

ACCOUNTING - CHANGING PATTERNS

The Impact of Regulatory Agencies

Address of

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The Impact of Regulatory Agencies ^{1/}

The impact of the requirements of regulatory agencies upon the development of accounting and auditing, whether for good or evil, has been the subject of discussion by experienced practitioners, present and past members and employees of such agencies, teachers and students. There is extensive literature on the subject, so much that it seems unnecessary to review it in any detail. However, one such discussion may be cited which covers the subject more broadly than seems necessary today. A past Chief Accountant of the SEC participated in "A Symposium on the Interrelationship of Law and Accounting" which is reported in 36 Iowa Law Review 270 (1951) and in expanded form may be found elsewhere under the title "The Influence of Administrative Agencies in Accounting." ^{2/}

I shall confine my remarks to a discussion of some of the major changes in accounting practice necessary to good financial reporting in a dynamic and expanding economy during a period in which there has been a continual increase in public participation in financing such expansion.

The Securities Acts

The SEC is relatively a newcomer as a regulatory agency when compared with the Interstate Commerce Commission, but the laws which it administers created some consternation in accounting circles when they were proposed in Congress. This was caused in part by the civil liability provisions of the Securities Act and in part by the prospect that the Securities Exchange Act would impose uniform accounting requirements on all industry similar to the uniform systems of accounts applicable to railroads.

The only practicing public accountant to testify during the legislative hearings on the Securities Act of 1933 urged that the required financial statements be certified by independent public accountants. Another leading accountant in a memorandum regarding this legislation said:

"In so far as accounting information is concerned, it seems to me fundamentally important to recognize that the accounts of a modern business are not entirely statements of fact, but are, to a large extent, expressions of opinion based partly on accounting conventions, partly on assumptions, explicit or

^{1/} 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.

^{2/} William W. Werntz, Chapter 4, Handbook of Modern Accounting Theory, edited by Morton Backer, New York; Prentice-Hall, 1955.

implicit, and partly on judgment. As an English judge said many years ago when business was far less complex than it is today, 'The ascertainment of profit is in every case necessarily a matter of estimate and opinion.'" 3/

This quotation expresses a point of view necessary to an understanding of financial statements, yet it is difficult to explain to laymen and to some accountants. This difficulty may be an indication that the profession may have over-stressed the importance of accounting principles and failed to emphasize independent objective judgments. The same accountant, in an address on December 6, 1933, before the Illinois Society of Certified Public Accountants here in Chicago, 4/ expressed the view that "there is reason to fear that responsible people will refuse to accept the unfair liability imposed on them by Congress under the Act, and will continue to refuse until juster provisions are enacted." He also said that he would "be extremely sorry if the effect of the Securities Act should be to place the distribution of securities and all the work attendant on such distribution in the least responsible hands." By some time in 1934, after some experience with the Commission and its staff, 5/ these fears seem to have been dispelled, at least to a considerable extent.

Mr. May was an important witness in the hearings on the Securities Exchange Act of 1934. In these hearings his objections to a uniform system of accounting were developed after his opening remark that "The fact of the matter is that accounting, especially industrial accounting, is essentially a matter of judgment, and you cannot put judgment in strait-jackets." 6/ His testimony questions critically the results to be obtained by such regulation as getting "a superficial uniformity which is not real." Elsewhere, Mr. May expressed the hope and expectation that the SEC would "not be led astray by the deceptive promise of uniform accounting, * * *," and would "no doubt use all its great influence to bring about by voluntary action as great a degree of uniformity in different industries as is obtainable, and will insist on consistency from year to year in the accounting of each corporation subject to its regulation." 7/ Whether these opinions were influential at the time or not in convincing the Congress that more could be accomplished by cooperative action than by rigid control, the Securities Acts as enacted were expressed in terms of general authority over accounting and have been implemented by regulations specifying the form and content of financial statements but not in terms of a uniform system of accounts. However,

3/ George O. May, Twenty-five Years of Accounting Responsibility, Vol. 2, p. 52, New York, American Institute Publishing Co., Inc., 1936.

4/ Ibid., pp. 70, 84. .

5/ Ibid., p. 113.

6/ Ibid., p. 97.

