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FINANCIAL STATEMENTS FOR INVESTORS

Recent events have focused the attention of the Commission upon the methods and techniques employed in auditing. While the McKesson case has been mostly in the headlines, two other hearings before the Commission--the Monroe Loan Society and the Interstate Hosiery Mills, Inc. cases--also involved matters directly related to auditing. In addition, a number of other statements filed with the Commission, but not taken to a hearing, have raised auditing questions.

The Monroe Loan Society case, involving a defalcation apparently amounting to $458,000, was discovered some time after a registration statement had become effective under the Securities Act of 1933. A stop-order hearing was held and it was determined that representatives of the auditors did not visit any branch office of the registrant for audit purposes in any of the years between the registrant's inception in 1927 and November 30, 1937; during this period no notes or applications for loans, held at the branch offices, were examined by the auditors; and during this period no branch office loans were verified by the auditors by direct confirmation with the borrowers. In its formal opinion the Commission held that the omission of an adequate examination constituted so complete a disregard of recognized auditing practice as to invalidate the accountant's original audit certificate and to impugn the integrity of the financial statements contained in the registration statement as it became effective.

In the Interstate Hosiery Mills case, in which the registrant filed financial statements, overstating its earnings and its assets approximately $900,000, a hearing was held to determine whether the registrant's securities should be delisted. At the hearing it was disclosed that the author of these falsifications was an employee of Homes and Davis, the certifying firm of accountants. Since there was no evidence of collusion between this employee and any of the directors, officers or employees of the registrant, or any partners or employees of the accounting firm, the issues developed at the hearing were principally whether the firm exercised due care in employing this accountant and in reviewing his work. The record in this case, including the testimony of expert witnesses for the registrant, failed to show that the review of the seniors' work was less extensive than that ordinarily made by accounting firms. In its opinion, however, the Commission indicated that it was satisfied that an adequate review would have exposed the irregularities and that if the views of the registrant's expert witnesses were to be accepted as to the usual practice followed by independent public accountants in reviewing the work of those responsible for the actual carrying out of the audit procedures, that practice required thorough revision.

Although the foregoing cases evidenced inadequacies in the procedures and practices followed in auditing, they hardly foreshadowed the McKesson & Robbins exposure. The first intimation of these irregularities was received on December 5, 1938, when appointment of a receiver for the company was sought. It was subsequently determined that the company's inventories and accounts receivable were overstated in amounts aggregating some $20,000,000. In view of the false and misleading information set forth in the financial statements which had been certified by Price, Waterhouse & Co., and on the basic of its preliminary investigation into

the auditing phases of the case, the Commission, on December 20, 1938, entered an order directing that public hearings be held to determine (1) the character, detail and scope of the audit procedure followed by Price, Waterhouse & Co. In the preparation of the said financial statements; (2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied in the preparation of the said financial statements; and (3) the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.

I hardly need mention the activity generated in accounting circles by the discovery of the falsification of McKesson & Robbins' financial statements. Various organizations have sponsored or participated in forums on auditing theory and practice. The American Institute of Accountants has published a report entitled: "Extensions of Auditing Procedure" which contains recommendations relating to the examination of inventories and receivables by auditors, the appointment of independent certified public accountants, and the form of independent certified public accountants' report. Numerous state societies of certified public accountants, the Controllers Institute of America and the National Association of Manufacturers have expressed their approval of the principles outlined in this report.

In the meantime the Commission has continued its hearings and its inquiry into the adequacy of present day auditing methods. In these hearings, which have now been completed, the Commission brought to the stand some forty-three of the two hundred and more persons examined, including representatives of Price, Waterhouse & Co., employees, officers and directors of the company, members of representative accounting firms and several other expert witnesses. The transcript of testimony of the expert witnesses is to be published shortly, and it is hoped will be of immediate general interest to the public as well as of permanent value to practitioners and students of auditing. A report covering the entire investigation is now in draft. Pending its publication, I am unfortunately unable to comment specifically on its findings.

