“Some Accounting Problems of the
Securities and Exchange Commission”

ADDRESS

of

CARMAN G. BLOUGH

Chief Accountant of the Securities and Exchange Commission

Before the

NEW YORK STATE SOCIETY
of
CERTIFIED PUBLIC ACCOUNTANTS

January 11, 1937

The wide distribution of corporate securities, the inability of the vast majority of investors to judge the value of their investments by any close-range view and their dependence upon information contained in published financial statements has placed a great responsibility upon the accounting profession. The Securities Act and the Exchange Act, because of the liabilities imposed thereby, have brought this fact home more forcibly than ever before although the responsibility of the profession has existed ever since businesses have offered their securities to the public.

Since sound and informative accounting statements are basic under each of these Acts, the part played by the accountant in their administration is extremely important and much dependence is placed upon the results of his work.

Many of you have expressed the belief that the Securities and Exchange Commission is in a position to make substantial contributions in the direction of more uniform accounting practices and more general acceptance of sound accounting principles, and when we note the number of occasions writers on accounting and financial subjects find for referring to the attitude of the Securities and Exchange Commission with respect to accounting matters, we can not fail to be impressed with the seriousness of the responsibilities with which the Commission has been charged. This is a challenging opportunity but the anticipated results can be realized only if the members of the profession and the Commission work together in the formulation and execution of sound policies.

In approaching the solution of the accounting problems confronting it under the Securities and Exchange Acts, it seems to me the Commission had several lines of action open to it. First, it might have attempted to lay down definite rules and regulations relating to accounting matters to be followed by all persons registering securities with the Commission. To have followed this procedure would have been virtually impossible, even if it had not been undesirable. The ramifications of accounting are so extensive that to have attempted to follow this procedure would have been a superhuman task and could not have resulted other than in the formulation of a series of regulations which, in many instances, would, undoubtedly, have been premature or unsound.

Second, the Commission might have adopted a positive position upon each accounting question as it arose, thereby establishing a principle to govern subsequent cases. This also would have been subject to the same weaknesses as the procedure previously mentioned.

Third, the Commission might have undertaken to study each registration statement with a view to having the financial data presented in such a manner as the Commission might deem preferable in the individual case. Such a procedure would have led to inconsistencies, detracted from the comparability of statements and only added to an existing lack of uniformity in accounting procedure.

A fourth course was that of studying the individual statements to determine whether the methods followed in their preparation are generally recognized and if not, to cause the statements

to be amended in accordance with generally accepted principles. It is this approach that the Commission has chosen to follow in the belief that it constitutes the most practicable procedure.

Consistent with this policy, the Commission has refrained, as far as possible, from prescribing specific rules relating to the presentation of accounting matters and statements may, for the most part, be filed in such form and using such generally accepted terminology as will best indicate their significance and character.

Since most of the required financial statements must be certified by independent public or independent certified public accountants, the practical effect of this provision is to leave the responsibility for the way in which the presentation is to be made, with certain expressed limitation, to the certifying accountant.

The suggested forms of financial statements incorporated in the several instruction books are given as guides, not as hard and fast rules. For example, the fact that they show the assets and liabilities classified in the order of current to fixed does not prevent the accountant from classifying them in the reverse order if that will best present the facts with respect to the particular registrant. Losses on sales of securities are shown as income deductions but that should not govern the method of treating such losses by a company engaged in the business of buying and selling securities.

There are, however, certain specific accounting requirements in the forms. They are not startling or original. They simply express principles followed by the better accountants. For example, even if the forms had not so required, most accountants would not consolidate with the accounts of the registrant those of subsidiaries in which the registrant does not own more than 50% of the voting control; would not include items not realizable within one year among current assets; would designate current assets or securities pledged to secure liabilities; would show separately and deduct from the specific assets to which they apply, any reserves provided against current assets; would exclude notes and accounts, known to be uncollectible, from both the asset and the reserve; would state separately amounts due from officers and directors, other than trade accounts subject to the usual trade terms; would state separately any long-term debt falling due within one year; would reveal contingent liabilities in footnotes; would state separately with explanation, any substantial non-recurring items of other income or income deductions; etc. Unfortunately, however, not every accountant is as meticulous in such details as we might wish.

