

DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: Problems in Accounting, Part II

Speaker: Mr. Andrew Barr, Chief Accountant
Securities and Exchange Commission

MR. BARR: This morning I intend to call your attention to some of the highlight cases in the Commission's history. Some point up matters of accounting principles, and others in auditing. I think that in the course of covering these I shall answer more fully one or two of the questions raised yesterday about what is an auditor and other matters of that kind.

We have been talking about principles. We noted yesterday that accountant's certificates today talk about generally accepted accounting principles. I should like to give you one reference, if you are interested in running down a discussion on that subject. There is a publication known as the CPA Handbook. It was edited by quite a large group of people from the American Institute of Accountants, the present Deputy Postmaster General, Mr. Maurice H. Stans, being the general editor. He did a very fine job. One chapter, written by Carman Blough, who was the first Chief Accountant of this Commission and now is the Director of Research for the American Institute of Accountants, is on the matter of principles. I have jotted down what he finds to be six guiding principles: One is that business as an accounting unit is separate from its owner. We deal largely with corporations and that is easy -- the matter of corporations. The same thing is true of partnerships. But when we get over into the broker-dealer area in the T. & E. Division, we have a lot of trouble with the individual **proprietor**. We try to keep his private affairs separate from his business.

Two, we assume that the business will go on, i.e., the continuity of the business unit. In other phraseology we would refer to it as the "going concern" concept. Our financial statements are not based on the theory that we are going to liquidate tomorrow. We expect the business to go on.

Three, we assume that the changing purchasing power of the monetary unit is not important. That is a point that is under severe challenge today, and I'll talk more about it later.

Four, we assume that operations of the business can be broken up into fiscal years, or even fractions of a year. We think it perfectly clear that the smaller that fraction, the less reliable the results; and we have had trouble in prescribing requirements for periods shorter than a year. Most of our real trouble in examining registration statements crops up in the interim period --

periods less than the full year -- and particularly if those periods are not certified. Another was to express that is that we match cost and revenue by periods.

Fifth, and this a long standing one, that accounting policy should be governed by conservatism. Some authors put it another way. "We anticipate no profits, and we provide for all losses." That results, in some cases, in what people praise as a conservative balance sheet, but may have just exactly the opposite effect when you get into the income statement. There is a famous case, the Kaiser-Fraser affair, in which all of the development costs were written off in one year and created a \$19,000,000 loss. The next year showed a \$19,000,000 gain. How must did the company earn in two years? That is an outstanding example of the difficulty **accountants run into in applying some of** these "rules of thumb."

Sixth, accounting shall be based on cost. That is still the accepted basis, although under severe challenge. The reason we have stuck by it up to now is that cost is subject to verification. We can get some objective evidence as to cost. If we deviate from that, we get into trouble.

That chapter by Mr. Blough goes on and discusses the challenges to these principles. If any of you have an interest in pursuing that further, that is the place to go for a very clear and short discussion. You can read volumes elsewhere, but that is a short summary of the whole thing.

Now for just a few cases that have made history. We got off to a fairly early start with a company called Unity Gold, which is a case that anybody here ought to be able to cite. It is found at page 25 of the first volume of the Commission's decisions.

This case had to do, as you might suspect, with a promotional gold mine, and established three things: one, that if you issue shares to promoters for promotional expense, you cannot call it property. It is what it is -- promotional expense. Two, if those promoters donate back shares which they actually receive for property, the property didn't cost the company as much as the total number of shares originally issued. The cost was only in shares actually retained by promoters. That concept was given expression in the American Institute of Accountants Accounting Procedure Bulletin later. There was no disagreement on that. We cited some of those textbooks that I mentioned yesterday in support of that principle. You will find an excellent discussion of that problem in Hatfield, for example.