However, while these cases indicate the need of a re-examination of the theories underlying the auditing procedures and techniques currently in vogue and may indicate a need for some significant revisions of auditing methods, there is little doubt but that accountants as a body, in auditing the accounts of publicly owned companies, have been keenly aware of their responsibilities. I am not always so sure, however, that the same can be said as to the accounting principles followed and as to the manner and form in which financial data is presented. As active practitioners, you are engaged in many varied accounting activities. You install systems; prepare budgets; participate in reorganizations, consolidations and mergers; render tax services of various sorts, conduct audits and investigations; and frequently you act as business advisors. In many of these activities the accountant has always been a direct agent of the management. It is not surprising, therefore, that accounting has been particularly sensitive to managements' viewpoint.

Today many corporations are publicly owned, but this has not had any great effect upon the environment in which accountants work. In most of their work, they still deal directly with the officers and employees of the company audited. It is to the officers or the board of directors, a group that should be expected to be conversant with the language of accounting and familiar

with the peculiar problems of the enterprise, that the auditors' report is addressed. The danger should be relatively slight that such a group would be seriously misled by or fail to understand the financial data presented because of the principles followed or because of the form in which presented.

In recent years much effort has been devoted to gaining recognition of the special interests and rights of investors in connection with corporate financial reporting. The difficulties encountered in portraying the financial condition of promotional enterprises illustrates the necessity of approaching questions of statement presentation and of accounting principle from the viewpoint of the investor. Promotional enterprises are generally speculative in nature. But the hazard of the undertaking is obscured in the orthodox balance sheet. In many cases that came to our attention during the first years of administering the Securities Act, mining property or mining claims had been acquired by the registrant in exchange for its stock. Frequently the property was purchased from the promoters. More often than not, the promoters were not only vendors of the property but were also the principal stockholders and directors of the registrant and, in the latter capacity, determined the valuation to be placed upon such property, and the number of shares to be issued for it. In some cases the valuation was arbitrary and not proven. In other instances it was based upon appraisals or engineering reports of doubtful validity. When such valuations are carried into the balance sheet they take on a wholly unwarranted air of reality. The unwary reader is all too likely to accept such balance sheets as comparable to those of established, successful companies, instead of as statements reflecting the promoters' optimism. In so doing he may readily overlook disclosure elsewhere in the statements or prospectus that no one has been "blocked out"; that both probable and possible ore are included in the valuation; that the valuation is based on engineers' reports made years ago; that the workings are under water, or caved in or inaccessible for other reasons, or that other disadvantageous conditions exist.

My illustration is rather extreme. Many of the cases to which I refer have been demonstrated in stop-order proceedings to be "wildcat" schemes. The illustration, however, may be of interest in that it indicates some shortcomings of orthodox financial statements in certain situations. Our solution to the problem may also be of interest. In Form A-0-1, for corporations organized within two years to engage in the exploitation of mineral deposits, an attempt has been made to overcome the misleading effect of financial statements of enterprises of this type, by eliminating the usual requirement of a certified balance sheet. In its place the registrant is required to submit certified schedules of (1) current assets and liabilities; (2) liabilities, other than current liabilities; (3) amounts due to and from promoters and other insiders; (4) non-current assets and capitalized expenses; and (5) capital stock; similarly, since the business ordinarily is not in productive operation, a certified statement of cash receipts, and disbursements is substituted for a statement of profit and loss.

In the schedule of non-current assets and capitalized expenses, the registrant is required to list and identify each material item showing, however, only the total number of units of each class of securities, the amount of cash and of anything else given therefor by the registrant. The dollar amounts are not permitted to be extended. Thus, no representations as to the value of the mining property or claims are made in the registrant's financial statements and the vexing problems of stock discount and capital surplus are avoided. Elsewhere in the registration

statement information is, of course, required as to the details of the promotion and the history and physical characteristics of the property.