One of our requirements is that the certification shall state the opinion of the accountant with regard to the financial statements of, and the accounting principles and procedures followed by, the registrant. The precedent for this is to be found in the form of accountants' reports developed by the correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange.

Compliance with this provision should not be unduly difficult. If the registrant's accounts have been kept in accordance with generally accepted accounting principles, that fact should be stated. If they have not been so kept, the fact should be brought out. Even though the statements presented by the accountant have been drawn to reflect accepted principles, it is quite

important for the investor to know the customary accounting policies of the registrant and its subsidiary companies. Such policies reflect the likelihood of integrity in the accounts during periods prior to those under review and they also reflect the attitude of the corporate officials.

The fact that the accountant finds it necessary, at the time of his audit, to make routine adjustments correcting minor errors in accounting procedure should not prevent him from stating that the accounts of the client have been kept in accordance with accepted principles of accounting consistently maintained, but if the client's customary procedure is to deliberately record transactions in such a manner as to violate accepted principles or if isolated items of major importance have been improperly handled, that fact should be stated. In any event the accountant should express his opinion as to whether the accounting statements properly reflect the financial condition of the company and the results of its operations and if they do not, he should state wherein they do not.

Because of the lack of agreement among accountants with respect to important accounting principles, it has been difficult to determine what position should be taken with respect to many of the statements filed with the Commission in which such controversial questions have been involved. A great many questions presented to us must be settled immediately. In many instances, we hesitate to take a position in favor of what we believe to be the best practice because there is no time for extensive research and consultation with leaders in the field and because we find that reputable and highly-thought-of practitioners have followed contrary procedures. In numerous instances where we believed the methods of accounting to be improper, we have accepted complete revelation of significant matters instead of insisting upon a revision of accounting statements as we would have if there had been a violation of an unquestionably accepted accounting principle. For example, we would not hesitate to require a company to amend its statement if it had included Government Bonds under the heading of "Cash", notwithstanding the fact that one accountant argued vociferously that such a procedure was proper. On the other hand, if the question involved the treatment of treasury stock, we might have the opinion that such stock was improperly shown as an asset on the balance sheet; yet the fact that there is substantial precedent for including it as such rather than as a deduction from capital and surplus might be sufficient reason for us to accept the balance sheet in which treasury stock was so shown, provided it was set out separately and the number of shares so held, together with their cost and and possibly their par or stated value, were clearly indicated.

Often, the principles with respect to which there is marked difference of opinion among accountants are such that in order to make the statements not misleading, it is necessary that voluminous notes be attached thereto. Apropos of this, in a recent issue of The Journal of Accountancy, a prominent member of your Society made the statement that "while explanatory footnotes are sometimes necessary, an accountant has not lived up to his full professional obligation if he accepts an unsatisfactory method, explained in a footnote, in any case in which by the exercise of courage and persuasion he might have brought about the adoption of a more satisfactory method which would have rendered the footnote unnecessary." Certainly the Commission would prefer that financial statements be so prepared as to eliminate the necessity for extensive footnotes.

In the course of our work, we have occasion to see a wide variety of procedures followed in the treatment of almost every conceivable kind of an accounting problem. The term "generally accepted accounting principles" has been widely used in accounting literature, particularly by the American Institute of Accountants and the Securities and Exchange Commission; yet I do not know of any satisfactory definition of the term. A principle in some fields of knowledge is a fundamental concept universally accepted by persons in the particular field; in others, it may be considered as a rule of action. When we modify principle by the words "generally accepted", there is an inference that there may be principles not generally accepted. This seems to place accounting in a class where principles are not immutable laws but rules of action. Accordingly, it would seem that the proper interpretation to give to the term "generally accepted principle" in the field of accounting is that it is a procedure for handling the recording and interpretation of a particular type of business transaction so extensively followed that it may be considered to be generally accepted. If this is a proper interpretation of the term, I am very much afraid it is difficult to name very many principles that are generally accepted.

