

of an investment company—it requires the fullest sort of disclosure both at the time the write-down is made and in subsequent reports, so that the shareholders may correctly appraise the operating history of the company. Such events, however, have been treated quite differently by various companies, with the results I have noted.

I may refer briefly to a case in which a company had for a period of 13 years prepared financial statements, including a profit and loss account and earned surplus account which reflected not only dividends received and expenses paid but also the net profit or loss on its sales of portfolio securities. At the end of the 13-year period there was a very large deficit in the earned surplus account thus computed. It was proposed by the company to reduce the stated value of its stocks and eliminate this deficit and start over on the new basis.

This was not all, however. It was also proposed to create at the start a considerable amount of earned surplus. To do this the company proposed to go back and reanalyze all of its past operations, with the intent of determining the aggregate income from interest and dividends, deducting therefrom the expenses and the dividends it had paid. All losses on securities, instead of being offset, as had previously been the case, against the balance of surplus dividend income, would not be charged retroactively to capital surplus. As a result, the company would have come out with a large balance in earned surplus, by accounting for its operations in a completely different manner than had been followed for some 13 years. Presumably, too, its decisions during that time were based on the results that had been actually recorded in its accounts.

The treatment of dividends paid is of course largely a financial problem, and the accounting represents largely a reflection of what the financial policy with respect to dividends is. However, I might mention one accounting problem of dividends—the method of reflecting stock dividends paid. Even though the New York Stock Exchange has announced certain definite policies, practice varies—since most trusts are not subject to these requirements. In a number of cases, stock dividends may be charged to earned surplus at so small an amount that, although the investor receives a considerable amount of stock as a dividend, earned surplus is not reduced to an appreciable extent. An example of the misleading nature of this practice occurred when a company declared an optional dividend of 30 cents either in cash or, at the option of the shareholder, in stock. Of course, the charge to earned surplus for the cash dividends had to be at 30 cents per share. Dividends declared in stock, although presumably an alternative, were charged to capital surplus at 1 cent a share.

Before leaving the subject of prescription of uniform accounts, I should like to note in passing that section 31 (a), as contrasted with section 31 (d), is applicable not only to registered investment companies, but also to other types of affiliates of registered companies, such as managers, investment advisers, distributors, and principal underwriters. This section, as I read it, gives the Commission authority to require certain information to be kept by these classes of people.

With respect to subsidiaries which are engaged in a related line of business or which are performing management or investment functions for the investment trust, the ability to require particular information to be included in the accounts seems necessary to insure the observance of any classification of accounts established for the investment

trusts themselves. Moreover, in order to insure observance of a number of the provisions in the other sections of the bill, it is, I think, necessary to be sure that the records of affiliated depositors and so on are required to contain the minimum of information necessary for the proper administration of the bill.

One of the principal parts of the reports which section 30 authorizes the Commission to require of investment companies will of course be the financial statements. Financial statements included in such reports are the ultimate goal of the power to prescribe a uniform classification of accounts. A necessary adjunct of the classification sections is, therefore, the control of the presentation of the information required to be kept in the accounts. This is given in general terms by section 30 (a) of the bill. Some may inquire, in view of the examination powers granted by section 31, as to the need of a certification of the statements by independent public accountants. I should like to emphasize here that to my mind certification by independent public accountants would serve a very useful purpose. While perhaps the examination sections would give the Commission the power to make frequent and extensive examinations, I have not conceived of them as examinations of sufficient regularity or indeed of such extensive scope as to supplant the usual annual or quarterly audit by independent accountants. It seems to me that such annual or quarterly audit should contribute to efficient and careful management, insure observance of the classification through review of the accounts and business, and should serve its normal function of deterring defalcations, aberrations, and unintentional errors, as well as to detect them after they have occurred.

[Section 30 (c) gives to the Commission the power to prescribe the nature and minimum scope of reports to security holders or classes of security holders. This directly raises the question of the adequacy of reports to stockholders at the present time. I think there is no question that during the past 10 years, through the heightened interest in accounting and finance and particularly through the influence of the Securities Act and the Securities Exchange Act, there has been a marked and continued improvement in the scope and nature of the financial information reported to stockholders. While this improvement is clearly noticeable, there nevertheless remain a great many cases in which the reports do not measure up to what appears to be the average or indeed the prospectus standards of the Securities Act. I have recently, as I think I mentioned, looked over a number of the 1939 annual reports by investment companies. These ranged all the way from a 1- or 2-page leaflet to a 20- or 30-page booklet, naturally dependent to some extent on the size of the company. Looking at them physically, there was a wide variety of methods of presenting the information to shareholders. Also it was by no means possible, from the facts given, to compare the companies directly. There was a tendency, naturally, for companies in the same sphere of influence, either through the same management or the same certifying accountant, to be more or less uniform.