Then a third point which was made in that case was that if the shares are par value shares and are issued and are recorded at \$1.00, but are selling at 15 or 20 cents per share, it is hard to **say that the property received is worth the stated number of shares at \$1.00. This principle has been applied in other cases. You look for outside evidence -- objective evidence where you cannot find it in** the actions of directors of the company. This technique was followed up in another case, which is a pioneer case, Brandywine Brewing Company, which is a pioneer case in one area. There again we had a mixture of promotion expense and property that had to be sorted out. The Commission in that case said that the fact that the directors acted in accordance with state law and claimed that these shares which were issued at \$1.00 per share made up the property received and was equal to the number of shares multiplied by \$1.00, could not foreclose the Commission from looking behind all of that to see whether the company actually got that

much in dollars. In other words, we don't take the statutes as binding. We look for evidence. This question cropped up again in the more recent case of Thomascolor, in which we, in effect, said that directors cannot meet in a hotel room and say that the patents are worth \$2,000,000 when there is no idea at all whether they will ever be successful and the cost to reach the stage at which the company went to the public was nowhere near the \$2,000,000. All these are things we have to watch for in promotional companies.

Some of those early cases like the Unity Gold case led to the adoption of a form for promotional companies in the method of expressing the accounts in such forms. You will see the result in our Forms S-2, 3 and 11, and the accounting parts are brought together in one package in Article 5A of Regulation S-X. So if you hear somebody talking about the 5A method of presentation, that is Regulation S-X Article 5A in which we say that you cannot put a dollar value on the properties that are received in exchange for original issue of stock in a promotional company. What we do is to describe the property and show how many shares of stock were issued for it, and we don't multiply it out in dollars. We don't get a balance sheet that will balance, and we let the story in the prospectus say what all this is about.

That seems like a revolutionary idea, but it was used many years ago in Texas Pacific Land Trust. I don't know whether any of you here are familiar with this situation. Years ago that company published a statement which showed just the working capital items in dollars, the rest of their property was in millions of acres of property in the southwest and in numbers of town lots. Nobody knew what it was worth. More recently you read something about it. I have seen the practice applied in one other published report to stockholders, but we have applied it here in all these promotional companies with some success. It avoids an argument as to whether a million shares of \$1.00 par value really brought into the company a million dollars worth of assets. We don't have to fight that out any more in the promotional stage. The problem arises when the company gets into operation. That is something else again.

We have had other significant cases. I might mention the Health Institute case as an example (Accounting Series Release No. 68). There we said the appraised value of a piece of property was not a good basis for a balance sheet when all of the objective evidence was to the effect that instead of being worth \$100,000 which was the measure in par value of shares issued, the property had been bought for around \$15,000, and the assessor said it was worth only about \$2,500. We said it didn't look like **\$100,000** to us.

Another interesting case for examiners and others who are interested in the problem is the Drayer Hanson case. The quickest place to find that is in Accounting Series Releases 64 and 67. That involves verification of inventories largely work-in-process inventories. Any of you who have been here very long know that the inventory problem is one of the toughest ones. This case gave us an opportunity to say some things about the verification of inventory. It was a post-war problem of a company moving into the air-conditioning business, a lot of difficulties arose as to determination of the amount to be shown for inventories. I won't go into the details any further.

I might have mentioned a recent case, that Mr. Blackstone knows a great deal about, on the question of values of properties, that is Great Sweet Grass. The promoters got together and issued shares for a collection of property and turned it over to some one else. Something that

had cost the promoters around \$2,000,000 was shown on the book at \$6,500,000. You will probably hear more about that.

There is another important pioneer case in the development of accounting policy dealing with a basic accounting problem -- distinguishing between capital and income -- that ought to be mentioned. In the Associated Gas and Electric case, a pioneer case in this area, the accounting was so confused that there were some charges made against capital that should have been made against income; and the Commission had a great deal to say about this inadequacy.

One point I haven't mentioned. We have developed the concept in a number of these cases of "arms-length" dealing. The Thomascolor case which was the promotion of a color photography device goes into some depth on that subject. We said, in effect, that the \$2,000,000 I mentioned, was a purely arbitrary figure. There was no arms-length dealing, although Thomascolor's accountants and experts insisted that there was evidence of it, we couldn't find it. We thought all the people involved were acting together and the transfers from one corporate entity to another were not at arms-length. It's a very involved set of facts and I won't attempt to explain all of it. I bring it to your attention as a place where you can find a discussion of that arms-length problem. You will find the accounting aspects of Thomascolor reported in Accounting Series Release 73. That was about six years ago. There is the case reported in the Decisions, and then there was a disciplinary proceeding against the accountant pursuant to Rule II(e) of the Commission's Rules of Practice. The 11(e) proceeding is published in Accounting Release 73. We said in the Thomascolor case that the accountants should have paid more attention to some of the cases I have cited. They should have known our history of practice and policy. They disregarded all of that in the accounting that they sponsored in Thomascolor. Those accountants were suspended from practice here for ten days. That created quite a problem for them and for their clients because they were a big firm. It is not a **matter** to deal with lightly.

