

THE ROLE OF ACCOUNTING IN THE REGULATION
OF THE ISSUE AND MARKETING OF SECURITIES
IN THE UNITED STATES

Address by

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before the

AMERICAN INSTITUTE OF ACCOUNTANTS

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I am honored indeed to be addressing outstanding accountants of many nations. The gracious invitation from Mr. Foye and Mr. Carey last April informed me that prominent accountants from Brazil, Canada, Cuba, England, Germany, Holland, Mexico, Puerto Rico, Scotland, and other countries would constitute approximately half of this distinguished audience. Chairman of the Securities and Exchange Commission, and not my learning, that entitles me to address you. My training and experience, prior to becoming Chairman of the Commission in June 1953 was that of a lawyer. I had, however, engaged in some corporate and financial practice and have acquired enough knowledge of this field to be cognizant of the wisdom of the classical couplet:

“A little knowledge is a dangerous thing;
Drink deep or taste not the Pierian Spring.”

It is fitting that this visit of yours is timed to follow the recent meeting of the Board of Governors of the International Monetary Fund and the International Bank for Reconstruction and Development. At a public forum during that meeting I had the pleasure of listening to a panel discussion concerning international investment participated in by our own Secretary of the Treasury, the Chancellor of the Exchequer of Great Britain, the Finance Minister of Brazil, and the Finance Minister of India. They outlined with some particularity the problems which confront capital exporting countries and capital importing countries. You know them: remittance of income, repatriation of capital, risk of expropriation, double taxation of earnings, legitimate aspiration for local control, exchange risks, etc.

As you know, in recent years movement of American capital to foreign countries (other than Canada) has been represented in great measure, not by acquisition of foreign securities by individual investors, but rather by government grants, by government loans, and by investment in subsidiaries by American corporations. With inter-governmental relations the Securities and Exchange Commission has nothing to do. The Commission's jurisdiction with respect to capital advances by parent corporations to subsidiaries is quite limited. However, if the world develops as we hope it will, its economic progress will be based upon a substantial flow of private investment across international boundaries and with that we do have something to do.

The United States, which emerged as a creditor nation after World War I, has perhaps less experience in international investment than have many of our Western European friends. The complex processes, the varying languages, the multiple laws, the differing customs, the involved techniques, call for skill and experience. The intelligent direction for foreign investment calls for a certain amount of what is suggested by a popular song entitled “Getting to Know You.”

It is to be hoped and expected that over the years the international movement of capital required to raise the standards of living of the world will be less by inter-governmental loans and investments and more by private investment. It would be normal also to expect that a source of capital for such private investment would be the United States.

The aggregate outflow of private capital from the United States in the last six years has been approximately 5 billion 4 million dollars, or an average of 900 million dollars per year. In addition the subsidiaries abroad of United States companies have reinvested earnings at an average of 600 million dollars per year during this six year period.

It is also significant to note the important change that has taken place in our balance of payments position. During the years 1946 through 1948 the transactions of the rest of the world with the United States resulted in a net collection by us of four and one-half billion dollars in gold and in dollar balances and investments from foreign countries; that is, they paid us that amount to settle their accounts. In 1949, we were in approximate balance and there were no net payments either way. But in the last four years, from 1950 through 1953, the reversal was pronounced, and our transactions with the rest of the world added about \$7,700,000 to foreign countries' assets in gold and dollars. Based upon present available figures, the outgoing trend is continuing and the calendar year 1954 will witness another billion and one-half dollars flowing to foreign countries to settle our accounts.

The outflow of investment capital, plus the balance of payments position would seem to indicate the validity of two conclusions:

- (1) That American capital is seeking investment abroad, and
- (2) That our net payments abroad are in such amount as to assist substantially in solving problems relating to remittance of profits and repatriation of capital.

The Securities and Exchange Commission is an agency of the Government charged with the responsibility of administering several federal statutes which seek to provide protection for investors and the public in their security transactions.

We have set up in this country a Federal system regulating the sale of securities based generally on the furnishing to investors of information with respect to the security and its issuer. Legal sanctions, both penal and civil, are imposed for misrepresentation or concealment. Under that philosophy the investor is free to select either a wise or an unwise investment. The law merely assures that he has adequate opportunity to find out what he is buying.

Since the basic philosophy of our federal securities regulations is one of disclosure, the importance of accurate accounting information furnished under generally accepted principles is readily apparent. It is only a statement of the obvious to say that the information most determinative of the value or potential value of a security and the progress of its issuer is the financial condition to a business and the financial results of its operations. Such information can only be derived from the issuer's financial statements accurately prepared and presented in such a manner as to be informative but concise; candid and uncolored; and disclosing every material fact necessary to make the statements not misleading.