Almost daily, principles that for years I had thought were definitely accepted among the members of the profession are violated in a registration statement prepared by some accountant in whom I have high confidence. Indeed, an examination of hundreds of statements filed with our Commission almost leads one to the conclusion that aside from the simple rules of double entry bookkeeping, there are very few principles of accounting upon which the accountants of this country are in agreement.

In this connection, the question may well be asked, "Are the terms 'generally accepted accounting principles' and 'sound accounting principles' synonymous?" Reluctant though I am to express such an idea, I have been forced to the conclusion that procedures so generally followed among accountants as to constitute substantial precedent are not always fundamentally sound. In such cases, I think the fault is in their historical development. Many accountants would probably question the soundness of certain principles that they follow from day to day if they stopped to consider them, but, in many cases, they follow the precedent of other accountants or the opinions of recognized authorities in whom they have confidence without reasoning the problem through to their own satisfaction.

You all know how precedents of this kind may become established. An accountant has a peculiar situation that he thinks may best be treated by some digression from what he himself considers to be the best practice under normal circumstances. Again a very positive and valued client has taken a position contrary to the accountant's best judgment but, in the particular case, the accountant, because he thinks the principle at stake is not sufficiently important to cause him to withdraw, accedes to the wishes of his client. After a few cases of this kind by reputable firms, some accountant, hurried in a job, accepts such precedent without giving careful thought to the problem. Subsequently, some textbook writer relates the practice as an example of a procedure followed in some instances and this is, in turn, cited by others in support of the practice. Thus a large body of precedent is established for a procedure that was first reluctantly undertaken as an exception.

The extent to which a particular practice is "generally accepted" is hard to measure. It is virtually impossible to take the various practices with respect to the same kind of transaction and

weigh them against each other to determine which is the most generally accepted. Those who depend upon precedent are usually content with finding a number of cases to support their position without substantial effort to ascertain the extent to which other practices are followed.

In explaining the foregoing, a few specific cases may be helpful.

One of the first problems that occurs to me, possibly because as I write this I have been interrupted to consider the matter, relates to the treatment on a balance sheet of assets for which a 100% reserve has been provided. The particular case is one in which patents that expired four years ago, and which had been fully amortized during their life by the creation of a reserve, were still carried in the balance sheet along with unexpired patents. The total cost of these patents was shown short on the asset side from which was deducted the full amount of the depreciation reserve, the net book value of the patents being carried out in the asset column. Is this in accordance with sound accounting principles? My own opinion is that it is not and I also question whether it is in accordance with generally accepted accounting principles. The same question might be asked in connection with a statement in which depreciable property is carried at cost with a full deduction for the reserve. The argument has been advanced, with good reason, that if the property is still used and useful in the business, it is not improperly shown in that manner but if it has been abandoned or scrapped, it is entirely improper for it to be included. Following that reasoning, it was argued, in the patent case just mentioned, that the company is still making profits through the use of improvements to the expired basic patents so that their cost might still be shown on the balance sheet even though fully amortized.

While we are on the subject of patents, I should like to raise a question with respect to the principle that should be followed in connection with the writing off of the excess purchase price of an investment in a subsidiary which was paid because the subsidiary owned valuable unexpired patents carried on its books at a nominal amount at the date of the acquisition of its stock by the parent company. Textbook writers and general accounting literature appear to regard the investment of a parent in its subsidiary as a cost figure that should not be amortized. Is there any generally accepted principle of accounting that would require the excess investment attributable to patents to be amortized over the life of the patents? Whether there is or not, my own opinion is that sound accounting principles would so dictate and I have taken that position in connection with a registration statement although the accountant in this case, a reputable one, was of the opposite opinion.

This same problem arises in any case in which the excess price paid by a parent for a subsidiary's stock is due to the fact that depreciable or wasting assets are carried on the books of the subsidiary at less than the value attributed to them by the parent company in the acquisition of the stock. In such a case, it would seem to me that the parent's investment in the subsidiary should be written off as the property values are depreciated or depleted in order that the parent should not reach a point where it would hold investments in the subsidiary at large values represented only by depreciated or depleted properties.

When we open up the question of consolidation, we find a great many problems for which it is difficult to point out generally accepted procedures. Various questions arise in determining whether a subsidiary should be included or excluded from a consolidated statement.

