

**ACCOUNTING IN RELATION TO REGULATION OF
SECURITY SALES**

ADDRESS

of

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I have welcomed the opportunity to meet with you tonight, but I have been concerned as to what I might say which would avoid the analysis and discussion of technical questions of accounting and yet be closely enough related to your work to furnish an excuse for my being here. What I am going to say was given a name, for the purposes of your program, before anything was put on paper. When I have finished, if the name seems poorly descriptive of what I say, I will feel sure that all of you have known other products which were inappropriately named.

It seemed to me that, unless I were to venture into a field whose landmarks were unfamiliar to me and in which I might easily become lost, I should not attempt any presentation of technical matters of accounting principles and techniques. There remained for me to try to put before you some suggestion of the general picture of the accountant in relation to the disclosures required by the Federal securities legislation. In trying to present that sketch, I have hoped to make the outlines clearer by referring, here and there, to the part which other professions have to perform. I may have gone a long way from the assigned subject. Whether I shall have helped to clarify the relation of the accountant to security sales regulation or shall only have suggested the unattainability of ends which seem so desirable, I must leave for you to form your own conclusion.

Almost four years have passed since the enactment of the Securities Exchange Act of 1934, creating the S. E. C. and transferring the administration of the Securities Act of 1933 from the Federal Trade Commission to the Securities and Exchange Commission. Both Acts, viewed as a framework of regulation, implicitly assume the validity of traditional economic premises of securities distribution and trading and the usefulness of the forms and mechanisms which had been developed to accommodate securities transactions. The legislation did not seek the fashioning of new instruments of investment procedure nor the alteration of basic concepts of the function of the investment banking process in our national economy. The markets, as before the legislation, remain open to the competition of the various seekers of capital funds. The process was to be invigorated and fortified by dissemination of information relating to the merchandise circulating in the markets. Administrative responsibility under the statutes is phrased in terms of protection of investors, and administrative authority, broadly speaking, is phrased in terms of disclosure.

Disregarding certain provisions of the Exchange Act prohibiting practices tending to create fictitious values for securities and granting the Commission relatively broad powers over trading in securities, the legislation aims to guide the investor in determining what securities to buy, hold, or sell, by making available material information essential to the formation of an intelligent judgment. This information is furnished in what is called a registration statement.

It is the job of the Commission to determine, within the framework of the legislation, the general types of facts about which information should be provided and to create a medium for communication

of the facts so that their significance and meaning are clear. It must search for the essential ingredients of disclosure and for the means of fitting the theory of disclosure to the needs of a nation of investors. That problem comprehends more than the mere drafting of documents; it embraces questions of structural organization, administrative procedures, and the discovery and employment of mechanisms to enable issuers of securities to supply, and the investors to digest, information.

It is inevitable that disclosure will be something less than complete; material factors which do not lend themselves to observation and articulation are not susceptible of communication. There is, however, a broad area of concrete tangibility within which facts may be ascertained and correlated into a pattern of relative materiality. Both Acts set forth in rather broad outline the character and extent of information required to be furnished by a company filing a registration statement. With the statutory schedules as the foundation, the Commission has adopted various forms to serve as a means to the registrant for furnishing information and a medium for the investor to digest the information. Aside from exhibits included in the registration statement, whose form and content are not shaped by legislative requirements, a registration statement consists of narrative information given in response to a series of questions or items, and financial statements, chiefly, a balance sheet and profit and loss statements, the greater part of which is summarized in the prospectus which circulates among investors. Roughly speaking, the significance and informative value of each part is heightened by the presence of the others.