As between unaffiliated companies with different accountants, there were wide differences both in the mechanics and substance of the presentation. In some cases portfolios were given in great detail. In other cases there was merely a summary statement followed by a list of shares held, without an indication of the cost or market value

of any of them. In very few cases was there a statement of both the cost and market. While most reports displayed a statement of net asset values, frequently no mention was made of a class of shares which had a negative asset value by virtue of the preference of prior shares.

The variations in the methods of accounting followed, which I pointed out earlier, were of course reflected in the statements, and may be worth repeating here. To take one item alone—the basis of carrying securities—the following methods were found: Cost; market value as of a specified date with subsequent additions at cost; market; cost or market; whichever is lower; and “cost or less.”

While aggregate unrealized depreciation or appreciation was in all cases given, the manner of presenting it varied widely. In some cases it was treated as a collateral notation; in others, as the basis for a separate statement in comparison with realized profit and loss; in others, as a reserve; in others, as an adjustment from surplus. Depending on the method, a company whose securities had depreciated might show a large earned surplus, with only a note as to the depreciation; or it might show a deficit in earned surplus. Similar variations were found in the method of handling realized profits and losses on securities sold. In one case, profits and losses on the sales of securities on hand at a given past date were carried to one surplus account, while all profits and losses on securities acquired subsequent to that date were carried to another surplus account.

In some cases, exception to the methods followed by the company was taken by the accountants in their certificate; but the certifying accountant is not always in a position to force a particular company to utilize any particular set of accounting principles. While he may have strong convictions of what should be done, his alternatives are only to withdraw from the engagement, or, if he feels the variation is not too gross, to qualify his certificate in an appropriate manner. The building up of a professional approval of a group of principles would doubtless have a strong moral effect upon investment trust management, but the mere existence of recognized principles would not necessarily mean that they would be followed by all. Moreover, a feeling of confusion is inescapable, it seems to me, when the company follows one principle in its statements and when the accountants are forced to take exceptions thereto in their certificate. In some cases, the underlying trust indentures themselves prescribe accounting methods completely contrary to recognized practice.

Inasmuch as the most direct method of apprising the stockholders and prospective purchasers of the condition of a company is perhaps its annual or quarterly report, leaving aside for the moment the Securities Act prospectus, I feel that some measure of minimum disclosure as well as frequency of reports ought to be obtained for this type of company. It will be recalled in this connection that reports to shareholders are not directly covered by the Securities and Exchange Acts.

I should like next to mention very briefly one or two accounting problems with respect to dividends. As I pointed out earlier, accounting generally does no more than seek to reflect in the accounts the financial policy as to dividends. However, it must not be forgotten that to a very large extent the dividend policy is based on the results of operations as revealed by the method of accounting used.

Thus, incorrect methods of reflecting, in income or surplus, amounts representing the receipts of stock dividends, rights, profits on sale of securities, and the like, would inflate or depress the income account, and so might affect the dividend policy. Failure to provide for security losses or understatement of them would accountingwise result in earned surplus when actually there was none, and so dividends apparently paid from earned surplus might in fact be out of capital.

Section 19, as to dividends, as I read it, attempts merely to provide the recipient of a dividend with a clear indication of whether the dividend represents income on securities, trading profits which to a great extent may be dependent upon the course of the market in general, or a return of capital. It does not attempt, except by the asset ratio provision, to determine when dividends may or may not be paid. However, there is a good deal to be said, in view of the extremely liberal corporation laws, in favor of laying down some standards. The difficulty is, of course, in taking into account the differences between types of trusts. For example, ordinary income to a diversified company ought probably to be available for dividends, without regard to security profits or losses. In a trading company, however, it would seem that not only realized profits and losses on securities should be taken into account but also an appropriate provision for unrealized losses.

As between the open-end and closed-end type of companies, there perhaps should be other differences, since the former in effect are engaged in a continual process of paying out appreciation in securities, through their redemption policy. If there have been losses, of course the redemption price also takes these into account. Finally there is a problem, at least with existing companies, of having two or three issues of securities with varying rights and privileges. I do not see how positive dividend requirements can be drafted without taking into account different types of trusts, such as I have mentioned, and the existence of varying classes of securities. Such a dividend provision would, of course, be lengthy. Among other things, the present asset ratio provision would have to be adapted more precisely to the varying classifications, in view of the positive dividend standards. Another possibility would be to lay down a few general principles within which the Commission was to work out detailed rules applying these principles, in collaboration with members of the industry.

