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“THE NEXT STEP IN ACCOUNTING”

ADDRESS

of

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Before the

ANNUAL MEETING

of

AMERICAN ACCOUNTING ASSOCIATION

at

Hotel Chalfonte – Haddon Hall

Atlantic City, N. J.

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Monday, December 27, 1937 – 2:00 P.M.

## THE NEXT STEP IN ACCOUNTING

I have been asked to speak to you about the next step in accounting. In complying I risk little since I have no reputation as a prophet. Before complying I should explain, what most of you will discover for yourselves, that I am not an accountant. But many years ago Dr. Oliver Wendell Holmes wrote that medicine learned "from a Jesuit how to cure agues, from a friar how to cut for the stone, from a sailor how to keep off scurvy, from a postmaster how to sound the Eustachian tube, from a dairy maid how to prevent smallpox and from an old market woman how to catch the itch insect." In later days when Henry Ford needed glass made in a continuous ribbon he was forced to go to engineers with no experience in glass-making. His experience with linen makers were somewhat similar and finally valuable contributions to the investing public in matters of accounting have been made by J. M. B. Hoxsey, Executive Secretary of the Committee on Stock List of the New York Stock Exchange. I am told he received no scholastic training as an accountant although he has had many years of accounting responsibility and experience. (Incidentally he is not a member of the Exchange but a full time paid executive.) These precedents encourage me in my present venture.

Before looking forward let me for a few moments look backward. I recall nearly six years spent largely in asking questions of accountants in the utilities investigation at the Federal Trade Commission. The investigation was largely an accounting investigation. In the light of later experience I regret that more attention was not given to the matter of accountants' certificates. I do not doubt that many accountants of the days covered by that investigation acted competently and ethically according to the standards of those days but I do recall instances of phoney intercompany profits, of write-ups used to create income or to relieve the income

accounts of important charges, of profits computed on the sale of securities without even bothering to deduct the cost of the securities, where the accountants certified the statements without exceptions. I recall the advent of the Securities Act of 1933, the Securities Exchange Act of 1934, the creation of the Securities and Exchange Commission in 1934, and the Public Utility Holding Company Act in 1935. I recall the writing of the forms and regulations for the registration of securities, the disappointments attending our search for well established accounting standards, the difficulty even of finding a definition for the word "audit", the weeks of arguments as to what should be required in a form and what omitted, the difficulty of deciding what an accountant's certificate ought to contain, the cooperation and contributions of accountants, some with axes to grind and others without. I think of the labors of those we induced to take a place on our payroll for a time, Jerry Dunn, Donald McCruden of Moodys, Dr. Saunders of the Harvard School of Business. I remember the committee of lawyers who, after telling us one of our forms was too long, were invited to submit a form of their own devising and brought back one longer than ours – I recall the struggles with the vexatious problem, not yet solved, of what should appear in a prospectus. Then there have been the numerous decisions of the Commission, discussing accounting principles, issuing stop orders against registration statements containing the results of improper accounting. There have been the rulings dealing with the certifying auditor's independence or the lack of it; there have been the innumerable cases under the Securities Act and the Securities Exchange Act which never reached the status of a formal proceeding or a public release where the companies involved corrected their statements usually on request. There have been the public releases prepared by our chief accountant, Carman Blough, stating his opinion as to correct procedure in various sets of circumstances, the releases by Harold Neff, Director of our Forms and Regulations Division, attempting to

demonstrate to the lawyers how technical legalistic descriptions of indentures and other papers found in many prospectuses could be reduced in size and content to short, plain, understandable statements. I recall our repeated and almost hopeless efforts to make it understood that we do not pass on the merits of securities. If there were times, I could review with you the provisions of the Uniform Classification of Accounts which we have prescribed for registered holding companies and for service companies under the Holding Company Act. I recall the great hope for substantial progress in accounting that arose when our National Supreme Court, albeit by a divided vote, issued its decision in McCandless v. Furlaud (296 U. S. 140) (1935) and held out therein some promise that the court's decision in the Old Dominion Copper case, (Old Dominion Copper Mining & Smelting Co. v. Lewisohn 210 U. S. 206) (1908) for so many years a haven for dishonest promoters, was on its way to the ash can. I recall the satisfaction that attended the reading of the same court's decision in Atlanta, Birmingham & Coast Railroad Company v. United States (296 U. S. 33) (1935). It was the first case so far as I can learn in which the court passed upon the use, in a balance sheet, of figures based on an estimate of the cost of reproducing a public utility property new. It upheld a decision of the Interstate Commerce Commission in which that Commission in passing on a proposed balance sheet in a reorganization refused to give weight to a reproduction appraisal. I recall also the disappointment which followed from the decisions of the Commission by a divided vote not to attack registration statements filed under the Securities Act of 1933 by the Northern States Power Company, The Chesapeake Corporation, the Monongahela West Penn Public Service Company, and the Thermoid Company. It seems interesting to note that the most serious differences of opinion that have ever occurred among the commissioners centered about an accounting problem, and yet, as you will see, there was no difference of opinion as to the accounting. I

think it best to review those cases briefly since there has been so much misunderstanding about them and because it may help to a better understanding of my discussion of the next steps.