I shall not attempt to estimate or appraise the effectiveness of the results which the Commission has so far obtained in its administration of this legislation. It may be worthwhile, however, to discuss somewhat the nature of the problems encountered by the Commission in its attempts to give vitality and significance to the statutory theory of disclosure. In doing this, it may be helpful to indicate the attitudes of the various professional groups most concerned with administration of the Acts, and the desires of those groups to have the Commission's practice and administrative procedure take a given form. In selecting these groups I do not mean to slight the importance of the issuer in the registration process. The professional groups appear in case after case and their general attitudes toward the statutes and their administration may be approximated. The attitude of the issuer, on the other hand, is difficult to synthesize since it varies from case to case, with the particular character of the problems confronting that individual issuer. The attitudes of professional groups, conditioned by traditional approaches and methods, are somewhat consistent and it is possible to generalize in their fields. As I propose to generalize about these things, unquestionably what I have to say will be subject to the criticisms of any generalization.

The three professional groups most prominent in the scheme of registration and disclosure are the accountants, the lawyers, and the engineers. Each of these three professions carries into its work with

the Commission the habits of thought peculiar to its group. The tools and skills of each are ideally suited to enlarging the significance and meaning of disclosure; traditional habits of thought and established relationship, however, sometimes tend to impair the effectiveness of professional techniques as a handmaid of disclosure.

Fundamental attitudes of the three groups toward the premises the Commission should adopt in formulating rules and regulations and drafting forms for the submission of information seem to me to take root in the ways of thought of the several professions. The lawyer wants certainty, precision and predictability in the forms and in the rules and regulations. He seeks the creation of a certain minimum procedure which, when followed, will place him in a position to assure his client that liability will not result. The accountant, on the other hand, prefers to supply financial statements in response to quite generalized flexible rules, the detail of the procedure to be followed and the form and shape of the financial statements submitted to be left largely in his discretion. One need only recognize that the principles of the science of accounting are in a state of flux and rapid development to be hesitant in wresting guardianship from the hands of the profession.

It would be unrealistic not to recognize the essential difference of the position of the two professions in the registration procedure and the character of the routine followed by each. Both professions respond to the performance of creative duties, if only out of a sense of professional workmanship. Recognizing that in the lawyer this urge is subordinated to the desire for certainty and predictability, one reason why the accountant does not feel this competing need to so great an extent is the smaller field of unpredictability which the accountant meets. When the accountant does his job he works primarily over a limited set of documents and ordinarily has no responsibility for facts occurring after the date of his certificate. His responsibility is for facts which may be developed in the course of a rather definite audit program or procedure. Further, the regular routine of an audit supplies some assurance that he will at least see all the facts which he may be expected to disclose. The lawyer, on the other hand, has no such minimum routine to follow in drafting a registration statement. He obtains whatever information the client is pleased to put at his disposal, plus whatever his own insight or capacity enables him to elicit. After the lawyer has completed a fair and conscientious job to the best of his ability, there may nevertheless be a failure of disclosure of which he is completely unaware. The accountant, however, who has done his job properly would at the end of his examination have made a reasonable verification of the material facts which lie within his field.

The engineer, accustomed as he is to occupy divers positions toward the subject matter of his work, is largely indifferent to the shape and form which registration requirements may take. One day the engineer represents a buyer; the next day, a seller; and as a day-to-day routine occupies the position of adviser to management. - No pervasive doctrine of independence of engineers comparable to that existing in the accounting field has grown up. The background of relationship affects the contribution of the engineer to the registration statement, but it does not lead him to urge the adoption of particular rules and regulations governing his work.

The Commission responds to the urge of lawyers to have the forms precise and definite insofar as their subject matter is susceptible of precision and definiteness. The intricate processes of finance make the job of creating a definite and self-contained form, consisting of items whose precise limits are ascertainable, a deeply perplexing and difficult task. Recognizing, however, that ambiguous and equivocal items would elicit a mass of superfluous information which in many instances would serve to confuse rather than clarify, the Commission itself seeks definiteness in the forms.

