

THE ROLE OF THE ACCOUNTANT IN THE
RESTORATION AND MAINTENANCE OF PUBLIC CONFIDENCE
IN THE CAPITAL FORMATION PROCESS

Address by

JAMES C. SARGENT
Commissioner
Securities and Exchange Commission
Washington, D.C,

before the

HAGERSTOWN CHAPTER
NATIONAL ASSOCIATION OF ACCOUNTANTS

Greencastle, Pennsylvania
October 15, 1959

To get here tonight, I had to perform something of a billiard shot. On Sunday I left our home in Chevy Chase, Maryland to drive to Philadelphia to attend the National Association of Railroad and Utilities Commissioners Convention, which has been taking place there during this entire week. Wednesday I had to be in New York, and I drove down here from New York today. Let me assure you that it gives me great pleasure to be here and to address you. Because you are accountants, I think it most important for me to be here in order to tell you something about the Securities and Exchange Commission and the significant role which accountants generally play in the proper functioning of our capital markets, which in every sense, lie at the root of our capitalistic economy. Unquestionably, there are areas where the SEC's jurisdictional scope is not familiar to many of you, and I would like at the outset to give you in rather thumbnail fashion a cursory review of the six statutes which we at the SEC administer, and also to tell you a little bit about our participation in Chapter X proceedings under the Bankruptcy Act.

The Congress adopted the first Federal Securities Law in 1933. This statute is known as the Securities Act of 1933. Its basic thrust is the requirement that corporations seeking to raise capital by the sale of new securities to public investors disclose all the underlying facts, financial and otherwise, of the particular corporation, so that public investors would be in a position to determine for themselves whether the securities to be offered meet their particular investment needs. In addition, this Act was designed to make unlawful the use of fraudulent devices to sell securities. From the standpoint of an accountant, the '33 Act specifically requires that the corporation, before offering its securities for public sale, file a registration statement, including a prospectus, in which all these factual disclosures are made, and which includes certified financial statements.

The second securities law is the Securities Exchange Act of 1934. This Act created the Securities and Exchange Commission as an independent Federal regulatory agency composed of five bipartisan members. Each member, of course, is appointed by the President for a term of five years, by and with the advice and consent of the United States Senate. These terms are staggered, with one term only expiring each year. Incidentally, the first five Commissioners were sworn into office in early July of 1934, so that the Commission is currently celebrating its Silver Anniversary. The '34 Act requires that all national securities exchanges, of which there are now 14, must register with the Commission; that companies listed on these national securities exchanges similarly register and file annual, semi-annual, and periodic reports. Listed companies must file their proxy solicitation material before they solicit stockholders' votes. In addition, the Act specifies that certain unlisted companies which have filed registration statements under the 1933 Act must undertake to keep up-to-date those registration statements by annual filings under the 1934 Act. In other words, listed companies and companies which have previously filed 1933 Act registration statements must make public filings of information about themselves, including in most instances certified financial statements on an annual basis. In addition, the Act requires that brokers and dealers in securities must register with the Commission, and in most instances, must file certified financial statements once in each calendar year.

The third Act passed by the Congress was the Public Utility Holding Company Act of 1935, which, as the name implies, is the Act which regulates the public utility holding company systems. Perhaps the most significant feature of this Act is Section 11, the so-called death

clause, which required the dissolution of large electric and gas holding companies which lacked physical integration as public utility systems. Today there are some 18 systems containing operating companies with total assets in excess of \$10 billion.

The fourth Act was the Trust Indenture Act, which complements the 1933 Act, except that it applies to indentures pursuant to which corporate debt securities are issued. Thus it requires that certain provisions be incorporated in the indenture to assure public investors, for instance, of the trustees' independence from management.

The last two Acts were both passed in 1940. As you probably know, the Investment Company Act regulates the publicly-held investment companies, including the mutual funds, and the Investment Advisers Act attempts to regulate persons who are selling investment advice to the public.

In addition to these six statutes, we act in an advisory capacity to the Federal District Courts in reorganizations under Chapter X of the Bankruptcy Act. In almost all areas of our functions we necessarily come in close contact with the accounting profession I suppose it could be said that at the heart of financial reporting and disclosure in the capital markets lie sound accounting principles, for there can be full and complete factual disclosures only if there are responsible accountants and dependable audits.