Suppose I move right on to that question of auditing and the independence of accountants. Some one asked yesterday what was a professional accountant. Professional accounting in this country is 60 years old. The Pennsylvania Society celebrated its 60th anniversary this week. The New York Society is also 60 years old, but is not having a special celebration. The Society of Chartered Accountants in Scotland had a celebration of its 75th just a couple of years ago. The accounting profession got started in this country because of a desire on the part of British investors to have an independent review of the companies in which they had invested in this country. The profession started by a migration of Scottish and British accountants to this country. They have developed as a profession with a desire to do an independent, objective review of the accounts of their clients.

Much professional accounting work is done for the benefit of bankers, and in the last 60 years for public investors. When accountants get through with their examination, they furnish a certificate or a report. Now if they are doing work just for a closed corporation, for the management only, they will tell the management from an outside point of view as to whether their accounts have been kept properly. They may accept some restriction on their auditing procedures. We don't recognize any restrictions on auditing procedures. It doesn't do too much harm if the contracting parties know what is going on and the statement doesn't go beyond them. The Institute has published a bulletin in its auditing series covering the circumstances under

which an accountant may give an opinion, a qualified opinion, or must take exception, or should not give an opinion at all. You will find the subject covered thoroughly in Auditing Bulletin 23.

In our work we have developed a concept of independence and a definition of who is an independent accountant to a greater extent than the profession. We are a little more stringent about it. Some accountants argue that independence is just a matter of a state of mind. "I know I'm independent. I know I'm not going to be swayed by any of the officers of the corporation or any pressure from the directors, or any pressure from anybody else. I'm going to give a fair review of these accounts and say what I think." That's the state-of-mind argument. We say that for our work and under our laws we should remove any outside evidence that the state of mind might be influenced in some way. So our rules state that an accountant may not own any securities of a client. He may not be a director, officer, or voting trustee, promoter, underwriter - have any of these relationships with his client. There are failures, of course, in the accounting profession as in any other profession. There are marginal people in any walk of life. I think, on the whole, we have been very successful in our reliance on the accounting profession.

Now some of the cases: One of the early ones was Cornucopia Gold Mines. We said in that case that the accountant who was both a director and owned stock could not be considered independent. The certificate there was not the kind of certificate demanded by the Act. His statements were therefore not certified statements. I don't have to cite a lot of these cases because you will find them all summarized in two accounting series releases: Accounting Series Release No. 22 and Accounting Series Release No. 47, which brings the discussion up to date and gives some administrative rulings on independence.

Now for two or three cases involving auditing. Resources Corporation International is found in volume 7 of Commission's Decisions on page 189. This case involved a fraud based on alleged mahogany timber lands in Mexico. The balance sheet said the **timberlands were** worth \$9,000,000. The accountants wrote a long certificate and **said they** didn't know whether the lands were worth \$9,000,000 or not and they had no idea what they were worth. The total balance sheet was just slightly over \$9,000,000, and that decision laid down the rule that if the exception is so extensive that the certificate, in effect, doesn't certify anything, it is no certificate. We cannot take it. There were assets of about \$35,000 out of the total \$9,000,000 involved that were covered by the certificate.

Interstate Hosiery you will find in volume 4 of Commission's Decisions on page 706. That was a peculiar case in which an employee of the accountant, for some reason never discovered, made a lot of entries on the client's books, falsified the reports and made the income look better than it was. Why he did that nobody **has ever** found out. But it gave us an **opportunity** to say that an accountant **cannot** review his own work. We had a lot to say about the inadequacy of the partner **review in** the case, but the basic principle laid down there for the first time in clear language is that an accountant is expected to come in and review the work done by management. The accountant cannot do the bookkeeping and then come in and review his own bookkeeping. We expect a double check, that is why the accountants are hired. The basic point in this case is that the financial statements are those of management, and the accountants must make an independent review of them.

