplification of corporate and capital structures. Also recapitalizations, mergers, and consolidations of these companies and their subsidiaries are subject to approval by the Commission, as are, with certain exceptions, the issuance and sale of securities and the acquisition of securities and utility assets. All of these matters involve the submission of various types of financial statements.

Under the Investment Company Act of 1940 the activities of companies engaged primarily in the business of investing, reinvesting, and trading in securities are subjected to regulation by the Commission pursuant to which they are required to file financial statements similar to those required under the 1933 and 1934 Acts.

It is an important function of the accounting staff of the Commission to determine, so far as practicable, that these various financial statements are all that they purport to be--accurate, informative but concise, candid and uncolored; that they are not false or misleading with respect to any material fact; and that they do not omit to state any material fact necessary to make them not misleading.

What we expect in these financial statements was well summarized, I think, by former S.E.C. Chairman Caffrey in an address before the American Institute of Accountants in Miami last year, when he said: "I assume that the accountant has told me how much the business made or lost during the year and how much it can pay out without impairing the investment. I expect the statement to be complete; if it covers income and outgo I feel entitled to believe that charges and credits have not been tucked away or placed anywhere else. If there are necessary qualifications to what I read in the figures I assume that these will be flagged for me where they are most pertinent and will be stated in such a way as to permit me to appraise the statement intelligently."

We have promulgated and published certain rules and regulations governing the form and content of financial statements filed with the Commission, and have supplemented these rules and regulations with a series of accounting releases which was started by Carman Blough in 1937. We have also prescribed classifications of accounts with respect to utility holding companies and minimum audit procedures applicable to the accounts of broker-dealers. All of these publications are available to interested persons and may be obtained as issued simply by requesting that your name be placed upon our mailing list. (Incidentally it appears that you Georgia accountants have not availed yourselves of this material to any great extent as I was able to find the names of only about a dozen of you on our mailing list.)

Regulation S-X, adopted in 1940, comprises a uniform set of accounting requirements applicable to the majority of the Commission's registration and report forms under the 1933, 1934 and 1940 Acts. This regulation incorporates a considerable number of the many well considered and helpful suggestions received from the large groups of accountants, registrants, and others, including representatives of the professional societies, to whom a tentative revision of the instructions were made available, and therefore should be of considerable assistance to accountants in their day-to-day work whether or not a filing with the Commission is involved.

This regulation, which has been amended from time to time, is now subdivided into 14 articles. The first four articles contain rules of general application, including a list of forms to which S-X is applicable, definitions of terms used therein, and requirements with respect to certification and consolidated statements. The next seven articles prescribe, respectively, the form and content of financial statements for commercial and industrial companies; commercial, industrial and mining companies in the promotional, exploratory or development stage; investment companies; insurance companies; committees issuing certificates of deposit; bank holding companies; and natural persons. The remaining articles deal with the form and content of surplus statements and supplementary schedules. A comprehensive table of contents is included. And a new article prescribing the form and content of financial statements to be filed by face-amount certificate companies pursuant to the Investment Company Act of 1940, is now being considered.

The Accounting Series Releases to which I have referred, now 66 in number, contain important statements of policy and indicate several things we desire in financial statements. For example Release No. 4, which though of considerable importance is very short, reads as follows:

Administrative policy on financial statements.

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

No. 9 pertains to the balance sheet presentation of preferred or other senior classes of capital stock having preferences on involuntary liquidation in excess of the par or stated value. Nos. 15, 16 and 25 deal with the accounting for quasi-reorganizations--the corporate procedure in the course of which a company, without the creation of a new

corporate entity, is enabled to eliminate a deficit and establish a new earned surplus account for the accumulation of subsequent earnings. No. 36 discusses the treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were purchased. And No. 45 covers the treatment of premiums paid upon the redemption of preferred stock.