Section 32, you will recall, requires that the independent auditors be elected by stockholders rather than be appointed by the persons who are also directly responsible for the transactions which the auditors are reviewing. It seems to me that, under present circumstances, the independent auditor is reviewing the operations of the company, including the activities of the operating management, with the purpose of expressing an opinion on the financial statements to be relied upon by stockholders and prospective stockholders. It is important, since the statements are to be used by this class of people, that his responsibility to them be strengthened as much as is possible. This method of selection, it seems to me, will give the auditor a greater sense of direct responsibility to the stockholders and should confirm him in his role of advocating a full and fair disclosure of the facts, even though those facts may not be as favorable as some would wish. This method of electing auditors is not, of course, a panacea for all of the problems of providing good reports for stockholders. It

does, I think, point in the right direction. It has been widely recommended by various groups. There has been some objection raised to it, on the ground that the stockholders are not in a position to determine what accountants are professionally equipped in experience and manpower to deliver the necessary services. It may be that this could be overcome, quite simply, by requiring that any nomination by the management at the stockholders' meeting be required to be made by a nonmanagement committee of the board of directors, which would also be responsible for the details of the audit engagement, and would be required to receive and consider the report and suggestions of the auditors.

Section 32 (b) attempts to do much the same thing with respect to the principal accounting officer of the company. It requires him to be elected by the stockholders or by the board of directors. The principal advantage in this method of selection is that it establishes a direct source of information to the board of directors, as distinguished from the operating management. This principle has been endorsed, with respect to corporations in general, by the New York Stock Exchange, by the Controllers Institute of America, and by others. In any event, such procedure would, I think, aid in furthering a system of checks and balances, within the management, against abuses of direct mismanagement and minor and major defalcations.

The final section which I wish to comment on briefly is section 32 (c) (1). This section authorizes the Commission to prescribe the minimum scope of, and procedures to be followed in, any audit of a registered investment company. This, I think, is a very delicate question. I have not the least doubt that the prescription of minimum procedures and minimum scope would be useless if the auditors were incompetent or were careless and lacking in alertness and intelligence. In other words, an adequate audit is composed of two essentials: an adequate program and an intelligent execution of it. Moreover, in the great variety of situations which an auditor may be called upon to face, it is utterly impossible to prescribe all of the steps which he should take under varying circumstances.

It has also been said with a great deal of justice that the mark of a good auditor is the series of supplementary tests which he makes in view of having seen or discovered certain things, rather than his ability to follow a set procedure. To take one example of this, there is the question of checking or physically verifying the existence of the portfolio securities. It would be easy to require, let us say, that securities in all cases should be examined. If, however, a reputable custodian held securities for several trusts, physical verification might be less valuable than a confirmation by the custodian. Unless the securities were physically segregated or identified in some way so that substitution was impossible, the auditor would have little means of knowing, when certain securities were shown him, whether these were the securities of the trust under audit. Presumably he would not be able to audit at one time all of the securities held for several trusts. In cases in which physical confirmation is necessary, a great deal of its value depends upon the safeguards which the auditor is able to set up against substitutions of securities, double counting, and the like. Moreover, much of the value of the audit depends upon the evidence he may accumulate as to whether the securities have at all times been devoted to the uses of the company and have not during the period

been misappropriated for use as private collateral or otherwise. There is the one further danger, of course, that in any prescription of minimum procedures, the result is that a maximum scope will result.

On the other side of the picture, there have been a number of cases, although examples are relatively rare today, in which the auditor's examination of investment trusts has been less in scope, whatever the quality of the examination, than is reasonable and desirable. These cases would, I feel, be avoided by the prescription of minimum rules. Many of the difficult problems of the auditor would be solved by the existence of a uniform classification of accounts, since a great deal of his work lies in the field of expressing his opinion as to the accounting principles involved and in persuading the company as to what are the best principles to be followed. Also, as I have pointed out above, the problem of auditing an investment trust, in comparison to the audit of a commercial or industrial concern, is relatively simple, since the investment company's assets are few in number and have many common characteristics, its liabilities are limited in character, and the general problems of operation are simple.