In view of existing unstable international monetary exchange, is it desirable to consolidate foreign subsidiaries? If they are included, the reader of the statement has no way of appraising the results of a fluctuation or an anticipated fluctuation in exchange rates between the date the statement is drawn and the date it is read, which, since they are no longer limited to the gold points, may be very significant.

If the fluctuation in exchange rates does not prevent consolidation of a foreign subsidiary, should it be consolidated if it is located in a country that places restrictions upon the export of funds? Would it not be seriously misleading, at the present time, for example, to consolidate a major subsidiary located in Germany? How much of the net income of that subsidiary can be considered income accruing to the benefit of the American company's security holders?

Should a subsidiary in reorganization under Section 77B of the Bankruptcy Act be consolidated? If it is in bankruptcy, there would seem to be little doubt but that it should be excluded although this is by no means universally done. In case the subsidiary is not in bankruptcy, however, there is considerable difference of opinion as to whether it should be included or excluded. When there are to be material changes in equities, or control may be lost, it would seem desirable to exclude them.

To what extent should companies of a nature widely differing from the parent be included in consolidation? Should a public utility include in its consolidation the affairs of a manufacturing company, or a steel company the affairs of a lumber company, or an automobile manufacturing company the affairs of a taxi cab company simply because of a controlling interest? If so, to what extent does a statement with such varied inclusions lend itself to analysis? Can one judge properly the affairs of the steel business when the figures include unrevealed amounts that must be judged in the light of the lumber business? Of course, the assets, liabilities, income and expenses of the important subsidiaries must be considered in connection with those of the parent company in order that the value of the parent's securities may be determined. However, these may be obtained from separate statements.

With respect to subsidiaries not included in consolidation, writers seem to be quite uniform in expressing the opinion that the equity of the parent company in the undistributed gains or losses of unconsolidated subsidiaries, as well as the parent's equity in their surplus or deficit accumulated since they were acquired, should be clearly disclosed; but generally accepted practice, if it is to be judged by the number of statements drawn in which this is not done, seems to deviate somewhat from the expressed principle.

In this connection, what is the accepted principle to be followed by a parent in accounting for profits and losses of its subsidiaries? Practice seems to be pretty well divided between taking up the profits and losses of subsidiaries by adjustments to the investment account and taking up only the dividends declared by the subsidiaries. Of those who advocate taking up only the dividends, some provide for losses of the subsidiaries while others do not. If the profits and losses of subsidiaries are to be taken up, is it proper to follow the same procedure when the company whose stock is owned is not controlled? We have had at least one instance in which a well-known accounting firm approved the procedure of a registrant in taking up its share of the

earnings of a company in which it owned exactly 50% of the stock although it disclaimed any control.

There is a great deal of accounting precedent for a parent to take up on its own books profits on sales to its subsidiaries at the time of the sale even though the goods sold remain in the subsidiaries' inventories or fixed capital accounts at the end of the accounting period. The discussions relating to the requirement that intercompany profits should be excluded seem to be devoted entirely to the problem as it relates to consolidated statements. Suppose a parent sells at a profit a considerable part of its output to its subsidiaries which use the goods so purchased as fixed assets in their own businesses. We had such a case recently. Under these circumstances, it would seem that either the profit on the sales to subsidiaries should not appear on the parent's statement or consolidated statements should be presented, in which case intercompany profits would be eliminated.

A principle of consolidation I had thought to be well established is the one governing the elimination of a parent's investment in a subsidiary against the capital stock and surplus of the subsidiary. I had always believed, and still do, that the proper basis for elimination is the value shown by the subsidiary's books at the date of acquisition. Of course, if the parent company has followed the practice of taking up the profits and losses of its subsidiaries, the basis of elimination is somewhat different but the excess to be accounted for should still be the same as it was at the date of acquisition. It is, therefore, quite disturbing to me to see the number of accountants who have eliminated the par values of the subsidiaries' securities without regard to their book value at the date of acquisition.

Another practice in connection with consolidated statements that I had always thought to be universal is that of showing the assets and liabilities on the consolidated balance sheet at the aggregate amounts of the assets and liabilities of the consolidated companies after elimination of all intercompany accounts. Yet one of the largest accounting firms in the country certified to a statement not long ago in which the minority interest in the assets and liabilities of the subsidiaries was eliminated so that no minority equity appeared in, and the minority's share of the assets and liabilities was excluded from, the consolidated balance sheet.

