

NEW YORK STOCK EXCHANGE  
COMMITTEE ON STOCK LIST

October 24, 1933.

*To the  
Governing Committee,  
New York Stock Exchange.*

Gentlemen:

On January 31, 1933, the President of the Stock Exchange addressed a general inquiry to all listed corporations, designed to secure information regarding the scope of audits and the responsibilities assumed by auditors which would put the Exchange in a better position to judge the value of audits to investors. In this letter, the request was made that companies whose accounts were audited should secure from their auditors and furnish to the Exchange, for its use and not for publication, answers to six questions. Of these questions, three dealt with the scope of the audit and three with the principles governing the accounting methods of the corporation and the form of presentation of accounts to shareholders.

The response to this request has been satisfactory, replies having been received from a large majority of the companies employing independent auditors regularly. A careful study of the replies received has brought to the attention of the Committee a number of points affecting particular companies which it has been deemed desirable to take up with those companies. In a few cases, the questions involved have been of very substantial importance, but the majority have been of relatively minor significance.

The replies have indicated very general acceptance of certain principles which the Exchange regarded as of primary importance and set forth in a statement attached to the letter of request, as follows:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as the packing house industry) in which, owing to the impossibility of determining costs, it is a trade custom to take inventories at net selling prices which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees or affiliated companies must be shown separately and not included under a general heading such as Notes Receivable or Accounts Receivable.

The Committee feels that all these principles should now be regarded by the Exchange as so generally accepted that they should be followed by all listed companies, certainly, that any departure therefrom should be brought expressly to the attention of shareholders and the Exchange.

In announcing on January 6, 1933, its intention of requiring after July 31, 1933, that there should be included in all listing applications, certificates of independent accountants in respect of the balance sheet, income statement and surplus statement for the most recent fiscal year, the Exchange indicated that in general the audit must cover all subsidiaries and the scope thereof be not less than that indicated in a pamphlet entitled "Verification of Financial Statements" issued by the Federal Reserve Board in May, 1929. The request of January 31 called for information as to whether these standards were currently being maintained in the audits of listed companies.

Upon the subject of the scope of audits, the existing position is outlined in a communication addressed by nine leading firms of accountants to the Exchange under date of February 24, 1933, a copy of which is attached hereto. In the interests of investors it seems desirable to make clear what is the scope of audits as currently conducted and to consider how far it is practicable to extend such scope and the responsibilities of auditors within the limits of a wise economy.

The bulletin issued by the Federal Reserve Board to which reference has been made indicated clearly that the scope of the examination therein provided for was not such as would lead naturally to detection of (1) defalcations on the part of employees, or (2) any understatement of assets and profits resulting from charges to operations of items which might have been carried as assets. The nine firms of accountants in the letter above referred to pointed out that the former limitation is particularly applicable to examinations of the larger companies which, generally speaking, constitute the class whose securities are listed on the New York Stock Exchange.

Your committee is satisfied that the detailed scrutiny and verification of the cash transactions of large companies can most efficiently and economically be performed by permanent employees of the corporation, particularly today, when bookkeeping is to so large an extent done by mechanical means, and that it would involve unwarranted expense to transfer such work to independent auditors or to require them to duplicate the work of the internal organization. Your committee, however, feels that the auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcation of major importance. Unless

so satisfied, the auditors should make clear representations on this point—in the first place, to the management, and in default of action by the management, to the shareholders. Your committee also suggests that this limitation on the scope of the audit, though an entirely proper one, should be specifically mentioned in the common form of audit report.

The Committee feels that the auditors should recognize a responsibility to verify and, if necessary, to report to the shareholders upon any transactions affecting directors or officers of the corporation in respect of which there might be a conflict of interest between such directors and officers and the general body of shareholders.

Turning to the second limitation on the scope of audits as outlined in the Federal Reserve bulletin, the accountants indicated that, generally speaking, their examination of the income or profit and loss account was perhaps less extensive than the procedure contemplated in that bulletin. The classification of the income or profit and loss account is clearly a matter of great importance to investors. Whether income is of such a nature that it may reasonably be expected to recur, or is of an exceptional character, is often a vital consideration in the appraisal of an enterprise, and failure to make such distinctions clear in annual accounts is one of the defects to which the Exchange has had to call attention most frequently in the accounts of listed companies.