Public offerings of securities by either the issuer or by persons in control of an issuer, and the obligations of issuers of securities listed on our national securities exchanges are governed respectively by the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities Act of 1933, the so-called "truth-in-securities law", requires the disclosure of certain information, in the sale of new securities and prescribes standards for such information, so that the investor will know what he is getting when he buys securities. Any issuer registering securities under the Act also undertakes to file annual financial reports with the Securities and Exchange Commission. The Securities Exchange Act of 1934 provides for the filing with the Commission of basic information when a security is listed on an exchange and for period reports by the issuers of listed securities.

In complying with the Securities Act of 1933 the issuer files with the Securities and Exchange Commission a registration statement which is examined by our staff to determine whether it complies with applicable disclosure requirements including the requirements with respects to financial statements. If it appears to be incomplete or inaccurate the Commission has authority to refuse to permit the statement to become effective. The Commission does not, however, approve the securities nor does the Commission make any representation as to the accuracy or completeness of the information.

Securities offered for exchange by an issuer with its existing security holders exclusively where no remuneration is paid or given directly or indirectly for soliciting such exchange are exempt from registration procedures. However, such offerings are not exempt from the application of Section 17 of the Securities Act and Section 10 of the Securities Exchange Act, which deal generally with fraud and concealment in securities and the disclosure standards previously discussed would provide analogies in determining questions of civil liability or violation.

I mention this matter of exchanges of securities because we anticipate that from time to time foreign issues will be making offers to exchange new securities for outstanding securities.

Financial statements of issuers filed with the Securities and Exchange Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934 are, with minor exceptions, required to be certified by independent public or certified public accountants. The Commission's requirements pertaining to the qualification of certifying accountants are rigorous. Such an accountant must be in good standing and entitled to practice under the laws of the place of his residence or principal office. Moreover, any such certifying accountants must be in fact independent, that is, he may not have any financial interest direct or indirect in the organization whose accounts he certifies. Nor may he be a promoter, underwriter, voting trustee, director, officer or employee.

In respect of accounts filed with it, the Commission is given broad authority. Both the Securities Act and the Securities Exchange Act authorize the Commission to prescribe the items or details to be shown in the balance sheet and earnings statement, the methods to be followed in the preparation of accounts, in the appraisal or evaluation of assets and liabilities, in

the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation of consolidated balance sheets and income accounts.

Despite the broad power conferred upon it with relation to accounting matters, the Commission has not, except in the case of certain companies subject to the Public Utility Holding Company Act, adopted general rule prescribing principles of accounting.

We have adopted a set of rules, identified as Regulation S-X, which specify the form and content of the financial statements required to be filed. Included in this regulation are the Accounting Series Releases which are composed mainly of opinions on specific accounting questions.

With respect to the accounting principles underlying the financial statements filed with the Commission, our approach has been to review statements as filed to determine whether the accounting principles reflected therein and the methods followed in their preparation are sound and generally recognized as such; if not, to suggest that the statements should be amended in order to avoid stop-order or delisting proceedings. This policy is stated in Accounting Series Release No. 4, April 25, 1938, as follows:

“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.”

The application of the principle stated in Release No. 4 naturally gives rise to the possibility of disagreements and uncertainty with respect to particular statements and specific problems. If a registrant makes a filing stating accounts based upon principles for which it claims there is substantial authoritative support, there can readily arise arguments as to whether the claim for support is well founded.

The great variety of problems which come to the attention of the Commission almost daily demonstrates quite clearly that accounting is not a branch of mathematics like

arithmetic or geometry and consequently as a practical matter cannot be made the subject of rigid rules. It is apparent that there are a number of matters concerning which not all of the accountants in this country agree as to treatment in financial statements. During the short period -- some 15 months -- that I have been Chairman of the Commission, some of these matters have been brought to our attention. For example, we have seen reflected in financial statements a variety of methods of accounting for stock options issued by corporations to their officers and employees; we have listened to arguments concerning accounting for emergency facilities part of the cost of which under our tax laws may be amortized over a five year period; we have had discussions -- some physical and some academic -- on departures from cost in the handling of depreciation and have declined a formal application to adopt a requirement that economic depreciation (based on replacement at current prices) be reflected either in the accounts or by other appropriate disclosures; and more often than one would expect we have found it necessary to comment critically upon balance sheet write-ups especially when made concurrent with a public offering of securities.

We have also had to give consideration to filings of foreign companies offering securities for sale in the United States. The financial statements contained in such filings for the most part have been certified by independent accountants located in their respective countries. Here again the certifying accountants have not always agreed, either among themselves or with the accountants in this country, as to the basic principles underlying the preparation and presentation of the financial statements.