Some very troublesome problems arise in connection with the separation of paid-in surplus, other capital surplus and earned surplus. Leading pronouncements in the field of accounting have taken the general position that capital surplus should not be used to relieve the income account of the current or future years of charges that would otherwise be made against income. Yet, it has been quite amazing to see the number of occasions that accountants have found for writing off against capital surplus items that, according to my standards, can properly be handled only through the income account or directly against earned surplus.

The position has generally been taken that where earned surplus deficits have been wiped out by transfers of capital surplus, the earned surplus should be so designated as to show the date of the beginning of the existing earned surplus. Also, when the write-offs are made pursuant to a reorganization, there appears to be no serious objection to their being charged against capital surplus even though the result is to relieve future income accounts of proper charges. In such cases, however, it is generally considered that the earned surplus should be exhausted before any

charges are carried to capital surplus and subsequently earned surplus should be dated. The difficult part of this question is to determine when there really has been a reorganization. It would not seem necessary to go through bankruptcy proceedings under the Bankruptcy Act to be reorganized although some writers advocate statutes requiring court approval of all reorganizations. If there has been a general scaling down of assets and a readjustment of capital stock through action of the stockholders with the avowed purpose of reorganizing the company's capital structure, it may be proper to consider that a reorganization has taken place. On the other hand, an action of the board of directors in writing off capital assets with a view to reducing future depreciation charges should certainly not, in my opinion, be considered a reorganization. Some companies have scaled down their assets due to the general change in the price level and have taken the adjustment through capital surplus. They support this action by the claim that the loss was a capital one – therefore properly taken against capital surplus. Accountants have differed very materially on points of this kind.

The desirability of using surplus arising through appreciation to write off operating deficits, though there seem to be many who support that practice, appears to me to be very questionable and the use of surplus created by the appreciation of one class of assets to revalue other assets downward is to me untenable. Yet one of our largest and best-known accounting firms specifically stated in a statement filed with our Commission that this was in accordance with accepted accounting practice.

Under what circumstances, if any, is it proper to write down assets when the effect of the write-down will be to reduce charges to income in future years? We have some fairly extensive pronouncements, as I have previously mentioned, against the practice of using capital surplus to relieve future earnings, but what about using earned surplus to do so? Suppose a company writes off a substantial amount of the cost of its property, or the cost of patents, or bond discount and expense against earned surplus created through income of previous periods. Is it acceptable accounting practice? It results in a conservative statement of the assets but it also results in a reduction of expenses and the commensurate increase in net income for future periods. Here again, there seems to be no consistent practice among accountants which could be pointed to as generally accepted. Many, while expressing the belief that it might have been preferable to amortize the assets, seem to find nothing to criticize and, in fact, some very vigorously uphold the practice of writing them off.

Another subject in which lack of uniformity of accounting practices continually raises difficult questions is the proper balance sheet presentation of capital stock. How, for example, should reacquired stock be treated? Should it be shown as an asset, should it be deducted from the capital stock or surplus accounts or should it be deducted from the combined capital stock and surplus? Recent literature on the subject, including the "Tentative Statement of Accounting Principles" by the American Accounting Association and the "Examination of Financial Statements" by the American Institute of Accountants, expresses the thought that the cost of reacquired shares of stock, which are reissuable, should be regarded as an unallocated deduction in surplus rather than as an asset. Yet we find a very large number of companies, whose statements are certified to by well-known accountants, that include reacquired stock among the assets. Our rules require registrants to state their reasons for so doing when they follow this

method of presentation. The reasons given are many and vary all the way from "general corporate purposes" to "required for fulfillment of stock-purchase contracts."

Another troublesome problem is involved in the treatment of preferred stock having liquidating value very much above its stated or par value. For example, we had a case not long ago involving a company having preferred stock with a par value of $1.00 per share and a liquidating value of $50.00 per share. The stock had been sold for $50.00 per share. At the time of the sale, $1.00 was carried to capital stock and $49.00 to capital surplus. Capital surplus had been legally created and was available for dividends, but on the preferred stock only. What, if any, is the acceptable manner of showing these facts on the balance sheet? Various methods have been followed in registration statements filed with the Commission.