Prior to 1924 the Northern States Power Company followed the practice of amortizing debt discount and expense by charges against income over the lives of the respective issues. In 1924 there was an appraisal made of its properties by an affiliate. It was never passed upon by any regulatory body; it was based wholly on an estimate of the cost of reproducing the property new and in arriving at present value it gave consideration to no other element. On the basis of this appraisal the company wrote up its fixed capital and investment accounts approximately \$15,000,000 crediting about \$7,000,000 thereof to a retirement reserve and about \$8,000,000 to capital surplus. In 1924 and 1925 the registrant wrote-off substantially all of its unamortized debt discount and expense against capital surplus. The effect of this write-off was to relieve the income account prior to the date of registration, August 31, 1934, of amortization charges of about \$5,000,000. The accountants in their certificate described the transaction and the effect thereof substantially as I have, and thereupon after saying: "Subject to the foregoing comments," certified to the statement. Before the registration became effective the clause quoted was amended to read "Except for the matters discussed in the foregoing comments." The auditors did not indicate otherwise either approval or disapproval of the accounting procedure. All the commissioners disapproved the accounting. The majority believed that there was such a complete disclosure in the statement as to comply with the statute and make a stop order proceeding improvident, and further, that the accountants' certificate had, in effect, condemned the accounting. The minority took the view that the accountants had expressed no clear opinion as to whether the accounting was good or bad, that the company's earnings record and earned surplus balance as stated in the registration were in effect untrue – amounted to

misrepresentations and therefore were violations of the statute. Prior to registering another issue of bonds and preferred stock in January 1937 and after registering under the Holding Company Act, the company made a series of entries which went far toward reversing the entries I have described, dealing with debt discount and expense.

In the Chesapeake Corporation case the company acquired large amounts of Chesapeake & Ohio stock from closely affiliated interests and recorded it on the books at such a sum and under such circumstances as to amount to a write-up, as the minority viewed it. Against a capital surplus created through this write-up the company charged off \$4,560,000 of unamortized discount and expense. The accountants' certificate stated what the earnings and earned surplus would have been had the discount and expense been amortized in the ordinary way, but the accountants stated specifically that in their opinion what the registrant did was in accordance with good accounting practice, an opinion with which all the commissioners, I believe, disagreed. Four months later, in the New York Times of April 13, 1935, we learn that the company "has changed its methods of accounting with respect to \* \* \* bond discount and expenses \* \* \* to conform with practices recommended by the Securities and Exchange Commission."

In the case of the Thermoid Company (1) the investment in a wholly owned subsidiary was included in the balance sheet at the net book value thereof as shown on the books of the subsidiary at the date of acquisition less dividends subsequently received out of surplus at date of acquisition. This carrying figure was in excess of cost to the reporting company. (2) The investment in a 98.1% owned subsidiary not consolidated was carried at cost, which was approximately \$2,693,000 in excess of the net book value as shown on the books of the subsidiary at date of acquisition. (3) The inclusion of the 98.1% owned subsidiary in the

consolidation would have resulted in showing a deficit instead of an earned surplus. (4) Discount on the corporation's notes was charged to capital surplus instead of being amortized by charges to profit and loss. All the facts I have described appeared in the registration statement. The auditors commented only on the charge-off of discount against capital surplus saying, "While this treatment does not conform to what is regarded as the best accounting practice, we believe it has sufficient acceptance in case of reorganizations or the organization of a new company to sanction it as in accordance with accepted accounting practices. An alternative and preferable treatment would have been to set up this amount in 1929 as a deferred charge on the Consolidated Balance Sheet and thereafter to amortize it over the life of the gold notes by annual charges to Profit and Loss account." They then told what the effect of such a procedure would have been. A minority of the commission recommended proceedings in this case not only because of the treatment accorded debt discount, but because of the inconsistency in the recording of the investments in two subsidiaries and because of the seeming distortion of the consolidated statement by the omission of the 98.1% owned subsidiary.

