they do not keep their books differently than they report in their annual statements to stockholders.

Senator TAFT. Even the Government bureaus have a pretty hard time agreeing, do they not, on which method to follow?

Mr. WERNTZ. That is true in some fields.

Senator TAFT. Does not the income tax require one thing and somebody else require another?

Mr. WERNTZ. That is correct. However, of course, those are for different purposes.

Senator TAFT. Well, it is inconvenient to keep your books two or three different ways, for two or three different purposes.

Mr. WERNTZ. That is perfectly correct; and I think it would be very fine if we could get them together. We have suggested at various times the possibility of avoiding some of those difficulties, but have not been able to get very far.

Coming to the specific sections of the bill, I notice some question raised as to the inclusion of the words "cost-accounting procedures" in the uniform accounting section. You may recall that in two other sections of the bill we are given power to require that services be rendered by certain subsidiaries at cost, and also certain controls over the sales load. The purpose of that particular phrase, which is rather strange for an investment trust, is to be sure that in exercising those powers we can require the information in the accounts which will enable us to tell whether they are actually rendering service at cost and to tell what the elements of the sales load are.

One other section of the bill has some important bearing on accounting, and that is the question of dividends. The bill as it is now written prescribes mostly disclosure, with some reference to the asset provisions. While it is a little out of my province, I should like to point out just briefly one or two of the difficulties you get into with dividends—possibly as an indication that something more than a disclosure statute is essential.

It seems to me that the question of the propriety of dividends for an investment trust depends very largely on a series of factors: First, the type of trust; that is, whether you have a diversified company or whether you actually have a trading company or a finance company; second, whether you have senior securities or not; and, finally, whether you are one of these open-end trusts making continual sales and repurchases or whether you sell in large blocks as a closed-end company.

If you have a diversified trust, it is hard to see why profits and losses on the sales of securities should affect the divided policy. On the other hand, if your business is trading, it seems to me the dividend policy should be keyed not only to the income from securities but also to the profits and losses on trading and, indeed, to the depreciation of the portfolio that is left over, since that eventually will be reflected in the profit accounts.

In your open-end companies you, in effect, are continually repaying part of the appreciation or depreciation of the portfolio; and for that reason there might very well be differences in the dividend theory—and also, of course, you are paying capital along with the depreciation or appreciation.

One other question that I should like to discuss is the little provision which gives the Commission authority to prescribe the minimum scope of the audit. That is a very difficult question, to my mind. It is clear to me that you cannot get good audits by writing rules; because they are composed of two things: first is the procedure and second is the alert performance of that procedure—more particularly the invention or selection of tests, after you have seen what you are getting into.

That sort of thing cannot be prescribed by rules, except with respect to a particular audit; and, obviously, you cannot prescribe rules for each audit.

On the other hand, it does seem possible to select some major points which every audit should hit. You would leave to the auditor his most important function, namely, discretion, by making those very skeletonized. In that way it would be up to him to fill in the blanks and make a good audit out of it.

Or you might possibly use a rule which merely required him to perform an audit in accordance with the accepted standards of the profession or—if you did not wish to refer to those—sufficient to present comprehensive and dependable statements.

Senator TAFT. I did not understand that. Are these Government auditors?

Mr. WERNTZ. No, these are private auditors.

Senator TAFT. These are private auditors?

Mr. WERNTZ. Yes. I think the auditor performs a very valuable function; and, to that extent, I think his work should be retained, but I think we need some method of controlling the work.

Those are just the high points; and with your permission I should like to introduce this.

Senator HUGHES (presiding). Yes.

Mr. WERNTZ. First, let me say that I have been chief accountant for the Securities and Exchange Commission since May of 1938. For 6 years prior to coming with the Commission in 1935, I taught accounting, corporation finance, and law at Yale University and the Yale law school.

The basis for my observations with respect to the accounting provisions of the investment trust bill is my work with the Commission primarily as chief accountant. In connection with this work I participated in the drafting of forms for annual reports of investment companies and have handled accounting problems arising with respect to investment trusts under the Securities Act and the Exchange Act. While I have not participated in the investment trust study, except occasionally in an advisory or consulting capacity, I have read a number of the reports and submitted comments with respect to some of them. I have given particular attention to the report on the United Founders group and to the general report on accounting practices which I believe has not yet been published. These two volumes deal primarily with the widespread and serious accounting and auditing problems and abuses which were found to exist in the period covered by the investment trust study. What I should like to do today is to review very briefly for the committee the situation which we have encountered in our recent work with investment trusts under the two securities acts and to comment briefly and in a general way as to the accounting provisions included in the investment trust bill.