The engineer has so far presented a problem considerably simpler than that of the lawyer or accountant, involving principally the enforcement of well defined norms and standards settled and developed in the profession. Expert opinions, matters of subjective judgment, may vary, but in the large engineering techniques have become a matter of substantial agreement, and it is fortunate that it is these latter rather than the controversial aspects of the profession which fall under Commission scrutiny. We have yet to meet, among the articulate elements of the profession, any objection to the standards we formulated in stop orders several years ago and have since consistently applied, that the engineer must follow the norms of his profession in making his investigation, and use intelligible language in stating its results.

The Commission also responds to the accountant's desire that he be given no too rigid standard for it recognizes that the practitioner has the first hand experience with actual materials and problems of business. The environment itself operates as a stimulant to creation and development of accounting principle. The books and records of a living business suggest alternatives to the auditing accountant -- possibilities of whose very existence a reviewing administrative body may be unaware. And, if several years of administration of the legislation have taught us anything, it is that, in large portions of the field of accountancy, we cannot predict that tomorrow's case can be adequately handled by today's technique, for yesterday's technique has so often proved insufficient today. As administrators, we are loath to trust our judgment much beyond the particular case. We can advance or withhold criticism on the particular facts but we are hesitant of treating our decision as precedent or principle. In a field which has only recently become a province of law, any lawyer knows the folly of codification. Recognizing that the accountant has an opportunity far more extensive than our own to an end identical with our own, we dare not stifle him in the due performance of his service. Apart from specific applications, which I need not at this point discuss, we have expressed our attitude broadly in our instructions governing preparation of financial statements of seasoned business -- "The registrant may file financial statements and schedules in such form, order and using such generally accepted terminology as will best indicate their significance and character in the light of the instructions." This is further exemplified by the Commission's attitude towards the accountant's certificate. Many of you know of efforts which at various times have been made to have the accountant's certificate presented along the lines of a definite pattern down to the smallest detail of format. The Commission has adopted a general rule setting forth the requirements of the content of an auditor's certificate. The form of the certificate is left to the certifying accountant. However, the

detail required to be included in the certificate should adequately reveal the scope of the audit and the opinion of the accountant with respect to the financial statements and the accounting procedures and practices followed by the registrant.

While the Commission has been able consistently with its responsibilities to give recognition to the desires of professional groups, it has learned that professional relationships and attitudes frequently operate in practice to minimize the effectiveness of professional skills in contributing to the product of disclosure. In the abstract, the aims and desires of the professional groups are not inconsistent or incompatible with discharge of the Commission's basic responsibilities. In practice, the fundamental impulse which gives rise to the effort to cause the policy of the Commission to take a given form is replaced by the effort to use the resultant of that policy as a means, if not of defeating disclosure, at least to diminish its effectiveness. Environmental factors in the area of professional practice impinge upon and influence the subject matter upon which the expert works.

We have observed that the lawyer plays the dominant role in the preparation of registration statements. He acts as interpreter, collector of information, and judge of the applicability of rules. In practice, the lawyer brings to his work in connection with the disclosure process his traditional attitudes and ways of thought. The desire for certainty, precision and predictability reflects itself in the lawyer's method of presenting information in a registration statement. The impelling urge and attitude with which the lawyer approaches all his work, namely, protection of his client, impart a character and tone to its content which may or may not be productive of its fundamental aim but often serve to minimize the effectiveness of disclosure of the material elements in the subject matter he handles. Literality of adherence to rule and inflexibility of procedure characterize his work in the registration procedure. Those portions of the registration statement which flow directly from his hand reflect the techniques and methods commonly employed in his profession. Summaries of contracts designed to reveal contractual advantages or disadvantages of the issuer and summaries of underlying documents such as indentures and charters designed to reveal the positions of the classes of security holders frequently are simply extensive quotations from the documents themselves. The material called for by the items and instructions is literally furnished. It is questionable whether the average person is informed by such a procedure and doubtful whether rules or regulations can be devised to induce lawyers to prepare summaries of legal documents which actually would serve to inform the reader who is untrained in technical legal verbiage.