7/ Ibid., p. 116.

under the Securities Exchange Act the Commission did adopt bookkeeping requirements for brokers and dealers in securities and does make inspections to insure compliance. The Public Utility Holding Company Act of 1935 authorizes, and the Commission has adopted, uniform systems of accounts for holding companies and mutual service companies; and the Investment Company Act of 1940 in Section 31(c) gives the authority for "providing for a reasonable degree of uniformity in the accounting policies and principles to be followed by registered investment companies in maintaining their accounting records and in preparing financial statements * * *." Rules adopted and presently in effect as to accounting records are expressed in general terms, and the financial statements are governed more specifically by pertinent parts of the Commission's accounting regulations.

Certification Requirements

The SEC, or rather its predecessor, the FTC, for a short time, appears to be the first Federal agency with authority to require certification of financial statements by independent accountants. We should remember, however, that the Federal Reserve Board in 1917 requested the American Institute of Accountants to prepare the bulletin "Approved Methods for the Preparation of Balance Sheet Statements."

As time goes on, we find an increasing number of governmental agencies requiring certified financial statements. The Small Business Administration has recently announced that under its regulations the financial statements of small business investment companies must be audited and certified by certified public accountants. 8/ The Rural Electrification Administration, which has utilized its own staff for audits required under the Act administered by it, recently announced that an increasing number of borrowers are being requested by the agency to provide for annual audits of their accounts by C.P.A.'s. 9/ Financial reports submitted to the Secretary of Labor for pension funds "must be 'sworn' to by the administrator, or certified by an independent or licensed public accountant." 10/

Bills introduced both in the House and in the Senate pertaining to the "Labor Management Reporting and Disclosure Act of 1959" provided for certification of annual reports by unions; and, although the Act, as finally passed, omitted such an explicit provision, it does give the Secretary of Labor broad authority to require annual financial reports

8/ 13 CFR 107.302-3.

9/ REA Bulletin No. 465-1, "Audits of Telephone Borrowers' Accounting Records," dated October 31, 1958, Sec. 2.

10/ "Welfare and Pension Plans Disclosure Act," Sec. 306(b), Public Law No. 836, 85th Congress.

and to establish safeguards to insure their accuracy. 11/ The Housing and Home Finance Agency requires independent audits in certain phases of its work. 12/ Both staff members of governmental agencies and representatives of the accounting profession have urged Congressional committees to adopt the requirement of certified financial statements for other agencies.

As might be expected, the older governmental agencies such as the FPC, FCC, ICC and the state commissions which exercise accounting regulatory powers over companies through a uniform system of accounts have usually not required independent audits.

Management Services

It seems to me, however, that even in the area where accounting procedures are regulated by an agency, the independent audit would provide an objective check on management. In connection with independence and an objective report on management, I would like to inject a word on management services. This is a very popular term today with the small practitioner as well as the national firm. I suggest that the independent accountant in furnishing such services to management keep two questions in mind: first, am I remaining an adviser to management and not entering the decision-making area? second, am I sure that the audit of the financial statements will not involve checking my own work? If both questions cannot be answered in the affirmative, the accountant's independence as to furnishing an objective report on management is in question.

It has been suggested that the rendering of management services sets up a conflict of interests which would render the accountant not independent. Much of the present day emphasis on this subject seems to me to be no more than a renewal of interest possibly engendered by the startling improvements in equipment available to business for handling the accounting and statistical problems created by the growing complexities of business operations. Systems work, cost analysis, budgetary controls and other aspects of business management have long been the province of the public accountant. It could be possible for an accountant to become so deeply involved in performing managerial services for a client that he would lose his objective approach to his audit engagement. In such a case he should concentrate on one activity or the other and not attempt to do both.

In my conversations with accountants and officers of their clients I have been impressed with the number of situations in which the records

11/ Labor Management Reporting and Disclosure Act of 1959 (September 14, 1959), Public Law 86-257, 86th Congress, S. 1555.

12/ News Report, Journal of Accountancy, November 1958, p. 16.

have been inadequate, nonexistent for some periods, not up to date, and, particularly with respect to inventories, provide no book control over the assets of the companies. In these situations improvement in accounting control is important to investors as well as to management. The need for managerial services in these situations is obvious. The adoption of procedures which would result in better and more timely reporting to management might well be considered a prerequisite to an invitation to the public to entrust its funds to the venture. The need for such services is not limited to unregulated companies. Timely reports for management purposes are just as necessary in regulated companies and may be obtained while at the same time the needs of the regulatory agency are met.