Ever since the Commission was formed in 1934, it has worked very closely with the accounting profession, including the accounting educators, and together we have bent our joint efforts to the development and acceptance of sound and generally accepted accounting principles and practices. The crowning achievement of the close relationship which has existed between us over the years has been the general acceptance by corporations seeking to raise capital through the public sale of their securities of sound accounting procedures and reporting techniques. Certainly, your profession has played a great part in the establishment of a sound code of accounting principles in their application to the registration and filing requirements of both the 1933 and 1934 Acts, as well as under other Acts which we administer. It is my fervent hope that your profession will continue to effect financial disclosure of the highest and most reliable type. Without you and your efforts in this area, disclosures would be literally worthless. In a very real sense, the Securities and Exchange Commission's accounting rules and regulations, especially Regulation S-X, represent nothing more than a codification of the best practices followed by leading professional public accountants during the period of our 25-year history. We, as a regulatory body, have been given a great deal of credit for the success achieved in getting corporations to tell their whole story before they sell their securities to public investors. It is my humble belief that much of this credit and success is directly attributable to the fine cooperation and assistance which we have enjoyed with members of your profession in the development of generally acceptable accounting principles. It seems perfectly clear that since 1933, there has occurred what can be referred to as a great evolution in corporate accounting standards and principles so that today, American public investors accept practically without question the accuracy of financial reports certified by independent public accountants.

In order to get to the topic which I have been asked to talk about today, it would seem to me to be appropriate to compare generally market conditions that existed prior to the Securities

Acts with those conditions existing today. For that purpose, I would like to take you back to the period prior to Black Thursday in October of 1929 when the stock market crash occurred. Even before that crash, there were many indications of unsound economic policies and procedures. A mere reading of the Federal Trade Commission study commenced in 1928 pursuant to a Senate resolution would recall to many of you a number of financial abuses which permeated the capital market processes and emphasized the need for some type of reform. These included inflationary write-ups of assets, acquisition of properties at grossly inflated prices, excessive issuance of debt securities secured by over-valued properties and assets. There are also instances cited where the management was preoccupied with financial maneuvering predicated essentially on upstreaming of subsidiary earnings to the top-heavy holding company parent to support the excessive dividends and interest necessary to maintain market acceptability of the holding company's securities. In addition, there were indications that a great deal of securities trading was based on inside information, hot tips, or purely speculative "get-rich quick" schemes. There was often little disclosure of the basic financial facts and figures of such companies, since such figures could not stand the light of fair disclosure. These situations could not last, and they didn't.

Few people remember that the value of all stocks on the New York Stock Exchange as of September 1, 1929, stood at \$89 billion. By the middle of 1932, or some three years later, this total aggregate value had fallen to \$15 billion, or to one-sixth of the 1929 market value. Certainly no figures could more aptly illustrate the completely demoralized capital formation process, in which investors' confidence in the integrity and honesty of the capital markets had almost completely disappeared. There were equally spectacular losses in the bond market and in international securities. In a very real sense, activities in the securities market had almost come to a staggering halt. There were few people in the midst of the great depression who considered a corporate security, be it of the debenture or equity type, as a proper medium for investment. American public investors took whatever money they had out of the market place, and put it in savings banks or sewed it up in the proverbial mattress. In contrast to the statistics of the value of stocks in 1929 and 1932, the value of all stocks on the New York Stock Exchange as of June 30, 1959, stood at \$298.8 billion.

As already noted, the Securities Act of 1933, which has often been described as the "Truth in Securities Act," was the first attempt by Congress to effect some regulation of the securities markets in order to alleviate the demoralized effect which this financial collapse had caused. It was followed in 1934 by the Securities Exchange Act. In my judgment, the effect of these two Acts was to cause public investors gradually to trust and rely upon the accuracy of the disclosures made by corporations which were selling their securities to the public. Today, faith and confidence in the integrity and honesty of the capital markets has largely been restored, not just because of what the SEC did, but also because of the tremendous contribution which your profession has made to the disclosure philosophy. Personally, I do not believe that the ideal of truth in the financial market place is more completely evident anywhere than it is in the opinion of an independent public accountant.

Today there is a large amount of reliable corporate financial information filed under the various Securities Acts we administer. This information is being constantly analyzed by independent advisory services, brokers and dealers, and investment bankers. Through them,

investors are being given the opportunity of deciding for themselves on the facts whether they wish to invest in particular types of business, be they blue chips or speculative newly-organized ventures. Thus the securities markets today are, in most cases, predicated upon relatively realistic facts, analyzed in the clear light of day.