The Committee recognizes that it is neither necessary nor reasonable to hold auditors responsible for minor errors in classification, or to ask corporations to incur the expense of examinations such as would justify the acceptance of such a responsibility. Auditors should, however, in addition to satisfying themselves that the net income reported is not overstated, accept the burden of seeing that the income received and the expenditures made are properly classified in so far as the facts are known to them or are ascertainable by reasonable inquiry. For instance, when non-recurring income, shown separately on the books, is merged with recurring income in the annual accounts, or when items properly chargeable against current income are charged against surplus or reserve, the facts are bound to come to the attention of the accountant who makes even the most cursory examination, and he should not certify without a clear qualification accounts in which anything of this kind has been done.

The inquiry has again emphasized the importance and the difficulty of the problem of properly reflecting the operations of subsidiary and controlled companies. Consolidation of accounts of companies in which there are very substantial outstanding interests is not a satisfactory solution—indeed, the Committee is satisfied that no method can be prescribed which could be applied in every case. Operations of controlled companies may be as important an element in the value of the parent company as those of the parent company or its wholly owned subsidiaries. Even where the operations of controlled companies are conducted at a negligible profit or loss, this fact cannot be ascertained if the result of such operations is nowhere reflected in the published financial statements. The Exchange has recognized that there must be an element of flexibility in the method of such presentation, so that corporations may choose, from among the several methods which will give the desired information, that one most suitable to its individual circumstances. For a considerable period of time past, the agreement covering this matter which the Exchange has requested from corporations applying for listing has read as follows:

“To publish at least once in each year and submit to stockholders at least fifteen days in advance of the annual meeting of the corporation, but not later than....., a Balance Sheet, and Income Statement for the last fiscal year and a Surplus Statement of the applicant company as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or, in lieu thereof, eliminating all intercompany transactions;

A similar set of consolidated financial statements. If any such consolidated statements exclude any companies a majority of whose equity stock is owned, (a) the caption will indicate the degree of consolidation; (b) the Income Account will reflect, either in a footnote or otherwise, the parent company's proportion of the sum of or difference between current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of report; and (c) the Balance Sheet will reflect, in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions. Appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries, in either parent company statements or consolidated statements.

Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking fund or redemption fund requirements of any controlled corporation whether consolidated or unconsolidated.”

The most costly, and the less satisfactory in some respects, of the suggested methods is the publication separately of the financial statements of each unconsolidated controlled corporation, for the reason that this imposes upon the stockholder, or analyst, the burden of determining for himself the equity of the parent company in the earnings of each such corporation, making it a burdensome matter for him thus to secure a true picture of the results of operation of the system as a whole.

With less information than is suggested by one of the methods in the foregoing agreement, the reports of any company having unconsolidated majority-owned companies are necessarily incomplete and may be positively misleading. The Committee believes that this is a subject which might well receive the consideration of corporate management and of organized bodies of accounting officers and independent accountants in order that adequate disclosure may become generally prevalent and not be confined merely to those companies which have executed the foregoing agreement with the Exchange.

At the same time, it might be desirable to attempt to develop a form of audit report or certificate which would be more informative to and more clearly understood by investors than the forms now currently in use. It would, in the opinion of the Committee, be advantageous if audit reports were so framed as to constitute specific answers to the last three questions embodied in the President's letter to listed companies of January 31, 1933, namely:

4. Whether in their opinion the form of the balance sheet and of the income, or profit and loss, account is such as fairly to present the financial position and the results of operation.

5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.

6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.

As suggested earlier in this communication, also, it might contain a clear statement of the scope of the audit in relation to detection of defalcations by employees.

The matters herein discussed seem to the Committee those in respect of which clarification and improvement of accounting practice are most desirable in the interest of investors. It suggests to the Governing Committee that these matters should be brought to the attention of listed companies and organized bodies of accountants and accounting officers, with a view to definite action along the lines indicated herein.

By the direction of The Committee on Stock List,  
J.M.B. HOXSEY,  
*Executive Assistant.*

RESOLVED, That the Governing Committee of the New York Stock Exchange concurs in the suggestions herein contained, and authorizes the Committee on Stock List to bring them to the attention of those concerned, as recommended.

ASHBEL GREEN, *Secretary.*

October 25, 1933.