Consideration of the public interest is the basis for our bookkeeping rules for securities brokers and dealers and also is behind our recent amendment of these rules to require that a trial balance be taken at least once a month. Procrastination by broker-dealers is dangerous as the Commission may suspend or revoke a broker-dealer's registration because of his failure to maintain proper records on a current basis or for failure to meet his capital requirements under the rules. A recent incident demonstrates the necessity for public accountants to be familiar with these rules. A broker who was found by our inspectors to be in violation of our net capital rule defended himself by alleging that his independent accountants had assured him that he was in compliance. The accountant had not made the determination in accordance with the rule. In this type of situation the accountant's work should be a protection to the broker as well as to the customer.

It may be noted here that the audit of a broker-dealer is most effective if made on a surprise basis. Our reporting rules recognize this need by not requiring a fixed reporting date or audits as of the close of the fiscal year. These reports often disclose matters which are followed up by our inspectors. Similar flexibility is provided under the Investment Company Act for certificates on security counts which, in the absence of a satisfactory custodian arrangement, must be made three times during the year, two of which are on a surprise basis with results reported directly to the Commission. I understand that other federal agencies require the independent accountant to render reports which can be used by the agencies in the enforcement of their regulations. More of this type of reporting is being considered.

Most of the work of independent accountants under the Securities Acts involves the rendering of an opinion on the financial statements after completion of an audit made in accordance with generally accepted auditing standards. In the staff review of these statements questions may be raised as to the propriety of the accounting followed or as to the adequacy of the audit. The answers to these questions must be those of an independent accountant rather than as an advocate for the client. Any other course invites trouble for both client and accountant.

Uniformity versus Comparability

The demand for uniformity in financial reporting in unregulated as well as regulated businesses is not new. Many remember the burst of activity in trade associations in the 1920's in developing uniform systems of accounts for industries for the purpose of gathering statistics for the members of the association. Some well-known schools of business participated in this activity and today some accounting firms who have a large number of clients in one line of business publish composite as well as individual operating results with identifications removed. The users of these figures must be familiar with the many variations in operating environment and management policies which could affect the results reported upon a uniform account classification. Except as indicated earlier the SEC has not gone this route but has endeavored to promote the clarification and general acceptance of accounting principles by decisions in individual cases and in cooperation with the accounting profession and other interested groups.

This seems to be an appropriate time and place for me to acknowledge the value to the Commission of the work of the Accounting Procedure Committee of the American Institute of Certified Public Accountants which gave way to the new Accounting Principles Board at the end of August. For the most part the bulletins of the Committee expressed opinions acceptable to the Commission. On rare occasions exceptions were taken either by letter or in rule making. One of the last acts of the Committee was a clarification (delayed by court action) of Bulletin 44 (Revised). This was necessary in order to fill a gap in the original pronouncement. One of the criticisms of the procedure bulletins has been that the intent is not clear on all points. Similar charges are made with respect to laws and regulations. This results in the development of a body of interpretations by administrators and the courts. A lawyer with much experience in high government office recently wrote that "one can always get an agreed paper by increasing the vagueness and generality of its statements." All of us, I am sure, wish the new Board success in its undertaking to develop clear thinking on the basic postulates underlying accounting principles and in the study of the broad principles of accounting.

The prospect of attaining complete unanimity of thought on accounting seems remote no matter how diligently we try. Notable efforts have been made with respect to principles generally applicable to the determination of income. However, even if we should agree that the matching of costs and revenues is the most important of these (and some would deny it), we are certain to disagree on the details of application. But I do say we should work toward reducing these areas of disagreement.

What should we do about inventories? Verification, or perhaps I should say failure to verify, and pricing of this item has been the most

important element in many of our troublesome cases in which financial statements were a factor. The propriety of LIFO as a basis of pricing has been debated for many years--praised by some and denounced by others as a device of the manipulator. Even the effort to get agreement that appropriate disclosure of the effect of this method as compared to others in which more current costs were used was counteracted by allegations that tax cases would be jeopardized or that such a disclosure would be misleading. Recently we have seen a complete about-face on the disclosure question in the desire to use LIFO for the determination of income but FIFO for the balance sheet.