While we have promulgated certain rules, regulations, and classifications of accounts, and have prescribed some minimum audit procedures, to which I referred previously, we have not attempted to lay down specific rules and regulations covering all phases of accounting reporting. Instead we have depended in a large measure upon the accounting profession to establish, and management to follow, sound and generally accepted principles of accounting which, when consistently applied, will produce the type of financial statement necessary for the protection of investors. Likewise the establishment of standards which will insure adequate audit procedures has been left largely to the accounting profession.

Most of the financial statements filed with the Commission are required to be certified by independent accountants. In view of the extent of reliance upon the certifying accountants manifested in the rules, which reliance is both direct, through the individual practitioner, and indirect, by way of the state societies and the national organizations, our constant and insistent emphasis upon the independence of the certifying accountant needs little explanation. As some writer once stated, "An accountant's independence is virtually his stock in trade." That characterization certainly fits in with the attitude we have in the Commission, for we regard the complete objectivity implied by the term "independence" as the major, if not sole, justification for the certification requirement in S.E.C. filings. Without discussing the subject of independence in detail, the importance of the matter is such that I want to point out that our concept of independence of certifying accountants follows rather strict lines.

As stated in Article 2 of Regulation S-X, an accountant will not be considered independent, for the purpose of certifying statements filed with us, unless he is in fact independent. Since the fact is one which often defies proof one way or the other, we have set forth in Regulation S-X and in the Accounting Series Releases a number of conditions under which an accountant will not be considered independent. In addition, there are several formal decisions of the Commission that amplify or clarify our concept. We expect an accountant who practices before us to be familiar with our views on the subject as expressed in this published and readily available material. Independence to us involves a great deal more than presence or absence of known collusive action between a client and

the accountant. Suffice to say here that we insist upon more concrete evidence of independence than the assurance of the accountant that a particular circumstance did not cause him to be biased in favor of a registrant-client.

A matter which is not often mentioned but which is appropriate to the subject of discussion is that of the completeness of the financial statements. Perhaps I can dispose of this briefly by saying that we expect the financial statements with their supporting schedules to be self-contained documents subject to the right of reasonable incorporation by reference from accompanying material. In the material subject to our jurisdiction, such as the prospectus contained in a Form S-1 Registration Statement, the problem is not one which has caused us a great deal of trouble. But too often in filings involving something less than a seasoned, established registrant, sufficient care is not exercised on this point. We feel that an investor is entitled to assume that all pertinent financial data for the stated periods or dates is presented in or with the statements or specific reference is made to data given elsewhere, such as, for example, in the so-called "non-financial" section of a prospectus. Neither a hunting expedition nor a searching analysis by experts should be made necessary.

Related to the matter of self-inclusiveness are the problems of how much to tell and how to tell it. The first might be disposed of with the admonition that we desire a reasonable degree of frankness in the presentation of material facts. On this score I feel compelled to observe that while I have a great deal of respect for tradition, it often has proven to be a poor guide. During the last ten years or so substantial strides have been taken in bringing to investors the information they need. The resistance to this was, and to some extent still is, traditional. It is my belief that the independent accountant can perform a valuable public service if, although recognizing the significance of long established customs, he does not hesitate to insist that they be ignored where the suppression of important facts is involved. I can not lay down before you any rule or test to apply other than the general rule. I can only urge that an enlightened self-interest argues in favor of the accountant's stand on the side of completeness in reporting. The vital significance of financial figures in our increasingly complex society I believe guarantees due recognition for those accountants who refuse to compromise with anything less, within the meaning of financial statements, than the full story.