This approach has not yet been extended to non-mining companies, although that is under consideration at the present time. However, for other promotional companies it is customary to require disclosure in the statements of some of the promotional characteristics. Thus, the number of units and the par, face, or stated value of the securities issued or to be issued for property must be given. The valuation at which the property was or is to be received by the registrant; the principle of valuation applied; the names of the person making the valuation and the relationship of such persons to the registrant, its predecessors, or promoters--all these are to be clearly set forth. Finally, if the valuation has been determined by the incorporators, directors or stockholders, or if it represents the par, face, stated, or market value of the securities issued or to be issued for the property, the registrant is asked to state whether such valuation is arbitrary or whether it has been proven.

Perhaps under certain circumstances balance sheets should not be submitted to investors even though the company's assets were not acquired in exchange for securities and even though the financial statements in question are issued as an annual report and not in connection with the sale of securities. A balance sheet presented a number of years ago by a company registered under the Securities Act of 1934 lends support to this observation. The bulk of its assets consisted of investments in and advances to wholly-owned real estate subsidiaries not consolidated. These investments were stated at cost; notwithstanding the fact that the cost of one particular investment of $2,000,000 was $1,400,000 in excess of the registrant's equity in the net assets of the subsidiary as shown in the books of the latter. In addition, the underlying properties of the various subsidiaries were subject to heavy mortgages, some of which were in default as to interest and principal. Taxes on some of the properties were in arrears. No provision had been made for depreciation of buildings and equipment. At that time the general real estate situation was precarious. Under such circumstances the registrant's balance sheet was meaningless. This was admitted. The first paragraph in the auditor's report which covered the scope of the audit was based on the standard form of report or certificate. Two pages of explanations and qualifications followed. But in the final paragraph the auditors explained that:

> ". . . the assets . . . are stated at amounts which will probably prove to be considerably in excess of realizable values. It appears that the necessary reserves to provide for such losses cannot be determined until economic conditions stabilize to an extent that will permit of a fair determination of the probable permanent value of the investments. It is not possible, therefore, at this time to present final balance sheets that fairly reflect the financial position of the companies and the accompanying balance sheets are submitted subject to providing for the losses that may ultimately be realized on investments now owned."

While such a report, which cannot be called a certificate or even an opinion, precludes any possibility of reliance upon the statements, is it not possible that a completely unorthodox presentation of the financial information would have been desirable? For example, perhaps schedules of current assets and liabilities, other assets, and shares outstanding, together with a schedule setting forth the equities of the group in the properties owned by the various companies

might have been a more realistic portrayal of the company's condition. The latter schedule might have been designed to show the cost of the various properties, the indebtedness against such properties to persons outside the group, the group's net book equities in each property, the principal and interest in default as to each property and the amount of taxes in arrears. This, at least, would have measured more clearly the gravity of the company's position.

The possible desirability of replacing or supplementing the traditional financial statements with new forms of statements may not be limited to promotional ventures and companies facing bankruptcy. Novel presentations may be the solution for a number of enterprises that as a group present conditions which the ordinary balance sheet was not designed to handle. A possible example that comes to mind is the incorporated open-end investment trust. Such trusts are generally obligated to redeem their own shares at any time for cash at a price based upon net asset values at current market quotations. In theory the cash required by the trust to redeem its shares must be obtained from sale of its portfolio securities. Thus the trust is faced not only with problems relating to the treatment of gains and losses on the redemption of its shares, but also with concomitant profits or losses on sales of portfolio securities. The relationship of these two classes of problems brings new aspects to each class. In addition the investor is interested in a market value measurement of his investment. On the other hand, he is equally interested in some measure of management efficiency such as that afforded by a comparison of cost with the current quoted value of portfolio securities.

In the case of one company, to my knowledge, this situation was met in the annual report to stockholders by a recasting of the usual balance sheet into a statement of net assets at present values in a way that is claimed to retain the essential information given by the old form and to furnish in addition a basis for computing the investors' present market equity. This was supplemented by a breakdown of the present net worth, distinguishing such items as contributed capital, surplus from income, surplus or deficit in trading profits and the net excess of market value over cost. A further statement analyzed the change in net asset value since the last report broken down to show net ordinary income less dividends, security profits both realized and unrealized, capital withdrawals, adjustments of reserves, and miscellaneous items. Finally, there was given the net asset value per share at each of the past ten fiscal dates. I need not stop either to commend or criticize such a report. It is sufficient here to point out that new forms and adaptations are not an impossibility.