Another case is A. Hollander & Sons, Inc. (Securities Exchange Act Release No. 3073). This company was a fur processing concern out of Newark, I think. There, through some slip in our administrative processes here, the decision in the case is published, but the subsequent 11(e) proceeding on the accountants is not published. It is not in the bound volumes. In that case the accountants stipulated all the facts in the other case and agreed to a suspension from practice for three months. There we said **it wasn't** any single thing that made the accountant not independent. It was the accumulation of a lot of things. The accountants had tolerated some false accounts on the books to cover up some transactions. They didn't take vigorous action to see that it was stopped. We alleged that they were subservient to management in that respect and in the presentation of some of the accounts on the balance sheet. There had been some lending of money back and forth between the accounting partners and officers of the company. We said that they were too tight a little group and we couldn't hold the accountants independent. There would have to be other accountants to do the job.

A very famous case all of you must have read about, especially those of you who read the New Yorker's review of the case about a year ago, was the McKesson & Robbins affair turned up in December of 1938. The summary of the Commission's report on that case is found in Accounting Series Release No. 19. **The report** is about 500 pages and the supplemental volume of expert witness testimony runs to another 500 pages. It is that case that led to the adoption by the Institute of a policy of publishing releases on auditing, the auditing series of bulletins. The first one was known as Extensions of Auditing Procedures No. 1. That one was put before the Institute at its annual meeting in San Francisco in 1939. About the same time the New York State Society adopted a similar rule. What was missing in McKesson & Robbins was about \$21,000,000 worth of inventories and receivables out of a balance sheet of about \$78,000,000. We thought that was a substantial **discrepancy** and one that the accountants should have discovered before it got to such size. The accountants had not observed inventory taking, made no physical test of the inventory, and had not confirmed receivables. The testimony that we took indicated that possibly they were not too far off in many of their auditing procedures from the general practice of the day. The partner in the case was an old English accountant, and he testified very vigorously on the stand that he would have been worse off had he looked at the inventory because if he had looked he would have been deceived just as well, and therefore he shouldn't have looked. We didn't take that. We said that it should be generally accepted auditing practice to get some physical contact with the inventory.

There are problems of inventory verification, as any accountant knows, but even in that case in the branch wholesale houses around the country the same accounting firm's offices in other parts of the country did observe inventory. So their practice wasn't uniform in their own firm at the time. But now it is generally accepted practice to observe inventory taking, or by some other device obtain physical contact with the inventory and know it is there. Also it is generally accepted practice to confirm receivables. By that we mean a direct contact with the customer -- the person who owes the money. It was argued, and as time goes by people who don't know about this case say that all you need to do is to see that the money is received and put in the bank. The trouble in that case was that the books were absolutely perfect, the money was reported as collected -- every bit of it -- and was put in the bank, but it wasn't a bank and they didn't learn that it wasn't a bank. The accounting just went around a beautiful circle. To the extent that any actual money was lost, it was drained off in very small amounts -- not more

than a couple of millions of dollars disappeared actually, as far as we could determine. That went to pay Mr. Coster's friends who knew who he was before he became Coster -- **that seems to be the story**. That set rolling this series of auditing procedure **bulletins that we think have had a very** salutary effect on the practice of the profession. We think it puts our auditing practices in this country ahead of those in foreign countries. Some of the expert witnesses went on the circuit and lectured all over the country on the subject, but I see evidence today that we ought to do some more lecturing. Some people think that something less than all this is adequate.