We do, of course, expect the accountant to insist upon the expert presentation of the figures and accompanying comments; for the independent accountant is presumed to give to the work a characteristically high degree of technical skill and expertness. This means

not only that facts should be stated but that their disclosure ought not to be submerged by unnecessary verbosity or by the employment of artful language. The use of certain accounting terms may be accepted as a necessity. At the same time the real meaning intended to be shown should not be veiled in jargon, obliqueness, or clever devices. To the extent that conventional terms and description are necessary, the meaning must be that which is both consistent and most nearly within the ordinary individual's comprehension. These are not mere abstractions to which I refer. Neither are they simply the indication of a hopeful idealism. The public accountant today stands in a unique and preferred position of public trust and confidence. Certainly it is reasonable to expect--and we do expect--that a certifying public accountant meets the high standard set up for him on the same unequivocal plane.

Among the areas in which vast improvement has been accomplished in connection with the accountant's relation with the public is the accountant's certificate or report. However, there are still enough instances of needed improvement to warrant a brief comment. The first problem area involves the matter of exceptions. It seems to us that an exception by the certifying accountant is of such vital concern to the reader that there ought not be the slightest question as to whether in fact an exception is expressed. In any event, we do insist that any equivocation in this respect be removed.

A second problem area is one which we feel deserves more consideration than has been given it in the past. I have in mind the use of the standard certificate to cover every kind of situation. Several interesting cases have come to our attention rather recently. Typical among these is the case where the registrant had no established business as yet, the prospects were highly speculative or the background contained unusual or irregular circumstances. This problem was in some instances accentuated by the fact that most, if not all, of the book entries were the work of the public accountants. To find the financial statements under such circumstances accompanied by such an inscrutable, sophisticated testimonial as the standard short form certificate, in our opinion, lent to the enterprise a misleading atmosphere of sound footing and solid business establishment. This situation is by no means obviated by footnotes to the statements themselves. I suggest that any accountant drawing up a certificate for a newly organized registrant, whether or not the corporation contains constituent elements of earlier enterprises, ask himself seriously if a modification of the standard certificate would not be a fairer presentation of the certification and whether the standard form may not furnish a cloak of respectability not completely warranted.

A matter very closely allied to the appropriateness of the form and language of the certificate is the extent of the auditor's

knowledge of his client, that is, knowledge of the kind of people with whom he deals, their background, character, choice of business methods, etc. This involves a broad subject and in some respects perhaps the auditor's responsibility cannot be delineated clearly. We need not attempt to explore all ramifications of the problem here. But there are certain conclusions that I feel need expression.

From time to time we have found accountants who do not regard the pursuit of the knowledge to which I refer as an audit matter. Indeed, standard publications on auditing give no, or almost no, consideration to the subject of such investigation. Even the highly significant and competent booklet "Tentative Statement of Auditing Standards," recently prepared by the Committee on Auditing Procedure of the American Institute of Accountants, makes no mention of investigation of the client as such. It seems unescapable that comprehensive knowledge of the client is implicit in many of the more explicitly stated procedures, such as, just for illustration, the evaluation of the extent of internal control or the practice of accepting explanations from officers and directors. First we have the case of an audit which has been performed each year over a long period. Then there is the new engagement where the business involved is long established and there is a high degree of management continuity; here an intermediate situation prevails. A third broad classification consists of the new client whose business is about to be launched or, if established, whose management has not stayed put. But any such classification, whether general or more detailed, simply emphasizes the probable difference in the degree of investigation required at a given point of time. Proper investigation is not only most assuredly an audit step to be performed just as certainly as, say, verification of bank balances, but must also be undertaken both thoroughly and expertly so that the results of the investigation are adequately reflected in the remaining audit procedures to be followed.

A strong opinion along these lines has been expressed by the Commission and I should like to repeat it here for the benefit of any who may have overlooked or forgotten it. In the Summary of Findings and Conclusions contained in the Report on Investigation in the McKesson & Robbins case, which summary was republished in 1940 as Accounting Series Release No. 19, the Commission indicated the following conclusions as to individual auditing procedures:

"In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that...he must now recognize fully his responsibility to public investors by including the activities of the management itself within the scope of his work and by reporting thereon to investors."

"The facts of this case suggest that for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such an inquiry should provide a valuable background for interpreting conditions revealed during the audit or, in extreme cases, might lead to a refusal of the engagement."