The work of the engineer is likewise affected by fixed relationships which have been established over a long period in the environment of his profession. With respect to those branches of the profession whose work embraces the observation, measurement and estimation of physical quantities, as is the case with mining engineers and oil geologists, the divers positions which those engineers may occupy toward the particular objective frequently have an effect upon the material submitted on their authority in a registration statement and prospectus, without the protective features which surround that same procedure in the environment in which it has grown up and developed. Those

engineers have been uniformly a part of the bargaining procedure in the purchase and sale of physical assets, and if the report of the engineer representing the seller has been fashioned by the influence of his attachment and loyalty to his client the resulting tendency to overstatement has been neutralized and opposed by an associate representing the buyer. However, when the engineer prepares a report under the aegis of the seller and there is no buyer's report, the picture of the physical assets will probably be one of excessive optimism. It is our experience that engineers have not given sufficient recognition to the absence in the disclosure process of the report emanating from the other bargaining party.

The engineer has uniformly been an adviser to the management in connection with the direction of operations. The equality of knowledge of the two parties is such that short cuts for communication of technical instructions and recommendations have developed and deviation from rigid application of engineering techniques has been engaged in, in recognition of the fact that no one concerned would be misled or deceived. While this is proper in the field of its origin it is not enough for an engineer to follow the same procedure in informing the public as to the character and nature of physical property. A report proceeding on the premise of rather complete knowledge on the part of the person to whom it is directed is not adequate for a wholly uninformed lay reader, as a basis for exercise of judgment. In one case, a report directed to the management and based upon recognized premises for such reports was used as a basis in the registration statement for a valuation placed upon a balance sheet and for a claim of known tonnage. In this case the engineer whose report was so used, condemned the use of it, and expressed the opinion that the claim to known tonnage and its use as a basis for a valuation figure in the balance sheet were unjustified.

The origin of accounting as a medium of informing the management concerning the progress and status of the business fixed a relationship whose influence over the development of accounting principles continues with marked vitality. When accounting, with the growth of large corporations, became not alone a means of guiding the management but likewise a means of informing widely scattered owners, no effective accompanying factors sprang up to assure freedom of the accountant of the management to account and report to his enlarged audience. Gradually the doctrine of independence evolved, designed to free the growth and development of accounting of managerial influences and give assurance to the security holders of the accuracy and reliability of the accountant's report. Several factors have come into existence and developed in the accounting environment to mitigate to a substantial degree adverse influences over accounting practices. The work of the New York Stock Exchange, the growth and strengthening of accounting societies, the creation of departments of accounting in our universities, the recognition of the value of accounting by courts, and, finally, the creation of various public agencies have all operated to some extent to free accounting and accountants of their fetters. It is true, however, that almost all the federal and state agencies are interested primarily in the administration of legislation, with accounting as a tool or guide, rather than interested in the subject matter of accounting itself. Despite encouraging developments, persistent qualities and factors of the active professional environment operate to

handicap both independent growth and development of accounting principle and wholly independent reporting. Servitudes, less tangible and influential than earlier servitudes, though no less real, still exist. And in our work we perceive the results of their influence.

We have had cases where the books and records of the company were maintained consistently and substantially in accordance with sound and recognized principles of accounting, and yet the management has requested and the accountant has adopted practices under which the certified statements prepared from these same records departed flagrantly from application of sound principle, even to the point where the statements did not truly reflect the facts shown in the basic records. In many cases, principles and procedures followed in preparation of the statements have been certified by the accountant even though they actually are, in his opinion, less satisfactory than other principles and procedures would have been. In other cases in which he can find no justification for the accounting practices of the registrant, he frequently states his exceptions in language that can only be confusing to a layman. The accountant who certifies should feel responsibility to state clearly and unequivocally his opinion of the results and the principles upon which the statements are based. The failure of the accountant to assume this responsibility is indicated by the fact that one of the most prolific sources of deficiencies in registration statements is the accountant's certificate. Ambiguous and non-informative expressions of opinion are relatively common.