As to depreciation, what possibility is there that uniformity can be attained on depreciation and maintenance accounting even on an industry basis. This is a hard question to answer, but in the meantime improvement in reporting the policies followed will help analysts to reach more reasonable conclusions.

It has been charged that accountants should not tolerate alternate procedures and certify that both are in accordance with generally accepted accounting principles. The Commission recognized in Accounting Series Release No. 4 that this condition exists but at the same time concluded that financial statements which "are prepared in accordance with accounting principles for which there is no substantial authoritative support, * * * 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."

Stock Options

Let me give you an example of the effort that was made on one subject which should be amenable to a generally acceptable solution. On the matter of stock options there has been a difference of opinion as to the accounting to be followed and also as to the degree of disclosure necessary in financial statements.

The Commission's present rule on the subject was adopted as an amendment to Regulation S-X in November 1953 ^{13/} after a double exposure of the problem for public comment. Suggestions have been heard recently that disclosure requirements on this subject should be reconciled--the principal point being that our rule requires more detail than is required by Section B of Chapter 13 of Research Bulletin 43 or by the New York Stock Exchange. The Exchange requires disclosure in annual reports to stockholders of the status of options at the beginning and end of the year as to number of shares and price and changes during the year. The Institute bulletin recommends disclosure of the status at the end of the year, including

^{13/} Accounting Series Release No. 76.

number of shares and price as well as the number becoming exercisable and the number exercised during the year. The Exchange does not express any preference as to accounting procedure. The Institute's current bulletin, as you know, fixes the time of measurement of compensation as the date of grant, whereas before revision the date the option right became vested in the grantee (usually the date when he could first exercise the option) was deemed to be the date when compensation should be measured. I think it is fair to say that the startling results obtained by the application of the earlier version, with which the Commission agreed at the time, to the financial statements in a registration statement led to the revision of the Bulletin.

To the original Bulletin 37 published in November 1948 there were one asset with a qualification and two dissents. Upon revision in 1953 there were two assents with qualifications, and one member of the Committee did not vote.

Our first exposure of the subject under rule making procedures was due to the evident disagreement among corporate and public accountants as to the appropriate manner in which the amounts, if any, to be charged against income representing compensation to recipients of stock options should be determined. The principal point of disagreement was over the time at which the determination should be made. Arguments in support of the date of grant, first exercisable, and when exercised were so inconclusive that the Commission decided that it would be inappropriate to prescribe a procedure for determining the amount of compensation, if any, of these stock options to be reflected in earnings statements. Instead, the SEC proposed the present rule calling for significant data as to the plan, number, option price, fair value, and total dollar amount of shares at the several dates and a statement as to the basis of the accounting to be followed. Appropriate summaries of this information are suggested.

The example which precipitated this revision was a five-year plan with one-fifth of the granted options becoming exercisable each year. The stock was of \$1 par value optioned at \$5.00 per share at a time when the market was lower than the option price. As time passed and the company prospered, the market price rose to a high of 33½ during the period covered by the income statements in the prospectus. After some discussion it was agreed that the principles of the bulletin applied but some special treatment was necessary. The "special item" treatment provided for in Regulation S-X was adopted with the result that for the last two periods reported net income of \$365,000 for a year and \$305,000 for nine months was reduced by \$107,000 and \$174,000, respectively-- amounts equivalent to the excess of fair market value over the option price of shares under the employees' stock options. The differences of \$258,000 and \$131,000 were captioned Net Income Less Special Item Credited to Earned Surplus.

The summary of earnings included per share figures based on Net Income with reference to a footnote in which the stock option accounting was described. So the bulletin was revised and our rule calls for more comprehensive disclosure than other rules on the subject.

Long-Term Leases

The accounting presentation of long-term leases in financial statements continues to be a controversial topic. Some accountants and business leaders contend that we should include in the balance sheet the capitalized debt under long-term leases to make it comparable with the balance sheets of those companies using long-term debt to finance the acquisition of similar facilities. A study in 1948 by the staff of the Commission on this subject led to a proposed Accounting Series release. After a discussion with representatives of the Institute, it was decided that an Accounting Research Bulletin would be issued, and Bulletin No. 38 (now Chapter 14, Accounting Research Bulletin No. 43) on "Disclosure of Long-Term Leases in Financial Statements of Lessees" was released by the Committee on Accounting Procedure in October 1949.