As to the Monongahela West Penn Public Service Company -- In December 1929, a time of high costs, an appraisal was made solely on a reproduction cost basis by an affiliated engineering firm. This appraisal by the way was a hasty one without detailed inventorying and pricing, what we call a "horseback appraisal". It was spread upon the books in 1930. On the basis thereof, certain electric and gas properties were written up \$8,180,445. This sum was credited to an account called, "Appraisal Value in Excess of Book Value". During the years 1930 to 1935 inclusive, abandonments of traction property, \$2,148,823 in amount were written off against the "surplus" so created. This left intact the earned surplus account from which the company continued to pay dividends on the preferred stock (held by the public) and, for a time,

dividends to the parent holding company on the common stock. The accountant's certificate as originally filed made no reference to the propriety of the write-off of abandoned traction properties against a "surplus" created (and "created" is the very word for it) from a write-up of electric and gas properties. However, after some agitation, the accountants filed an amended certificate. It included the following: "Neither the practice of the company nor general accounting practice calls for provision for such losses out of income or out of reserves created out of income, and in our opinion they are properly chargeable against any capital surplus, including surplus arising from reappraisal of properties assuming the correctness of such reappraisal (which, being a question of valuation, we, as accountants, cannot pass upon). In the absence of appraisal surplus, sound accounting practice would, in our opinion, have permitted the charge of the losses against a capital surplus created by a reduction of capital or otherwise, or alternatively. They might have been charged against surplus earned prior to abandonment or over a period of years following abandonment; the extent to which the earned surplus of June 30, 1935, would have been reduced if the latter alternative had been followed cannot be stated. The earnings would not have been affected." Again, as I understand it, all the commissioners disapproved the accounting -- But a majority thought the disclosure satisfied the statute.

The minority thought the balance sheet and earnings statements were misleading and violative of the statute. What treatment should be accorded this company under the Holding Company Act because of these entries remains to be determined.

The argument as I have tried to indicate revolved about differences as to the law rather than differences as to accounting. I regret that an attempt was not made in these cases to establish the principle that if an earnings statement and a balance sheet reflect the results of improper accounting, they amount to misrepresentations or misleading statements in violation of

the Securities Act. In the absence of a court decision I have no right to go further than to reiterate the regret that an effort to have the questions settled by a court decision was not made. The policy of the Commission evidenced by those decisions has been followed in a number of subsequent cases, although there has been a pronounced improvement in the treatment of debt discount in registration statements.

The Commission has shown a tendency to depart from this policy somewhat. Thus the Commission took a firm position against a registrant in the following circumstances. The company had purchased a property at arms length bargaining from strangers. It paid, let us say, \$400,000 (the figures are assumed), it had a reproduction appraisal made which showed a valuation of \$1,000,000. It recorded its property at \$1,000,000, credited \$600,000 to capital surplus and announced its intention of charging off certain items such as organization expense against this surplus. The Commission protested, threatened stop-order proceedings and the company reversed the entries and recorded its properties at cost, \$400,000. This precedent has been followed in several other cases. The circumstances did not then seem to require a formal public opinion or release concerning any of them. I now think, however, that the publication of such instances, possibly with names omitted, would be so informative to accountants and prospective registrants, that it should be required.

In the Northern States case and the other cases described, the majority thought it might not be entirely fair to proceed against the registrants since the Commission had not promulgated the rules on the subject of accounting which the Securities Act seems to authorize. This brings me to the first of the next steps in accounting which I am to describe.

The staff as the result of instructions has for some time been studying the proposal to issue some rules dealing with accounting and appraisals. We are not thinking of a mass of rules

or innovations in accounting. We are trying to express a few standards as to principles which we believe are accepted by a majority of good accountants, especially of those who do not assume the role of special pleaders for their more lucrative clients. The approach must be cautious, but my experience with accountants leads me to the conviction that they regret that standards are not more exactly defined. They recognize as we do that in many aspects of accounting, inflexible rules cannot now be laid down. But it cannot be that there are no real standards in accounting. It seems to me, that one great difficulty has been that there has been no body which had the authority to fix and maintain standards. I believe that such a body now exists in the Securities and Exchange Commission. Its success or failure will depend in large measure on how wisely it exercises this function.