There is no question in my mind but that the investment banking business in general maintains a very high standard of integrity, honesty, decency and fair play. The six statutes which we administer impose high standards of financial reporting and require of management certain responsibilities toward investors, all of which have contributed to a better understanding by investors of corporate operations. As of June 30, 1959, there were 2,236 issuers required by the Securities Exchange Act of 1934 to file annual and periodic reports, including certified financials, with the SEC because their securities are listed on national securities exchanges. In addition, there are some 1100 companies which are required under Section 15(d) of the Securities Exchange Act of 1934 to file annual financial reports by reason of having sold securities to the public under a Securities Act of 1933 registration statement. It might be of interest to you to know that in the last 25 years, there have been in excess of 15,000 such registration statements filed for a total dollar value of \$161 billion. One-third of these filings and one-half of the dollar amount involved have occurred in the last six years.

Since World War II, American business corporations have been expanding and developing at a very rapid rate by raising enormous amounts of capital. Between 1946 and June, 1959, corporations spent around \$74 billion in increases in working capital, \$298 billion in new plant and equipment, and \$8 billion in other assets. Of this \$380 billion of business expansion, \$282 billion came from internal sources such as depreciation accruals and retained earnings, with the remaining \$98 billion of new money being raised from the sale of new securities, and bank and mortgage financing. During the fiscal year ending June 30, 1959, there were 1226 registration statements filed under the 1933 Act for a total dollar value of some \$16.6 billion. Speaking prospectively, we have seen no indication of any letup in the needs of corporations for obtaining increased amounts of capital. In each month of calendar 1959, there have been sizeable increases in the numbers of registration statements filed with the Commission, and in the dollar amounts sought to be obtained through the registration process. Thus in September of 1959, there were 146 registration statements filed seeking a total dollar amount of \$1.5 billion, which compares with 82 for a total value of \$738 million in September 1958. That month was in no sense atypical of the situation which existed in the other months of 1959. I think these filing statistics will indicate to you why I have emphasized here tonight the importance of sound accounting practices. In my judgment, such tremendous amounts of public money could be raised only in an economic system in which an independent accounting profession is responsive to the public need.

From the standpoint of the securities markets, perhaps no element of accounting is more important than the independence of the certifying public accountant. On December 11 of last year, the SEC announced the publication of an additional release in its Accounting Series, dealing specifically with the independence of public accountants. This release - No. 81 - in effect has summarized certain types of experience which have occurred under Rule 2-01 of Regulation S-X since the publication of the previous Accounting Series Release, No. 47,

published on January 25, 1944. It also has an appendix which gives all of the pertinent references concerning the practice of accountants before the Commission. There are many of you, because you represent clients who have gone into the capital markets, who are no doubt familiar with these Accounting Series Releases. On the other hand, there are probably many of you who today have had little or no concern with the functions of our Agency. Nevertheless, in my judgment, the rather recent tremendous and dynamic expansion of the capital markets will inevitably require your corporate clients, sooner or later, to consider going to these capital markets to obtain essential external financing in order to continue to produce the capital goods and thus to participate in maintaining in our country the highest standard of living known in the world today. As the capital markets expand, there will be the need for proper accounting representation by companies in local communities or cities located far from the financial centers of Wall Street or LaSalle Street to obtain such essential financing. My advice to you, therefore, is that you become thoroughly familiar with the Commission's Regulation S-X and the rules adopted thereunder. On the basic question of independence, the Accounting Series Releases which I have already mentioned are most important in order for you to comprehend certain types of conduct or relationships which may disqualify you from acting in the preparation of registration statements before the Commission. On this question, the Commission has always taken the position that the resolution of the problem depends upon facts to be determined in light of all the pertinent circumstances of any particular case; but there are certain relationships which, of themselves, destroy the independent status of an accountant under our rules. Obviously, it is not practical to specify all the circumstances which might prevent an accountant from being independent. But in both of these releases there are illustrations of types of cases wherein an accountant has been found to be lacking in independence. For instance, in Rule 2-01(b), of Regulation S-X, the Commission had recognized the increased complexities in the business world by stating :

“...an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest: or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.”

Let me assure you that the basic reason that the Commission has published its Accounting Series Releases is to give to your profession helpful guides in determining norms of conduct which will maintain the privilege of practicing before us. The Accounting Series Release No. 81 has thus in effect summarized heretofore unpublished rulings on independence which have arisen under the several Acts administered by the Commission. Of course, you realize that a Commission finding in any particular case that an accountant is not independent according to our rules is not intended to reflect on his professional standing or qualification to serve other registrants with the Commission. But it is often most unfortunate for us to have to make a determination that one of your profession is not independent in any particular case merely because the accountant has believed sufficiently in his company's management and its future potentials to have purchased securities in the company. Yet we have, on occasion, been forced to make such rulings in order to insure that the accountant is completely disassociated from the company and its management.