Prior to the issuance of Bulletin No. 38 we had been requiring certain information on long-term lease rentals in Schedule 16 dealing with supplementary profit and loss information. 14/ In the 15th Annual Report to Congress 15/ we stated the policy being followed as to when leased property and any related liability should be shown in the balance sheet. Three types of long-term leases, depending upon the terms of the contract, were outlined:

- (1) Simple lease arrangements containing no provision for acquisition by the tenant of title to the property.
- (2) A lease which involves the purchase or repurchase of the property by the lessee, and provides that the periodic payments made under the agreement will be applied against the purchase price of the property.
- (3) A contract incorporating an agreement which permits but does not obligate the lessee to acquire title to the property either during the life of the lease or upon its termination.

14/ Instruction 5 to Rule 12-16 of Regulation S-X required prior to 1950 a statement of the aggregate annual amount, if significant, of the rentals upon all real property now leased to the registrant and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases.

15/ 15th Annual Report, Securities and Exchange Commission (1949), pp. 181-182.

Supplemental information in a balance sheet footnote concerning lease obligations assumed and annual rentals is now considered adequate disclosure for simple long-term lease arrangements. Those leases which are clearly purchase or repurchase contracts should be shown at their full contract cost, less appropriate allowance for depreciation, on the asset side of the lessee's balance sheet, with the liability under the purchase contract reflected under an appropriate caption on the liability side. This treatment is in accord with the recommendation in Chapter 14 of Accounting Research Bulletin No. 43. One has to go beyond the form of those contracts in which acquisition of title is permissive and determine whether, in substance, the lessee actually intends to acquire the property. Some factors to be considered in making a decision are: 16/

- "1. Whether the rentals are to be applied against the purchase price, and if so, whether they are out of line with rentals under leases not containing acquisition provisions;
2. The estimated value of the property at the time the purchase option becomes exercisable as compared with the agreed purchase price, if any;
3. Whether the contract provides for an extension of the lease period, and the amount of the rentals to be paid during the extended period."

In some of the articles I have seen on long-term leases the writers have prescribed the balance sheet capitalization of all long-term leases, regardless of the terms of the contract. While there may be some merit in capitalizing all long-term lease commitments, there are also certain grave dangers, and thorough consideration should be given to all factors before departure from present day accounting principles and practices. One has only to recall some of the mining cases of the 1930's to realize that recording leased assets may be used to inflate the balance sheet. 17/ These cases will also indicate that there is more to be considered than the mere reflection in the balance sheet of a liability for future expense payments even though it is an item which most likely will be paid. A recent article by a representative of an investment banking concern, however, has indicated that an influential group, institutional investors, does consider the impact of long-term lease capital by including it in a recast statement. Perhaps we should give attention to requiring disclosure of any additional data necessary for a more accurate recasting.

16/ Op. cit., pp. 181-182.

17/ American Terminals & Transit Co., 1 SEC 701.
Canusa Gold Mines, 2 SEC 548.
Franco Mining Co., 1 SEC 285.
Great Dike Gold Mines, 1 SEC 621.
Poulin Mining Co., 8 SEC 116.

Conflict of Jurisdiction

The Securities and Investment Company Acts are designed primarily for the protection of investors. The Holding Company Act charges the Commission with the protection of investors and consumers. Other federal and state regulatory agencies have a primary interest in consumers and then an interest in investors as a source of financing. It is inevitable, perhaps, that some commissions would adopt conflicting orders and regulations relating to accounting matters. Even the Uniform Systems of Accounts approved by the National Association of Railroad and Utilities Commissioners are not uniformly adopted by the respective state regulatory agencies. Specific changes in some of the accounts or in their application will be made by a state agency to conform with its regulatory philosophy.

An example of how regulatory agencies may differ on accounting matters as they affect the consumer or the investor groups is in the treatment of "plant acquisition adjustments" in rate cases. Plant acquisition adjustments represent the difference between the cost to the accounting company of property acquired as an operating unit and the cost of such property when first devoted to public service. The several federal regulatory commissions and a number of state commissions exclude "plant acquisition adjustments" from the rate-base and exclude the periodic charges for amortization of such amounts from the "cost of service." Such commissions are said to use the "original cost" concept in determining the rate-base. Other commissions may include the cost of the property to the company in the rate-base and include the periodic charges for amortization of such cost in the "cost of service." Such commissions usually are operating under the "fair value" concept of the rate-base. A few state commissions in arriving at the "fair value" rate-base give consideration to the estimated "reproduction-cost-new" valuation of the plant assets.