The problems to which in the past we have devoted the greater part of our time are those involving matters of accounting principle. These come to us in informal pre-filing correspondence and conference or as a result of examining statements after filing. Many of such problems can be settled without extensive research after discussion with the registrant or its accountants. Others, more difficult or recurrent, become the subject of an extensive survey to observe the methods followed or advocated in other cases and by other accountants. During the past year, for example, studies of this type have resulted in accounting releases dealing with the presentation of preferred stock having preferences on involuntary liquidation in excess of par or stated valued, and the treatment of unamortized bond discount and expense applicable to bonds which, prior to maturity, have been retired out of the proceeds of a sale of capital stock. In the first of these it was indicated that when the liquidating preference was in excess of par it would henceforth be necessary to set forth the aggregate and per share amount of such excess and the

amount of dividends in arrears, if any. If the sum of these two exceeds the sum of the junior capital and the surplus, a condition not so rare as you may think, a definite statement to that effect is required. Any restrictions on surplus growing out of this condition must be indicated and buttressed by an appropriate opinion of counsel.

The second release mentioned arose out of a series of cases in which bonds had been paid off prior to maturity out of the proceeds of an issue of stock. In some of these cases the unamortized discount and expense applicable to the retired bonds had been continued as a deferred charge to be written over the remaining portions of the original life of the expired bonds. The opinion, while recognizing the possibility of varying cases, indicated that as a general rule such items should be at once charged to earnings or earned surplus, since the debt to which they were applicable no longer existed in any form.

Another matter to which we have devoted a great deal of thought in the past year or so is the question of that kind of corporate revamping which is termed quasi-reorganization. Pending further study of the multitude of cases in our files involving this point we have made no public announcements of our position. However, the direction of our thinking has been outlined in an article in the June issue of the Accounting Review.

To illustrate some of the cases which have been worked out without a public ruling I may choose a group which involve the accountants' tendency toward conservatism. Undoubtedly, that tendency is commendable. It may, however, be carried to extremes or used to justify policies that might better be classed as contrary to most generally accepted accounting thought. This often takes the form of conservatism in today's balance sheets with resulting unconservatism in future income statements. The question is of some special importance in our work since, under the Exchange Act at least, our definition of an investor is one who is faced with a decision whether to buy, hold or sell securities. It must be recognized, I think, that one who sells securities on the basis of understated balance sheets and income accounts may have been as seriously misled as one who buys securities on the basis of overstated balance sheets and income statements.

In one respect accountants in this country have recognized the dangers inherent in conservatism. The practice, somewhat prevalent in England, is here generally condemned of correctly determining the profits of an enterprise on its books and then deliberately understating the profits in the company's published financial statements by transferring a portion of such profit to what has been called "secret reserves". On the other hand, the practice of writing down assets below any fair estimate of value or any fair determination of cost applicable to future periods is still quite common. In many instances this practice is carried to its extreme, and tangible as well as intangible assets are written down to a nominal amount of $1.00.

In one case a listed company reduced the net book value of its assets as of a particular fiscal date from approximately $19,000,000 to a nominal amount of $1.00. Since that time it has been the policy of the company to maintain the fixed assets then in existence at a net book value of $1.00 and to charge all provisions for renewals and replacements to profit and loss. The company capitalizes the cost of new property other than replacements of the old property and accrues depreciation on the newly capitalized property at what appear to be reasonable rates.

This method of handling its property accounts severely distorts the company's operating results and we have required that the effect on the earned surplus and profit and loss statement be disclosed in footnotes to the balance sheet and profit and loss statement. Question may also be raised as to whether the much more common practice of writing patents and similar intangibles down to a nominal amount does not result in similar distortion of the future balance sheet and income accounts.