You might be interested to know that Accounting Series Release No. 81 contains some 54 examples of situations where independence was lacking or where the Commission took no action with respect to the qualifications of the accountants. I urge you, if you have not already obtained a copy of this release, to obtain one by writing to Orval L. DuBois, Secretary, Securities and Exchange Commission, Washington 25, D.C. I am sure that you will find the release and the examples most helpful.

Let me add this caveat: the law is clear that industries must incorporate into their registration statements financials which have been certified by independent accountants. The Commission has the responsibility of ascertaining from the facts whether audits made pursuant to this legal requirement are made by qualified independent accountants. The Commission Rule 11(e) under its Rules of Practice, and its Rule 2-01(b) of Regulation S-X make this responsibility crystal clear. Under Rule 11(e), the Commission may disqualify and deny, temporarily or permanently, the privilege of appearing or practicing before it to any accountant who it finds, after a hearing in the matter, not to possess the requisite qualifications to represent others; or to be lacking in character or integrity; or to have engaged in unethical or improper professional conduct. The proceedings, of course, are conducted in private and may or may not result in a published opinion. Such proceedings have been rare. Generally speaking, problems arising under Regulation S-X so far as accountants are concerned, usually involve the determination of whether a particular relationship is of a nature which will prejudice the independent status of an accountant; with respect to a particular client. I might also say to you that, in administering its Rules and Regulations, the Commission has not attempted to set up objective standards for measuring the qualifications of accountants other than requiring that they be in good standing and entitled to practice as accountants in their place of residence or principal office. We certainly expect that accountants appearing before us will have adequate technical training and proficiency, and will conduct their audits in a workmanlike manner in accordance with generally accepted auditing standards. Rule 11(e) recognizes that ethical and professional responsibility is founded upon character and integrity.

The financial statistics required by the Commission's forms are the conventional balance sheet, income and surplus statements, together with certain supporting schedules prepared on a cost basis as determined by conventional accounting practices. Let me assure you that the Commission has left, and will continue to leave, the development of sound accounting principles to the accounting profession and to educators.

To those of you who have had nothing to do with the SEC and suddenly find yourselves in a position of having to advise a corporate client as to its requirements, I suggest that in the first instance you attempt compliance with the fundamental requirements of the American Institute of Certified Public Accountants, and that you thoroughly familiarize yourself with the statutes, rules, regulations, and forms, especially Regulation S-X. If there is still doubt in your mind as to the proper procedure which should be followed in a particular case, address a letter of inquiry to Andrew Barr, Chief Accountant, Securities and Exchange Commission, Washington 25, D.C. I am certain that you will receive promptly from him the proper forms and regulations. With the forms there are detailed instructions. However, the forms are not blanks to be filled in merely for filing purposes. The forms prescribe the financial statements to be furnished under a variety of conditions. If none of the indicated conditions seem to fit your particular problem, there is a

provision under which we are permitted to work out an appropriate solution. Let me assure you that Regulation S-X and the forms adopted thereunder, as well as the rules and regulations, have been developed with the advice and cooperation of the accounting profession. They are under constant revision as a result of the fine spirit of cooperation which exists between your profession and the Chief Accountant's Office, so that the forms are in every sense up-to-date in the use of conventional terminology consistent with present accounting practice. I might just say to you that if you want unnecessary delays, just ignore the requirements of the forms and send in a collection of audit reports which you may discover in the corporation's files. In the past, on occasion this has happened, although I suspect it was without the accountant's knowledge. Such audit reports, as you know, are usually in the long form designed for management or bank credit purposes, and are in much greater detail than is required or desirable for public reporting purposes. In such situations, about all we can do is to advise the registrant to prepare an amendment in proper form.

By way of conclusion, I would like to express to you my fundamental belief that sound accounting and auditing are the cornerstones of financial integrity. The requirements of the Federal securities laws with respect to accounting rules and independence have been of immense value to the accounting profession, to industry, and to the investing public. In 1936, the SEC said:

“...The insistence of the Act [Securities Act of 1933] on a certification by an ‘independent’ accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedures and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities.”

Time and again we at the Commission have reiterated this view for it is as true today as it was two decades ago. The enormous amounts of capital which American industry must raise through the capital formation process in the years ahead cannot possibly be raised if the investing public does not have confidence and faith in the honesty and integrity of the capital markets. Confidence in the integrity of these markets depends on the maintenance and continued improvement of American accounting and auditing standards.