Regulatory agencies have required the classification of excess costs to the acquiring utility over original cost as well as any excesses of original cost over acquisition cost to be recorded in the same account, and the net balance of this account to be added to or deducted from the plant account depending on whether a net debit or credit balance results. A common procedure in consolidated statements of unregulated companies has been to report debit excesses as consolidated goodwill and credit excesses have often been added to capital surplus.

Of outstanding contrast is the general policy of the regulatory agencies to require periodic amortization of the Acquisition Adjustment Account or the immediate write-off to earned surplus. In unregulated companies no amortization program for intangibles of unlimited life is required by Accounting Research Bulletin No. 43, although the bulletin does state that the intangibles "should be written off when it becomes reasonably evident that they have become worthless." Even when goodwill is thus written off, according to the bulletin, the charge does not need

to be made against income where "its effect on income may give rise to misleading inferences." However, in reports filed with the Commission these charges have been deducted from income (as special items if material in amount). Seldom is any action taken to write off credit excesses.

That the policy of reporting the excess of underlying equity in net assets of subsidiaries over the cost of the parent's investment therein as consolidated capital surplus is fairly common is evident from reviewing recent issues of Accounting Trends and Techniques and cases in our files. Accounting Research Bulletin No. 51, recently promulgated by the Committee on Accounting Procedure, does not condone this practice. Paragraph 8 provides:

"Where the cost to the parent is less than its equity in the net assets of the purchased subsidiary, as shown by the books of the subsidiary at the date of acquisition, the amount at which such net assets are carried in the consolidated statements should not exceed the parent's costs. * * * A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable."

The bulletin further provides for allocation of the excess of equity in net assets over investment cost to the specific assets to which it is attributable with corresponding adjustments of depreciation or amortization. In addition "in unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis."

The amortization requirement for consolidated goodwill is not so definite. Paragraph 7 of Accounting Research Bulletin No. 51 does indicate that portions of the excess cost of investment over equity in the net assets of a purchased subsidiary attributable to tangible assets and specific intangible assets should be allocated to them. This paragraph also states that depreciation and amortization policies should be restated to provide for the absorption of the allocated excess over the remaining life of the related assets. Any difference remaining is carried as an intangible in the consolidated statement and the only provision for eliminating such item is found in Chapter 5 of Accounting Research Bulletin No. 43. It seems that any intangible that remains from consolidation may represent a payment for excess earning power and should be amortized against future earnings resulting from the operations of the subsidiary. Does the publication of Accounting Research Bulletin No. 51 suggest a reexamination of currently accepted practice with respect to good will? Accounting Series Release No. 50 expresses a preference for writing off good will through timely charges to income.

Progress in Financial Reporting

Breaking the life of a corporation down into periodic intervals of one year or less will probably continue to be an underlying cause of many of the basic problems of accountants. We are all aware that income can be measured fairly accurately for the whole life of a joint venture or other enterprise; but as we attempt to shorten the period for reporting operations the more difficult our task becomes and it is attended by a widening of the limits of fair reporting.

At one time the Securities and Exchange Commission required quarterly reports of revenues and sales. In October 1952 the Commission proposed revised rules calling for detailed quarterly statements of profit and loss and earned surplus. These rules were not adopted as they met strong opposition from accountants and registrants. About a year later the requirement of quarterly reports of sales and revenues was dropped.

The Commission believed, however, that some interim information was desirable and in addition believed that there was a great demand for frequent reporting of business operations from other governmental agencies, business research units, financial analysts and bankers, universities and other parties interested in business conditions. At the behest of financial analysts and others, we started preparation in 1954 to request comments and suggestions from interested parties relative to reviving our interim reporting on a semi-annual basis. Unfavorable comments received covered a wide variety of subjects including the misleading effect that might be inferred because of seasonal variations, year-end adjustments due to difficulty in allocating revenues and expenses to short periods, need for taking additional physical inventories, the fear of liability of company management in submitting unaudited reports, the unfairness to listed companies as opposed to non-listed ones, and the increased cost both to registrants and the government.