Let me cover two or three points today that I'm sure you will read about in the papers or hear conversation on as current debatable problems. "Good will" is one. Mr. Blackstone asked me to say something about good will. Good will in the formative stage of the big corporations in this country has been described by the financial writers as "water". You have heard of watered stock. That gives good will a bad name. The Commission has endeavored to get that sort of good will out and by our present policies not let it get in. But if good will is bought and paid for at fair consideration, it has value. That presents an accounting problem. We have one release on the subject, Accounting Series Release No. 50, in which we say that you cannot write off purchased good will against capital surplus. If you are going to write it off at all, it has to go against earned surplus or through a timely program of amortization. Personally I think it ought to be amortized, but some people don't agree. So it is not a settled question. We think that our Release No. 50 was ahead of the times so far as the Institute's practices are concerned. They got out a bulletin recently that joined us in saying that you cannot write it off against capital surplus. They say that some kinds of good will have permanent value, therefore you don't have to write it off at all unless you get some evidence that there is a loss in value. But it is all right if you want to adopt a program to amortize it. Where we have an opportunity to discuss it with a client and the accountants we urge amortization, but we have not taken the position adamantly that it has to be amortized where there is perfectly good evidence that it has value bought and paid for. That is still in the area of debate.

Depreciation and taxes. I won't take time to explain all of that. You have heard of accelerated depreciation; you have heard about certificates of necessity; and you are probably aware that in some areas of accounting, accounting is done one way for tax purposes and another way for corporate reporting purposes. If the differences create an important effect on the reporting of earnings year by year, we think an adjustment ought to be made. That is still in the debateable stage in some circles. There has been an attack on the I.C.C.'s accounting because they won't permit the adjustment to be made. There was an application made over there for a change in their rules which the I.C.C. turned down. That was brought by an accounting firm.

Mr. Blackstone also asked me to mention depletion briefly. There is another place where the allowances for tax purposes differ from corporate accounting. In extractive industries where depletion can be measured, it is usually accounted for on a unit of production basis, based on allocating the cost of the properties on a basis of an estimate of the number of tons or other units of ore that can be taken out of the property. Of course those estimates have to be changed from time to time and the rates changed from time to time. Tax laws give a benefit through what is known as percentage depletion. That varies with the strength of the representations made by various oil and mining interests: oil gets 27-1/2%, some other minerals **get 23%**, 17% and other

rates. Those are pure tax concessions. Some of them carry a limitation that the deduction cannot result in more than half of the net. That is why you see in the case of an oil company a very low relationship between the taxes paid and the amount of income before taxes.

In the nonferrous metal industry there is a difference of opinion among accountants as to whether depletion has to be recorded at all. A recent filing by Anaconda Copper, some of you may have noticed, showed income before depletion. They said that not taking depletion was in accordance with the general practice in the nonferrous metal industry. The practice is sufficiently common that we took no exception to that method of reporting. The reason for that is that in copper, lead, zinc, gold and silver, it is very difficult to determine what the reserves are, and the amount varies with the price you can get for the product. Low-grade ore can be sold if the price is high, and has no value whatever if the price is low. That is part of the difficulty in arriving at any meaningful measure of depletion in that area. Some people insist that some token charge ought to be made anyway, and some of the companies do it. But it doesn't have a very significant relationship to earnings. Analysts writing on mining companies say that each individual investor ought to compare his costs with what the company reports and not worry about what the company's bookkeeping shows. The investor should figure out a depletion charge for himself based on his cost.

We have some problems in the area of consolidations. I can't explain the principles of consolidation to all of you in five minutes. We have had some debates -- there are problems as to whether foreign subsidiaries ought to be included. That is usually tied to the foreign exchange situation. If the funds cannot be brought into the home office because of foreign exchange control restrictions, it is usually unwise to include the foreign subsidiary in consolidation. There are some industries that feel they have to bring it in in order to show really what they are doing. There are some companies that make full consolidation and then back out of the income statement the amount of the earnings represented by unremitted funds to measure net profit. General Motors did that.

We have had some trouble in the past with problems of finance and real estate subsidiaries. Most of the big finance companies that are subsidiaries of heavy industries are not included in consolidation. That has been a debatable subject. In the chain stores we had a real estate problem. I think it was Safeway or Allied -- I have forgotten which one -- Safeway doesn't own its furniture and fixtures or its automotive equipment, or any of its stores directly. They have subsidiaries which own such assets. They threw all of those subsidiaries out, and we said that wouldn't go. It was not a fair picture of the business. You couldn't say that you are running a store without any counters, and without any trucks, and without a building to house the merchandise, when in fact all of these were owned by subsidiary companies. We said there you have to put them into consolidation. They complied but they publish it about three ways now. The primary motive **there** was to get the debt off the balance sheet. They just don't want to show the heavy debt that is incurred to buy the buildings and the fixtures, in some cases -- all of it mortgaged. We think that is an unfair presentation and have objected.