Questions as to the propriety or impropriety of conservatism are also frequently encountered in cases in which the assets of an enterprise are revalued in a quasi-reorganization. To me, it is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond their fair value. If this and certain other requirements are complied with in effecting a quasi-reorganization, thereafter profits and losses resulting from causes subsequent to the effective date of the quasi-reorganization may be credited to or charged against earnings or earned surplus subsequent to such date, as appropriate. This treatment of profits, as well as the entire idea of a quasi-reorganization can only be justified on the theory of a new start or a new entity. In a recent case a registrant had carried its investments in salable securities at cost. It wrote down a number of its investments to their fair value, but it did not restate those having a fair value in excess of cost. A few days after the effective date the assets that had not been restated were sold at a 50% profit of approximately $1,000,000 which was included in current earnings. If this particular registrant had been a new enterprise, and had acquired these assets in an arm's-length bargain, it is hardly conceivable that they could have been resold a few days later at such an enormous profit. Looking at it in this fashion, the Commission required the registrant to amend its statements to treat the profit on the transaction as applicable to the period before reorganization. While it may be conservative from a balance sheet point of view to restate assets at less than their aggregate fair value in a quasi-reorganization on the theory that the company is making a new start, it certainly is not conservative if profits thus made possible are used to inflate subsequent earnings. From the investor's point of view, much emphasis should be placed, as it has in current years, upon a correct statement of earnings and earning power.

So many problems have arisen in connection with quasi-reorganziations that I should like to conclude with an example which involves not so much a question of conservatism as it does the disclosures necessary for the investor when a legally permissible course of action is not in accord with sound accounting. It has been widely recognized that the rule that "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise require to be made against income" is subject to the exception that corporations which have accumulated a deficit in earned surplus may upon complying with certain requirements eliminate the deficit against paid-in surplus. This is what I have previously referred to as the theory of a "new start". One of the requirements to be met is that the facts must be "as fully revealed to and the action as formally approved by the stockholders as in reorganization". This step in the procedure is specifically called for as you know in the bulletin "Examination of Financial Statements", as well as in "A Tentative Statement of Accounting Principles" and in the Commission's Accounting Series Release No. 1".

In the particular case to which I refer the use of paid-in surplus for the absorption of an earned surplus deficit had been approved by the registrant's board of directors but not by its

stockholders. Counsel for the registrant represented that under the company's charter and applicable state law, it was permissible to effect this transaction without approval of the stockholders. On the one hand, there was a violation of an accepted accounting principle. On the other hand, absorption of the deficit was an accomplished legal fact and to fail to give appropriation recognition in the financial statements would be to conceal that fact and the effects that might flow from it. Such concealment would likewise violate accounting principles. As a solution to the problem the Commission required that to effect the proper disclosure the caption "Capital Surplus" should indicate parenthetically the amount of the deficit written off and that under the caption "Earned Surplus" the statement should show the deficit in earned surplus since organization, from which should be deducted the deficit charged to capital surplus; that the balance extended should be termed "Earned surplus since the particular date" and that the face of the balance sheet should indicate that the deficit was charged to capital surplus by resolution of the board of directors and without approval of stockholders, no such approval being required by the charter or applicable state law. The Commission further felt that inasmuch as the stockholders had not approved the absorption of the deficit they should be informed of its possible results. The registrant accordingly appended to its statements a footnote to this effect:

> "Stockholders usually assume that a dividend is paid out of earned surplus. If in fact or practical effect, it is paid, in whole or part, not out of earned surplus but out of capital or capital surplus, the stockholders, unless aware of that fact, are likely to be misled. And if certain losses are charged against capital surplus, then the result may be that, in practical effect, subsequent dividends will be paid, in whole or part, out of capital contributions in such a way that stockholders may not comprehend that fact."

It is well worth considering whether comparable treatment ought not to be accorded cases in which ordinary dividends have been charged against paid-in surplus or surplus arising from revaluation of assets although earned surplus was then available.

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