"Furthermore, an examination of this kind [for corporations whose securities are held by the public should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted."

Our experience in the eight years since the foregoing conclusions were published has served only to strengthen our belief in the necessity for the investigation mentioned and for acceptance of the idea that management itself must be regarded as within the scope of the audit. As a final consideration of this topic I might say that there is no necessary reason to debate the question as to whether a management of doubtful or suspicious character is entitled to the services of an auditor, as it is to the services of legal counsel. The only question is whether, in the light of full knowledge, appropriate alternative audit procedures are available. If they are not, there should be no hesitation in withdrawing from the engagement.

I have referred to some extent to tradition as a basis for accounting practices. Many traditional practices have, of course, stood the test of time and have proven by experience to be sound: for example, the cost convention as to carrying assets. But, as a member of the profession stated recently:

"Accounting is by no means static. It is unquestionably progressing in the acceptance of new techniques and concepts. Those who deal with public representations are recognizing more and more that honest and adequate financial reporting is indispensable to the creation of an informed public, which is a requisite to any eventual settlement of conflicting economic interests. Several important developments in recent years in the accounting for business income testify to this trend. Depreciation, once a charge contingent upon and variable with profits, is now treated as a uniform procedure of cost apportionment. The writing

up of property is in general, though not complete, disfavor. The use of capital to absorb losses has been outlawed...The misuse of general contingency reserves to distort reported business results has been proscribed...These changes which have evolved in the last 20 or 30 years are ready proof of the responsiveness of accounting to social forces. Each of these developments come as an acknowledgement that the previous practices were not wholly truthful or adequate in reports of stewardship."^{1/}

Certainly it is our desire that financial statements filed with the Commission keep step with the developments in accounting practice and reflect the replacement of practices which the profession as a whole has satisfied itself are outmoded.

It seems appropriate, while discussing the things we desire in financial statements, to indicate some of the things we do not favor with respect to such statements or their preparation, or their consideration by us. We dislike "trial balloons"--unorthodox or novel, or even improper, practices reflected in the statements, which may have a material effect thereon but which have not previously been brought to our attention. We certainly are not adverse to the development of new practices and procedures as they are proved to be desirable or necessary, but we, as well as registrants and their accountants, have usually found it helpful to discuss departures from recognized procedures in advance of filing.

We, of course, welcome conferences with registrants and their authorized spokesmen concerning financial statements either filed or to be filed. Occasionally such conferences have been attended by an officer or officers of the registrant accompanied only by an attorney, tax expert or economist. I have found that discussions of accounting principles and practices which are not participated in by the accountant who has certified or will certify the financial statements are usually inconclusive and unfruitful.

From time to time registrants and their accountants have conferred with our staff without sufficient preparation; either they have neglected to provide themselves with all the facts necessary to a decision or have not familiarized themselves with the applicable rules and regulations. This, of course, is to be deplored. I should like to emphasize the importance of a well prepared case as a time and money saver (particularly to the registrant, who more often than not has travelled a considerable distance and is under the additional expense of expert advisers), and suggest that a letter in advance of a conference outlining the principal points to be discussed will help to minimize the time, and consequently the expense, incident to such conference.

^{1/} "How New Standards of Financial Reporting Grow from Social Responsibility of Accountants," By Maurice H. Stans, C.P.A. Journal of Accountancy, August 1948.

And finally we cannot accept financial statements prepared in accordance with accounting principles for which there is no substantial authoritative support despite disclosures contained in the accountants' certificate or in footnotes to the statements. This policy is clearly stated in Accounting Series Release No. 4, which I referred to previously, but I mention it again because it is not uncommon for financial statements to be filed accompanied by an accountant's certificate which properly takes exception to a practice or principle reflected in the statements. And in such cases the registrant usually expresses surprise when he is advised that we consider the statements deficient.

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