One of the questions with which the Commission must sooner or later come to grips is this one as to reproduction appraisals. It has plagued the rate making authorities ever since William Jennings Bryan and associate counsel in 1898 acting as they undoubtedly believed in the public interest, induced the Supreme Court to hold that in fixing rates for public utility companies the authorities must allow a fair return upon the present value of the property and that in arriving at present value consideration must be given to a number of elements. One of them was stated to be "the present as compared with the original cost of construction." From this our present unwieldy, slow, and expensive theory of valuation based on an estimate of the cost of reproducing the property now has grown up. But the Court has never so far as I can learn approved it for balance sheet purposes or for any purpose except as an element to be considered in a rate case in arriving at present value, in fact the Birmingham R.R. case squints toward disapproval. For some years past there has been growing space the vicious practice of using reproduction cost estimates as a basis for figures in balance sheets, disregarding every other

element of present value, applied not only to utility companies but to ordinary unregulated industries. These figures have been used to balance security issues, to inflate asset accounts, to water stock, to create alleged income, to create surplus accounts for the purpose of absorbing charges that should be made against earnings. I believe the Commission, if it issues the rules I have mentioned, should set its face against this practice. When one realizes the complexities and antipathies which reproduction appraisals have engendered in the field of rate regulation, one regrets its use in balance sheets. It is based on a misapplication of the doctrine of *Smyth v. Ames*. Its principal products will be confusion and deception.

All this suggests the questions, "What is accounting?" "What are its purposes?" These questions must be answered, and answered soon, if the business of investing and the responsibilities of corporate directors and officers to their stockholders are to have sound bases. I venture to suggest an answer. It may be entirely wrong. I think the purpose of accounting is to account – not to present opinions of value. This is not to say for example that current assets should not be carried at the lower of cost or market, or that the setting up of proper reserves and similar accounts do not require judgments. I am attempting to generalize. The value of a corporation's property may be much or little – or uncertain. Its cost is usually certain. The capital entrusted to the management can usually be ascertained. What has been done with that capital can be ascertained through accounting. The steward must account for the talents entrusted to him. Accounting to me means the making of a historical record of financial events. Valuation is a very different matter. I do not mean that there are no circumstances under which unrealized losses or gains should be recognized on books of account. I do believe that unrealized gains should not be entered upon accounts until the probability or certainty of the permanence of the gain can be well established. I believe that good accounting should observe this principle.

But there are other matters with which the rules must deal. Write-downs made for the purpose of decreasing depreciation allowances and increasing net income must be dealt with. So eventually must the uses to which capital surplus can be put. The proper treatment of the undistributed earnings of subsidiaries must be on the agenda, and the whole subject of the proper handling of debt discount, and the charging off of losses and expenses against a reduction of capital stock while earned surplus remains undisturbed. High up on the list must appear an item dealing with that excrescence, that abomination which charter-mongering states – corporation “Renos,” (inspired perhaps by the states competing for divorce cases), have put upon us in their “liberalization” of corporation laws. I refer to that kind of preferred stock which, let us say, is issued for \$50 a share, pays a dividend of \$3 a share, has a call price of \$52, is entitled upon liquidation to \$50 in preference and has a par value of \$40. The Company issuing it brings us the balance sheet on which the preferred is carried at \$40 a share and \$10 a share is carried to a paid-in surplus account. We have seen many such. The company’s lawyers tell us in written opinions that there is no restriction upon the use of this surplus, that it can be paid out to the common stockholders in dividends. Only one lawyer has filed an opinion with us that a court of equity would in such circumstances restrain the payment to the common stockholders of the \$10 capital contributed by the preferred stockholders. We are told we must accept the balance sheet in the form I have described because the law permits the unrestricted use of the surplus created in the manner I have described. The stock is a \$50 stock in every essential respect except the one which is of the least importance, the par value. Practices such as these menace the welfare of capitalism. Those responsible for them should take heed lest in winning too many such battles they lose the war. Many of you have had similar experiences where the accountant’s objection is met by the corporation’s lawyer who is called in to say that the law permits that to which the

accountant objects. The lawyer swallows or cooks up what the accountant gags over. A little more discretion in sore of the third houses would aid the cause of accountancy. These are not mere academic bookkeepers' arguments. They go to the very vitals of investment appraisal and corporate responsibility. "Accountancy," a famous French financier is reported to have said, "is government." It is the heartbeat of modern corporate finance.

Now for another step. For some time Mr. Neff has been engaged in the writing of one form designed to replace several of our outstanding forms. It will in principle – for there are minor exceptions – be available for all business companies having been in existence more than two years. It will be available whether the registration is for an original cash offering, for an exchange, or for a secondary distribution.