The manifestations of environmental influences in the work of accountants before us establish definitely the necessity for action by the Commission in formulation of standards governing the preparation and presentation of financial statements. Though we are reluctant to take action which may work to stifle the free play of creative forces in the active area of the practice, we are even more reluctant to let those forces be suppressed and distorted. Influences adverse to the growth, recognition and wide adoption of sound principle have thrived principally because there has been no impartial authoritative agency to review accounting material prepared for presentation to the public. The pressure of competitive factors, in cases, overcomes devotion to principle. Stubbornness is not likely to be carried to the point of loss of a client. The Commission may serve as an authoritative tribunal to restore the balance. But if the accountant is to derive full advantage from the existence of an authoritative body upon which he may rely, the Commission must at times exercise its authority. The manner of exercise of our authority depends largely upon the quality of the accountant's output. We hope to avoid rigidity and inflexibility of rules. 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. The Commission on April 25, 1938, issued a release on this point in this language:

"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."

However, it seems to me that, by and large, the experts who have a hand in the preparation and draftsmanship of registration statements and prospectuses overlook their larger opportunities in the field of disclosure. This may be due to unwillingness or it may be that the role I am about to describe is not deemed by the experts to represent an opportunity, and it is probably true that they are not alone responsible. At all events, this is a field in which they are equipped to play a dominant and particularly useful part to the credit of their professions and one where expert techniques and methods would be particularly productive of significant and vital informative material. Any general form which the Commission adopts will turn out in practice to be inadequate in particular cases. Material factors will fall in the interstices. Beyond this, there is an area of material factors having influence upon the particular enterprise the ascertainment and understanding of which are beyond the capabilities of the average intelligent investor. For lack of a more apt description, these factors may generally be characterized as intangibles, although many of them are not intangibles but definitely existing facts in the totality of the enterprise which do not lend themselves to ready observation and precise measurement.

These intangibles are nevertheless the very factors which may influence most the ultimate investment value of a security. Were it not for their existence, the appraisal of security values could always be expressed with almost mathematical accuracy and without the need of intelligent judgment on the part of the investor.

The task of the expert, ideally performed, would be to so present the facts that the investor might determine the extent to which they have affected and therefore may affect his investment. Has a new

competitive product begun to encroach on one field of the corporation's sales? The profit and loss statements, if adequate for this purpose, will not disguise this fact under mounting sales in other fields. Is the value of a patent subject to diminution by technological developments as yet only in the laboratory stage? If the engineering appraisal or survey has not considered this question, it has fallen short of its full usefulness. The management, occupied with the day-to-day problems of running the business, may often be honestly unaware of the very existence of such factors. But the professional consultant, called upon to prepare specialized information for the use of the investor, has not served him if he has not pointed out the existence and known effect of the long range intangibles which may ultimately so substantially affect the investment.

The character and extent of any contribution of the expert in this field will depend in large part upon his attitude in approaching his work. If his attitude is colored by the feeling that a literal adherence to the techniques of his profession is sufficient, material factors which might otherwise have been disclosed and communicated will remain unknown to the lay reader, and form no part in his judgment of the enterprise.

I know of cases where the expert has ranged over all the factors which enter into the formation of a judgment but has stopped short of applying expert analysis to the facts presented or has expressed his opinion in such an ambiguous fashion that it is valueless to the lay reader. The expert may perceive from the presence of given factors that a factor not perceptible to the inexperienced eye is likewise present. It is not enough for the average investor to have pointed out to him those things which are observable and measurable. The expert should bring to bear upon the facts so presented his expert skills and procedures to expose the existence of other critical factors apparent only to him unless specifically identified and pointed out. I recall one registration statement which contained as an exhibit a report of a survey of the business of a particular issuer. The report undertook to express an opinion concerning the status of the business and the results which might accrue from the financing. It stated quite bluntly that the business was uneconomic and the program proposed to be executed by use of the money obtained for the financing would only serve to heighten the uneconomic position of the company within the industry. It developed that the registrant, at the time of filing the registration statement, was unaware of the contents of the report and, upon being apprised of its nature, sought to withdraw the report and substitute the report of a second industrial engineer. The Commission denied withdrawal of the report but made no objection to the filing of the second report. The second report was not subject to attack on the ground that it misstated or overstated any of the factors of the enterprise. The only criticism that could be made was that the second report was not informative. It added nothing whatsoever to the information already included in the registration statement.