Another subject which might be commented upon is that of instalment sales. Accounting literature has, I think, been considerably affected by the necessity of devising accounts to meet the requirements of the Internal Revenue Acts. Long treatises may be found on the deferring of profits on instalment sales, etc. but it is questionable whether these apply to the presentation of financial data for other than tax purposes. Very few companies filing registration statements make any attempt to defer income or to segregate instalment sales or the profit on instalment sales from their other business. What should be considered good accounting practice in this respect?

What generally accepted principle governs the treatment of unexpired bond discount and expense on a refunded issue and the premium on the call of such refunded bonds? These items are handled in a variety of ways; some charge them directly to surplus; others amortize them over the unexpired life of the old bonds while still others amortize them over the life of the new bonds. While writing them off immediately to surplus is undoubtedly the most conservative procedure, there seems to be justification for writing such amounts off over the unexpired life of the old bonds provided this does not make the annual charge for interest, discount and expense greater than it was on the old bonds. If by following such a procedure, the charge becomes greater than it would have been under the old bond issue had the bonds not been refunded, I think an amount should be written off directly to surplus sufficient to cut down the annual charge at least to a figure no greater than it would have been under the old bonds. It does not seem proper to defer any of the expense attributable to the old bonds to a period beyond their unexpired life, notwithstanding the fact that this appears to be a common practice, because it is impossible to determine that such periods gain any advantage out of the refinancing. Whether they do or not will depend entirely upon the general market conditions and the interest rates at the date the old bonds would have expired.

In this connection, it might be appropriate to mention the procedure to be followed in handling duplicate interest charges in a refunding operation. For example, suppose it is proposed to refund one or more outstanding issues with one new issue. It may be possible that it will be necessary to issue the new bonds quite some time before the earliest call date on one or more of the issues being retired. In some cases this duplicate interest has been charged to income immediately; in others, it has been included with bond discount and expense for subsequent amortization. In the latter case, some have deferred the interest on the new bonds, charging the interest on the old bonds to expense, while others have deferred the interest on the old bonds and

charged the interest on the new bonds to expense. Where there is a material difference in such interest rates, the variation may be significant.

Another question of considerable importance is the proper treatment of profits and losses on the sale of portfolio securities by an investment trust. Some of the companies who carried these profits through the profit and loss account during the prosperous days ending with 1929 subsequently decided that profits or losses from such transactions did not belong in the current earnings statement and, accordingly, about the time of the fall of the market, they began to pass these items, principally losses, through the surplus account. Some companies consider profits on the sale of portfolio securities to be in the nature of capital and reserve them for the exclusive purpose of taking care of losses on similar transactions. Some have been consistent in always carrying such items through the profit and loss statement and others have been consistent in always carrying them through surplus. Reputable accountants have supported all three of these methods. There seems to be no generally accepted practice in this respect.

The examples cited are only a few of the many that confront us in registration statements filed with the Commission.

Mention might be made of the varieties of ways followed in the treatment of (1) Income tax provisions for periods of less than a taxable year; (2) Surtaxes on undistributed profits; (3) Processing taxes; (4) Unassumed mortgages on property purchased subject to the mortgage; (5) Dividends on treasury stock; (6) Depreciation or retirement provision; (7) Long term debt falling due within one year; and a host of others.

In each of the examples mentioned some accountant has supported each conflicting viewpoint and has averred in his certificate that the statements reflected the application of accepted accounting principles.

This discussion has been mainly devoted to the recital of the variations in accounting practices followed by members of the profession because I saw no better way in which to bring home to you the extensiveness of the need for greater uniformity as we see it in our day-to-day work. What the future policy of the Commission will have to be I am not prepared to say but we are reluctant to undertake the prescription of principles to be followed except as a last resort. It is hoped the profession will itself develop greater consistency in the many places where uniformity appears essential to avoid confusion in the presentation of financial data and you may be assured the Commission stands ready, in whatever way it can, to assist the profession in accomplishing this purpose.