For these reasons, it seems not at all impossible to prescribe a minimum procedure. This might be done, for example, by prescribing merely that a financial statement would not be accepted as certified unless certain required audit steps had been completed to the satisfaction of the auditor. To avoid giving the impression that what was prescribed constituted a complete audit program, the steps prescribed could be made so obviously a skeleton as to leave to the auditor that field in which his discretion is most important, namely, the selection or even invention of steps to meet special problems which he finds in a particular case. It might be satisfactory merely to have a general rule: For example, that a statement would not be accepted as certified unless the certificate of the auditors affirmatively represented that the audit made was not less in scope in any respect than that advocated by the accounting profession. Perhaps the rule might read that the audit was to be not less in scope than was necessary to present comprehensive and dependable financial statements.

Senator HUGHES. (presiding). The auditors who testified here before the committee seemed to think that they were a profession of high standards and regulations, and so forth, and should not be disturbed at all or regulated in any particular, or any suggestions made as to how they should do their work.

Mr. WERNTZ. Senator, I think they are a profession of high ideals.

Senator HUGHES. Yes.

Mr. WERNTZ. But I think we can assist them in policing their own profession, by securing to them these advances that they agree upon.

Senator TAFT. What is it you want to do about that? I have not looked at that part of the bill.

Mr. WERNTZ. I am not sure that the language in the bill as it is written is the best approach; but I think the Commission should have sufficient powers to insure that the term "certified statement," as filed with it, means certified upon the basis of an examination which auditors in general would believe was sufficient.

Now, Senators, we can tie that either to their own procedures or to certain minimum procedures that the Commission might adopt, after consulting them, or to some abstract standard, such as sufficient to present comprehensive statements.

Senator TAFT. Do you provide for an audit by the Government?

Mr. WERNTZ. We provide for an examination.

Senator TAFT. An examination?

Mr. WERNTZ. But I have not conceived of those as being sufficiently regular or necessarily as extensive as you would need.

Senator TAFT. I do not know; but I have been on a bank board where it almost seemed to me that the private audit was superfluous, with the type of Audit that the Federal Reserve Board today makes of a bank. The money paid for an outside audit seemed almost an unnecessary expenditure.

Of course, directors do want it, because they want to be sure what it says; but the stockholders of a bank rely entirely upon the Government's statement, really, in the end, rather than upon the private audit.

Mr. WERNTZ. Well, under these examination sections, I had not conceived of a regular or surprise basis of examination to that extent, but rather of special performance examinations, in view of violations and things of that sort.

Senator TAFT. I do not see the purpose of regulating private auditors if you are going to audit the thing yourself.

Mr. SCHENKER. May I say something, Senator?

Senator TAFT. Yes.

Mr. SCHENKER. That section with respect to examinations by the S. E. C. is not comparable to examinations by bank examiners. It had its genesis in the suggestion made by Earle Bailie, who is chairman of the board of Tri-Continental, that the most effective thing you can do is to have the power, if you suspect that something is wrong, to send somebody in to take a look at their books.

It does not contemplate regular examinations to see if their books balance, or anything of that sort. This is really a supplementary power to the investigatory powers of the Commission.

Here is what Mr. Bailie said, in his statement which he read at our public examination, and which he sent to his stockholders [reading]:

It seems to me that both the investing public and the investment company management would benefit from some method of providing assurance to the public and to shareholders that the provisions of any regulation are being adhered to scrupulously and carefully.

As a possible means of providing such assurance, I venture to suggest periodic verification of security holdings and review of transactions by a bureau of examination and audit, to be set up by the Securities and Exchange Commission for that purpose. The function of the bureau would be similar to that of the national bank examiners, in that it would verify security holdings and review the transactions of the investment company at periodic intervals.

Any report of criticism, based on such examination, would be sent to the directors of the company, for their attention and action; and the failure of the directors to take appropriate action within a reasonable time should permit the bureau to put its findings before the shareholders themselves.

I think he goes even closer to a national bank examiner's audit than we envision, Senator.

What we felt was that you just cannot tell, unless you have a chance to go in and take a look at the books, when you think something is wrong, really; and I do not think it is contemplated that we shall have the same type of thing that you have with the national bank examiner, and have a big staff of auditors to go and make an audit of the company.

Isn't that so?

Mr. WERNTZ. That was my understanding of the difference.

Senator TAFT. Offhand it seems to me more important than any of the rest of the bill; I mean that I would rather have that than all the rest of the bill put together—just from what I have heard here. It seems to me more likely to eliminate all these abuses than all the different kinds of regulations you can make.

Mr. WERNTZ. When coupled with the uniform requirements.

Senator TAFT. Of course, you would have to have uniform statements.

Mr. WERNTZ. That is what I mean.

Mr. HEALY. Do you mean the accounting regulation or the power?