We have had a lot to do with proper accounting for pensions. Pension are still a debatable problem, as to how to account for pension costs in industry. At one time companies were not even recognizing the liability for pensions that were irrevocably committed to retired

employees. We have insisted that this be accounted for and a recent bulletin of the Institute has caught up with us and says that ought to be recognized. I won't expand on that any further, but leave that in **your minds** as a debatable area, even today.

We have trouble on stock options. We have seen the Institute adopt the bulletin which we thought was right and expound the theory that there was compensation involved in most of these stock options. Then a case came along that seemed to make that look a little ridiculous. Consolidated Engineering had issued a stock option at \$5 when the stock was selling at \$3, and when the restricted stock option tax law came into being they just happened to have a program that fitted into the law. The price went on up to \$23 or \$25, people exercised the options, and by measuring compensation under that bulletin and our previous theories, it absorbed about 40% of the income. The president of the company came around and said it was absurd. "The better I do, the worse I look." That gave the Commission and the Institute a line of departure to review the whole thing. There were three different ways to do it advocated by various accountants. So our rule, which you will find in Regulation S-X in one of the subparagraphs of Rule 3-20, is full disclosure. You will find some remarkable disclosures in some of those notes of benefits to officers of corporations through the stock option plan.

The last item in this series of current accounting problems is the one of changing price levels. I mentioned in my series of generally accepted accounting principles that we don't recognize change in price level. There is a very vigorous minority of accountants and businessmen who say that present reporting practices are behind the times, that we are not reporting proper income. It is not a new subject. The first work on it, so far as I know, in book form, was written by a man named Henry Sweeney. He called it **Stabilizing Accounting**. That was back in the early 1930s. The American Accounting Association, a group of professors, got a grant of funds to study the problem, and their reports have just been published that **past year**. Four corporations contributed their own records, their staffs, and the cooperation of their independent accountants to work with the committee making the study. There is a little primer that goes along with it as to how it is done -- how you make adjustments to change in price level.

The most significant general review of this whole problem in the last ten years is reported in the book, Changing Concepts of Business Income. The Rockefeller Foundation provided the funds in cooperation with the American Institute of Accountant and others. A committee for a study of business income was set up, and that committee included leading economists, lawyers, practicing accountants, teachers of accounting, corporate executives, and representatives of labor unions. They held repeated meetings, wrote draft after draft. They broke it up in sections. The economists wrote a preliminary report; Arthur Dean handled the legal end of it; and the accountants -- George C. May, the retired senior partner of Price Waterhouse, was the moving force behind it. The chairman of the committee, his successor as senior partner of Price Waterhouse, Percival Brundage, is now director of the Bureau of the Budget. That document went all through this question of changing price levels and what ought to be done about it. They conclude, after a great deal of study, that for the present it may well be that primary statements of income should continue to be made on bases now commonly accepted. The corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate the determination of income measured in units of approximately equal purchasing power, and to provide such information wherever it is practicable to do so as part of the material upon which

the independent accountant expresses his opinion. I forgot to mention that there were chief accountants of three Government agencies on this committee -- this Commission, Federal Power Commission, and Federal Trade Commission.

That subject is still alive. You will hear more of it this year -- perhaps a great deal about it this year. There is one telephone company in Indiana that got an order from the Indiana Commission to introduce price level adjustments into their accounts, report on that basis, and to use it for rate purposes. The Illinois Commission permitted Peoples Gas, Light & Coke Company to use it for rate purposes, but did not permit them to introduce it into their accounts. It is something that we have to consider because of its increasing importance.