After a public hearing in March 1955 the Commission required the filing of certain summarized earnings data on a six-months basis. The hardships accompanying the determination of such data were noted, particularly the need for relying on reasonable estimates, and in recognition thereof the Commission exempted such reports from the liability for misleading statements under Section 18 of the Securities Exchange Act.

This mid-year report is essentially a disclosure of sales and revenues, extraordinary items, income taxes, and net income or loss. As far as I can tell, this has been a satisfactory compromise between the groups who did not favor any interim reporting and those who urged that quarterly profit and loss statements be filed. With the great diversification in operations which has developed, it may be that some breakdown of sales beyond the present requirement of separation of service revenue of over 10% of the total should be required. In Form S-1 we do require disclosure of sales by product lines which contribute 15% or more of the gross value of business done.

It is interesting in this connection to note that reporting sales of major product lines has recently been advocated in a suggested revision of the Company Laws of Ghana. 18/ Another unusual item in the Proposed New Law of Ghana is the reporting of liabilities at the amount repayable "less where appropriate, a reasonable deduction for discount until that date." 19/ The proposed law, while noting in some places that recognition had been given to SEC requirements, provides for upward restatement of assets by action of the board of directors and in this respect varies drastically from our practice of not permitting such upward restatements. However, the Ghana Law requires the disclosure of original cost. The provision with respect to upward restatements is not clear as to whether depreciation need be taken on the higher amount although dividends may not be paid from the appreciation surplus. 20/ Such surplus may be transferred to stated capital.

I mention this Ghana report as evidence of the improvement in financial reporting in foreign countries. While the offering of foreign securities in the United States is limited, there is evidence of a growing interest in our financial markets and in our requirements as to accounting and auditing. The arrangement of affiliations with foreign accounting firms by American accounting firms is further evidence of the movement of American capital abroad.

The appearance of Mr. J. Kraayenhof of the Netherlands, former President, 7th International Accounting Congress Committee, and Past President, Netherlands Institute of Accountants, on the program of the recent annual meeting of the American Institute is further evidence of our interest in accounting developments abroad. Mr. Kraayenhof made a strong plea for "the widest acceptance of a uniform set of intelligible rules," but at the same time warned that rigidity in the fixing of accounting principles would not result in real comparability but "would only lead to the risk of the shadow being accepted for the substance." In support of his endorsement of international uniformity in accounting principles he asked "What good reasons can be upheld, other things being equal, for adopting different principles in various countries as to the valuation of stocks, as to methods of depreciation, as to whether or not reserves are concealed in the accounts or whether provisions are to be made for deferred taxes?"

18/ Proposed New Company Laws of Ghana Committee for Revision, General Comment No. 8 on Financial Statements, p. 337.

19/ Op. Cit., p. 330.

20/ Op. Cit., p. 79.

Mr. J. S. Seidman, newly elected President of the American Institute of Certified Public Accountants, announced in a press conference on the day of his election that he would press for action on three major challenges, one of which was standardization of international accounting principles. I can assure you that the SEC is directly concerned with the success of this project and will participate in any appropriate way in assisting the accounting profession in this country to meet this challenge.

Progress in Accounting

I have cited examples of efforts made by the accounting profession and the SEC to keep pace with the business world in the application of accounting principles to new conditions. A basic requirement throughout has been to reach a fair presentation of financial condition and results of operations. Some critics contend that the response to a need for change is not quick enough. Others insist that new ideas must be observed and tested by experience before being recognized as generally accepted and applicable to all similar situations. During the period of observation, alternative solutions to accounting and disclosure problems develop and when it is proposed to designate one method as having met the test for general acceptability resistance to change is based upon the grounds that a decision should have been made before permitting the alternative methods to become established. What may be considered progress by some is deemed by others to be interference with vested rights. The former group sometimes point to government agencies such as the SEC with the charge that we discourage needed changes in accounting procedure by a too rigid insistence on conformity with our rules and regulations, the Accounting Research Bulletins or other formalized accounting standards.

Progress in the field of accounting is facilitated by representatives of various professional groups meeting and exchanging ideas in conferences, through correspondence and through professional publications. The SEC finds it particularly necessary to keep informed of the changes and new developments in the field of accounting theory and auditing. As changes and new developments occur in the business world, the financial statements of the several thousand commercial and industrial companies required to file statements with the Commission are modified to keep pace with a dynamic economy. A glance at some of the statements filed in the 1930's will reveal many striking contrasts when compared with those being filed today.

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