Senator TAFT. I mean the right to inspect and the more or less periodical examinations and certification of the statement that goes to the public as an official statement guaranteeing that the Government has checked.

Mr. HEALY. If that were carried out well and quite extensively, I think it is entirely possible that you might consider at least dispensing with the work of private auditors.

Senator TAFT. I did not think so much of dispensing with the work of private auditors, but merely that if you did that, I did not see why you should bother with the private auditors. You can let them do as they please. You have rules that the auditors would have to comply with, and they are going to have to follow the rules that the Government inspectors certify; they cannot make the audit different. They may examine different things; but when they finally come out with their statement, they are bound to follow what the Government prescribes with respect to their statement.

Mr. HEALY. They are bound to follow what the Government prescribes in accounting; but if the bill is changed, they will not be bound to follow what the Government prescribes as to auditing; and the bill gives the Commission the power to prescribe the auditing.

Senator TAFT. I mean that I did not see what difference it made to the public. If the Government audits, it does not make much difference to the public how complete the private audit is. That is for the directors to determine.

It seems to me they would say, "We do not want a complete private audit; all we want is this thing covered, that that thing involved."

Mr. WERNTZ. There may be a different type of certification. That is to say, if the auditors have not made the type of examination which the profession itself believes to be the basis for such a certificate, then they may in effect be expressing an opinion without a satisfactory examination; and this provision is for that.

Senator TAFT. Do you have the S. E. C. regulating the auditors?

Mr. WERNTZ. No. We have this provision to the effect that certified statements are required; and then we have a brief rule which says that, in effect, it shall be the same as the industry requires.

Senator TAFT. The problem seems to be no different for the investment trusts than for all the other forms of security-holding and investment companies.

Mr. HEALY. The problem continually is what is an audit? That is the problem we continually are confronted with, in considering the statements we get. They say it is a balance-sheet audit or a detailed audit. There does not seem to be uniformity of definition.

However, under Mr. Werntz' suggestion—which I may say is acceptable to the Commission—that part of the bill would take some rewriting.

Senator TAFT. What is the section?

Mr. WERNTZ. That is section 32, I think.

Mr. HEALY. We have had so-called audits with certificates, where the auditors did not verify the portfolio.

Mr. WERNTZ. Page 73, line 17.

Senator HUGHES. They checked on the information given them about particular things, but they did not make a complete audit and were not certifying that they had done so?

Mr. WERNTZ. They very rarely make a complete audit.

Senator HUGHES. So, so far as the public was concerned, it was of no value at all.

Mr. HEALY. The question always recurs, "What do you mean when you say, 'I have audited'?"

Senator HUGHES. Yes.

Mr. HEALY. Nobody has ever given a completely satisfactory answer, that I have heard.

Senator HUGHES. While you are looking up that, I do not want to take you away from the subject of the audit, but I should like to say at this time that Senator Wagner has sent over to me correspondence that has passed between the Federal Reserve Board and the Commission, with respect to duplication of Federal supervision. There are letters and answers; and I suggest that they be put in the record for our information.

(The letters referred to are as follows:)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, April 22, 1940.

HON. ROBERT F. WAGNER,
*Chairman, Committee on Banking and Currency,
United States Senate, Washington, D. C.*

DEAR SENATOR WAGNER: This refers to your letter of March 15, 1940, requesting a report from the Reserve Board on the bill, S. 3580, relating to the registration and regulation of investment companies.

The Board is advised that the evidence submitted to your committee discloses the desirability of legislation which will provide for adequate regulation of investment companies in the interest of the public and in the interest of investors. It is understood that representatives of the Securities and Exchange Commission and of investment companies are submitting detailed comments to your committee with respect to the various provisions of the bill, and the Board will not undertake to comment on all of these provisions.

The Board has noted that enactment of the bill in its present form might result in duplication of Federal supervision of banks and holding company affiliates of banks. The Board feels that such duplication of supervision should be avoided and to that end representatives of the Board have discussed the matter with representatives of the Securities and Exchange Commission, and the Board and the Securities and Exchange Commission are in agreement that certain amendments should appropriately be made to the bill to avoid such additional duplication of supervision.

These amendments are described in some detail in the attached copies of correspondence between the Board and the Securities and Exchange Commission and are to the following effect:

Amend section 3 (c) of the bill by adding an additional paragraph as follows:

"Any holding company affiliate, as defined in the Banking Act of 1933, which is under the supervision of the Board of Governors of the Federal Reserve System by reason of the fact that such holding company affiliate holds a general voting permit issued to it by such Board prior to January 1, 1940; and any holding company affiliate which is under such supervision by reason of the fact that it holds