I should like to wind up with comments on how we work around here. I should like to leave the idea that so far as I am concerned, and I have had some experience in cooperating with lawyers, examiners, and others in the Division of Corporation Finance, that I don't think you can pigeonhole our work and say the lawyer does this, the accountant does that, and the examiner does another thing. We are a team operation, and that goes beyond the Division. We cooperate with the other Divisions, and we get cooperation from other Government agencies where necessary. Some of you know that we follow the practice of sending prospectuses over to C.A.B. or F.P.C. and we have direct telephone contact with the people who know something about those companies that are jointly under our jurisdiction for one reason or another. We get a great deal of help from that kind of cooperation. It comes on down into our own daily work here. We have a directive, Administrative Procedure Memorandum in the Division of Corporation Finance, that in one area in particular, the summary of earnings, that table many of us think is the most important single item in the prospectus, is the joint responsibility of the financial analyst and the accountant. I think that is the way it ought to be. I had something to do with the writing of that memorandum and emphasizing that point. The financial analyst may bring an entirely different approach to that thing than the accountant who is looking for technical matters. An accountant ought to be an examiner and an analyst, but I'm willing to concede that a financial analyst may have a different approach to it.

I should like to use that as a springboard for saying that examiners and lawyers, if they see anything in the documents they are reviewing that suggests to them there may be an accounting problem, ought to bring those problems to the attention of the accountant. The accountant in the section is accounting advisor to the group as well as having his own chore of reviewing financial statements. Under our present pressures the summary prospectus is doubly important in requiring very close relations between the lawyers, the examiners, and the accountants. Some of our clients bury that summary prospectus in the material filed and neglect to say anything about it in the covering letter. Occasionally the covering letter which mentions the summary prospectus gets into the hands of someone who doesn't realize what it says -- who lays it aside as a routine document to look at later when he has time. There may be a summary prospectus buried in there that the client wants day after tomorrow. We realize that summary prospectuses cause trouble. We have to give service on them. But in order to avoid making a serious mistake we must look at the underlying financial statements, at least see what is in the notes and make sure that the summary of earnings and capitalization table in the summary prospectus are in good form and don't omit any material fact. We have **had some** trouble as to what kind of notes should be included. When you separate the summary of earnings from the

full financial statements you have the problem of whether there is anything buried in the notes in the full prospectus which should be mentioned in notes in the summary prospectus.

We had better get the gist of any serious note comment concerning the full prospectus into a note in the summary prospectus. These are the things that require immediate attention on the part of all of us. Frequently we can detect a serious flaw, particularly in the unaudited interim piece of a summary. On new companies we have trouble. I don't think there have been many summary prospectuses used on new companies. But let me urge you to look at that quickly and let the accountants have a look at it just as soon as it gets in. **Then** put your heads together and make sure that you hit the high spots at least -- anything that might cause anybody to get a misleading impression of the company should not be allowed to get out.

In connection with the summary, there is one thing that may be of interest to new people. We don't have time to cover all the things here. We had a lot of trouble with Kaiser-Fraser on their registration statement some years ago. Kaiser sued Otis for 17-1/2 million dollars because Otis did not go through with the financing. The District Court allowed Kaiser \$3,120,743.51. It was appealed as you can imagine. On appeal, the higher court reversed the District Court on the ground that the summary of earnings was misleading and denied any recovery to Kaiser.

Out of that case grows the requirement that you find now in Instruction 5 to Item 6 to the summary of earnings in an S-1. We extend that over to similar summaries in proxy material: that there must be a representation that all adjustments necessary to a fair statement of those unaudited interim periods have been made. We must be furnished with a letter itemizing all the adjustments that have been made other than normal recurring accruals. Normal recurring accruals in accounting contemplate the normal accruals for depreciation, interest, provision for bad debts, and things of that kind. They are regular procedure in developing a proper income statement. I will just cite one episode in connection with that rule. We had a conference one day over a proxy filing, in a textile company. The lawyer for the company came in. Mr. Orbach, in his penetrating way, asked a few questions about inventories. Our conferees aid, "Excuse us, we will come back after lunch." After lunch they reported that they had adjusted the inventory down by \$400,000, which in that company was substantial. We had told them that this rule applied. I am satisfied that it has forced management to make a more careful review of what they are **turning in than they** had done in the past on unaudited material. So it has had good effects.

Let me now give you one warning: Don't any of you sign to take the CPA examination on the basis of these two hours.