While it appears that, to some extent, accounting principles upon which financial statements of foreign issuers are based are derived from specific governmental requirements, usually involving tax considerations, it appears that some concepts of accounting which are not recognized in the United States are generally accepted abroad. For example, it has been represented to us that it is acceptable practice in the Netherlands in determining net income to base depreciation provisions on estimated replacement value rather than on historical cost.

Very real questions frequently are posed by the arithmetical impossibility of converting the result achieved by one method of accounting into the result which would have been achieved by the application of another method.

Differences of opinion among certifying accountants are not confined to the preparation and presentation of financial statements but are reflected as well in the procedures followed by them in auditing the accounts and records which form the basis of the financial statements. In this country compliance with generally accepted auditing standards requires that the auditor shall, whenever practicable and reasonable, be present at the inventory taking and by suitable observation and inquiry satisfy himself as to the methods followed, and shall confirm accounts and notes receivables by direct communication with the debtors. It is my understanding that these procedures are not mandatory in England or Germany and perhaps in other countries. I understand, however, that in those countries the independent accountant will not certify financial statements without having satisfied himself in some manner as to the credibility of the amounts shown for inventories and receivables. In this connection there was brought to my

attention recently the following abstract from the “Diary of A Chartered Accountant” published in The Chartered Accountant in Australia¹

“***a letter came in the other day from English associates covering the required audit of an Australian subsidiary. It was interesting to see the emphasis they placed on stock [inventory] verification at balance date and on the movement of stocks during the year *** it is interesting to note how insistent they were on observation of physical stock-taking. My impression is that English practice is veering inevitably towards the American view on the point, though not on the extreme followed in the McKesson and Robbins case.”

From the foregoing partial list of accounting and auditing problems with which the Commission is confronted, it is apparent that some degree of turmoil exists with respect to the financial reporting of domestic issuers, a situation which is present in somewhat greater degree when statements of foreign issuers become involved. As one prominent Netherlands accountant has summarized it, “When in a particular case one has to deal with a great number of countries the obstacles mount to such an extent that, in consolidating or compiling the various data, you feel as if you mix a cocktail of ‘good old Scotch’ and water from the canals of Venice.”² However, when one considers the vast complex presented by the problems of industry, it is some comfort that the areas of controversy are relatively so small.

You can see that questions are presented to us in specific cases. Consequently, it is difficult to be specific in stating over-all policy.

The legitimate mutual interest of our people and the peoples of other lands in encouraging American investment abroad naturally suggests removal of needless barriers to the access of foreign issues to American capital markets. On the other hand in view of the availability to American investors of relatively attractive investment opportunities at home, they are in position to insist upon receiving in respect of foreign issues information similar to that which they receive in respect of domestic issues. Moreover, from our standpoint as a regulatory agency, an imposition of less complete disclosure requirements on foreign issues would lead to demand for a similar relaxation of requirements in respect of domestic issues. In other words, it is normal to expect that American companies will demand “most favored nation treatment” in their own country. This would be retrogression for which our Commission should not be asked to take responsibility.

Our legal requirements for disclosure, our high standards for independent accountants, our insistence upon sound accounting principles, and the requirement for the furnishing of the relatively voluminous statements and schedules have, over a period of twenty-

¹ Volume XXIV, No. 10, April 20, 1954, p. 727.

² The Accountant, Volume CXXVIII, No. 4082, March 14, 1953, p. 299 (J. Kraayenhof).

one years, materially raised American accounting standards and have afforded a very real degree of protection to American investors. There was no absence of complaint about the inconvenience of all this. But the over-all result has been good. Consequently, the accounting standards which we have helped to evolve have in a sense become a part of the mores of the American capital markets. And, I think it fair to suggest that this fact is one which must be recognized by foreign enterprises which seek capital funds from private investors.

There are no magic formulas to solve the perplexing questions which I have mentioned tonight nor many of the questions which you will hear discussed next week. It may be that at some future date there will be debates on the same subjects at an International Institute of Accountants.

Accounting is basically a technique of reflecting financial facts. The traditional free press in this country testifies to the belief that an organization of people does best when the people who compose it know the facts. Our Commission has loaned, and will continue to lend, its knowledge and legal support to those who help us develop better and more informative corporate accounting practice. It has goaded a good many stragglers into falling into line.

As we sit here tonight and contemplate the place of sound accounting as a medium of information in the international movement of capital. I hope that there is general agreement with the philosophy of adequate disclosure which I have tried to espouse I theses remarks.

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