I also recall a registration statement filed by a public utility company. An important question in evaluating the securities to be offered was the adequacy of the water supply for generation of hydroelectric current. The only expert opinion relative to water supply was an opinion of counsel concerning the nature of the title to the water

rights held by the registrant. The statement as originally filed set forth, interspersed throughout, the aggregate of factors from which an expert might be skeptical as to the adequacy of the water supply. Factors essential to a determination were omitted and others were stated ambiguously. Certain of the ratios indicated to the examining group that the water supply might not be sufficient for the needs of the plant. A deficiency was cited, aimed directly at this question, resulting in an amendment which set forth in clear and unambiguous terms the various conditions, physical and contractual, which might operate at particular seasons to render the supply inadequate.

In another report by an engineer which came to our attention, the opinion was expressed that the high profits which the issuer was then enjoying would invite competition from others as soon as the extensiveness of the profits became known. Consequently, he cautioned against the expectation of profits in that volume and predicted a diminution of profits and a period of quite severe competition within the industry.

I do not want you to think that the absence of a statement by an expert bearing upon the venture necessarily creates a gap in the information necessary to the exercise of judgment. In many cases the management has knowledge which it supplies. In many cases, the observable and measurable facts of the business which are set forth in the registration statement and prospectus serve alone to point the proper conclusion as to the merit of a given security. Frequently, the examination process results in amendments which operate to a substantial extent to supply, if not information on the point, at least a specific statement of the nature of the hazard involved.

Nor do I neglect the fact that the standing of the expert in relation to the registration process, and the conditions under which he obtains his work frequently make it impracticable for him to get to investors the full benefit of his expert knowledge. I am speaking of the gaps which have to be filled and which I hope can be filled, in some measure, by the efforts of the Commission and by the growth of the professional standing of the experts. Time will be needed for even the imperfect fulfillment of the investor's needs. There will be required also a recognition of the expert's responsibility, not to his client alone, but to all those to whom his client goes for funds.

I hope that what I have said makes somewhat clear the general outlines of the process of disclosure. Evidence is not lacking of the conflicting claims on the professional groups of their client and of the public to whose respect they owe their status. In particular cases the interest of client and public may seem to be in conflict: In considering the seekers of capital as a whole there is little doubt that they as a group would benefit by clear statement, though a contrary course might seem of present advantage.

My comments about the professions may have suggested to some of you a feeling of unfriendliness toward them. Such is not the case -- quite the reverse. I have been considering some differences of viewpoint in meeting the difficulties besetting the way toward a goal common to us both. It would be ungrateful not to speak of the real help these

professional groups have given us to surmount so many difficulties in the last five years. Accountants have given wholehearted assistance to the Commission in designing requirements that would operate to inform investors with a minimum of burden to industry. Lawyers have given unceasingly and unselfishly of their time, both in suggesting the form for rules and regulations to take and in reviewing the product of our own staff. Professional societies have been equally ready to do their part in fitting the new legislation to the needs of investors. The contributions of mining engineers, which resulted in many of the best features of the form for new mining ventures, is a case in point.

Modern business is technical and complicated. It uses the labors of unnumbered scientists and the accumulated invention and experience of our race. It operates on a scale undreamed of in any other age, with factories, warehouses and stores spread over a continent. It seeks money, and within the four corners of a prospectus this enterprise must be described to people unacquainted with its technique and inexpert in the language of accounts. To make that description adequate and understandable is our common task.