I sometimes wish it might turn out to be what it has jokingly been called: "The form to end all forms." It will take up anew the matter of the accountant's certificate. We are far from satisfied with many of the certificates filed with us. We think the accountant should state clearly his opinion as to "the financial statements of, and the accounting principles and procedures followed by, the registrant and its subsidiaries," as the instructions require. By "clearly" we mean "clearly" – we do not mean in language that only the expert accountant and the experienced financial analyst can understand. We do not want an opinion in a sort of cipher that would stump Francis Bacon himself. The two securities acts are remedial statutes designed for the protection among others of the unwary and inexpert. I think accountants should express their opinions in ordinary non-technical language and not in stereotyped phrases that few outside the accounting profession have the key to. "Subject to the foregoing" will not suffice. These thoughts lead to another question and that is what protection is to be afforded the accountant who is discharged because he will not stand for improper accounting? The Commission is anxious to

join in any proper effort that can be made to protect him. I suggest that perhaps the first efforts along these lines should be made by the accountants themselves. If we learn of such cases, we shall try to deal with them. There are questions in our forms designed to show changes in accounting methods and changes in accountants – but I think the next move on this issue is the accountant's.

The new form which is under way and the accompanying regulations, when submitted for criticism, will propose the following provisions, if present plans are not changed: viz-

- (1) That companies organized since January 1, 1928, give a complete segregation of surplus as between (a) paid in surplus, (b) surplus arising from revaluation of assets, (c) other capital surplus and (d) earned surplus. (This does not mean that the Commission approves revaluations in general.)
- (2) That for companies organized prior to January 1, 1928, the same requirements are to be included as at present, except that an additional segregation of surplus arising from revaluation of assets is included in the headings called for and if there is no segregation, the descriptive caption is to indicate all types of surplus included in any combined account.
- (3) Under the heading "Historical Information", which is outside the financial material certified by the auditors, there is to be required for each of seven years preceding the three year period reviewed by the auditor, a review of the surplus accounts, not an analysis thereof and not a review of the accounts from which balances were transferred to surplus. Some other changes from Form A-2 will be suggested. In general, they will be based on our experience with the old forms. This has shown them to be inadequate in some respects and too exacting in others. An effort will be made toward simplification,

but I cannot promise that it will be successful. In the face of modern corporate practices, of complicated inter-company holdings and inter-company transactions, of modern devices in corporation law, I can not promise that difficult involved situations can be described simply. The simplification of registration forms will ebb and flow in response to the simplification of corporate set-ups and practices.

As to other steps – the Commission will continue to refer to state commissions and accountant's institutes, those cases where it finds accountants willfully or knowingly, participating in the presentation of false statements and where it can not itself disbar the accountants from practice before the Commission. It will give a clearer definition of its acceleration policy, that is; the considerations which will influence it in permitting registration statements to become effective without waiting the full twenty day period after amendments are filed. By this means it will attempt to promote improvements in matters as to which it can not act by stop orders. Blough will continue his accounting releases. Neff will, I hope, persist in his efforts to induce lawyers to be terse. The Commission will continue to wrestle with prospectus requirements and will soon permit the use of much shorter prospectuses for well established companies. The Commission will not promulgate accounting classifications for operating subsidiaries of registered holding companies that are subject to state commissions or the Federal Power Commission. The Commission will continue its efforts to develop a body of accounting principles through its decisions. These and other future steps such as the accounting provisions of the O'Mahoney – Borah Federal Corporation Licensing Bill, will engage our attention as they will yours. The Commission is making a study of investment companies, pursuant to a Congressional mandate. When its report is made to Congress, it will include, I believe, a recommendation for control of accounting, exceeding that given by the securities act. Whether it

is wise or possible to go the point of establishing uniform classifications is yet to be decided.

The Commission will continue to recognize the propriety of the profit motive in our present system, the necessity of industry to acquire capital through the issuance and sale of securities, the impropriety of acquiring that capital, that is, other peoples' money, by misrepresentation or by anything short of fair and frank disclosure of all the important facts. We shall continue to seek and when it seems wise to rely upon the cooperation and advice of accountants, lawyers and representatives of industry. We shall try to be honest enough and brave enough to turn back when we discover we are on the wrong track. We ask you to recognize as we do, the difficulty of deciding many of our problems. We ask you to help us. We want you to write to us and to talk with us, to give us your advice and your ideas. You are largely free from bias or self interest or subservience to clients. As teachers of accounting, as students, as scientists in this complex business world of ours, your contributions can be of especial value. The task is worthy of the best there is in us. If it fails to bring us much money, let us remember as Emerson told the students at Dartmouth many years ago: "Truth also has its roof, and bed, and board."

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