In place of the varied problems of the industrial or commercial company, the investment trust is concerned principally with a much smaller group of accounting problems. These relate to the valuation of its portfolio securities, its treatment and determination of profit and loss upon the disposal of securities, the determination of its income when received in other than cash, and the reflection in its accounts of the corporate action of declaring dividends and selling and redemming its shares. While these accounting problems may be limited in number, they are nevertheless complex. One of the principal difficulties is the question of how to present the results of operations. The investment trust deals largely in marketable securities and is therefore concerned not only with the classical cost concept of accounting but also with a present estimate of value. It is the interrelation of these two values which leads to most of the complex problems which investment trust accounting faces. Like its accounting, the problem of auditing the investment trust is relatively less complex than the problem of auditing an industrial or commercial enterprise. Auditing these companies involves principally a determination that the securities and cash are there, that the securities and cash have been used solely for the purposes of the corporation, and that disposals and acquisitions of securities and income from interest and dividends have been properly accounted for.

Although investment trusts have been relatively numerous since about 1925, so that their accounting problems have been forcefully before the industry and the profession for at least 15 years, there has not as yet appeared a single comprehensive accounting discussion, in the form of a manual or handbook, for example. There have been a number of articles, most of which deal with special phases or with financial problems. None of them has attempted to present a well-developed accounting basis for the investment trust. There has been, I think, a general improvement in accounting methods for investment trusts during the past 10 years, particularly since the enactment of the Securities Act and the Securities Exchange Act. This improvement has worked toward a development of the standards of accounting principles applicable to investment trusts and has also worked toward more disclosure to stockholders and investors of the condition and the results of operation of these trusts. Notwithstanding this improvement, there remain in many fields, as I shall point out later, two or more well-recognized methods which are diametrically opposed to each other. As a result, under the Securities Act and the Exchange Act, which are principally disclosure statutes, we have not felt able to do more than accept any one of the well-recognized methods in a particular field, possibly with the disclosure of the results on some other more common basis in particular cases.

Uniformity of disclosure is particularly important to stockholders and investors with respect to investment trusts. Essentially, the investment trust is selling an investment service which usually is coupled with continued managerial discretion in the type of investments to be made. While this is the common feature of all investment trusts, it does not mean that there are not different types of trusts and that as between these different types of trusts there should not be differences consistent with their inherent purposes and expressed appropriately in their accounting and reporting. Nevertheless, if two investment trusts fall within the same general group, it is extremely important, in my opinion, that their financial statements and the principles upon which those financial statements are based should be as nearly uniform as is possible, so that stockholders and investors may readily compare the performance of the two trusts. As an example of importance to stockholders, I may cite at this point the difference in result that can be reached in determining the cost of a particular security sold by a given company. If we should assume that a company had purchased a thousand shares of a particular stock at $10 a share and at some other time had purchased a thousand shares at $20 a share, it will be seen that the aggregate cost of the 2,000 shares is $30,000. However, if 1,000 shares of this block are sold at $15, there are at least three bases, and possibly more, upon which investment trusts customarily report the results of the sale to their stockholders. Those trusts employing the average basis would report no profit on the sale since the average cost of the 2,000 shares is $15 per share.

Those trusts which report on the first-in first-out basis would report a profit of $5,000 since the first shares purchased cost $10 each. Those trusts which use the specific certificate method would be in a position to select which of the two certificates they would sell. Should they select the $20 certificates, a loss of $5,000 would be reported, whereas if they selected the $10 certificates a profit of $5,000 would be reported.

The argument is sometimes made that if the sales price in this case reflected the market price then at all times the unrealized depreciation or appreciation on the remaining shares plus the realized profit or loss reported would total the same figure, thus making the method of determining cost with respect to the shares sold immaterial. However, it is my belief that a realized profit or loss is quite a different thing in the average case from an unrealized appreciation or depreciation. By making the sale, the company has changed its investment. The proceeds presumably will be invested in some other security subject to different risks and different conditions. The unrealized depreciation or appreciation on the unsold securities is of course still subject to the risks on the old securities. Moreover, the dividend policies of many trusts depend in part on the amount of profit or loss realized on securities sold. Finally, given an unscrupulous management, there is every opportunity for misleading stockholders, and, so long as several conflicting methods remain in use, accountants are powerless, or at best can only note an exception.

It is frequently argued that disclosure of the methods employed, with the possible inclusion of a statement of results on some other method, is all that is necessary. Mere disclosure, however, in most cases is not sufficient to enable comparison of companies using different methods. Ordinarily the disclosure will not be sufficiently complete to put the two on a comparable basis. Even if the disclosure is sufficient for that purpose, generally, only an expert accountant or analyst will be in a position to make the necessary computations. Furthermore, in reporting the results of the two trusts in the statistical services and in news items, the explanations necessary to make the comparison are rarely carried over, so that what customarily happens is that the results of one trust on one basis are compared with results of another trust on another basis. Some certifying accountants take exception to certain of the above methods of determining cost of portfolio securities sold. Other accountants would take no exception. The reader of the statements, unless he is in a position to appraise the relative desirability of the various methods, is at a loss, in my opinion,

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to determine the significance of the certifying accountant's exceptions in such cases.

I feel, therefore, that uniform accounting between trusts of the same class is most desirable. The question is how to obtain this uniformity. In my opinion, it is necessary to have some regulatory body clothed with sufficient authority to study and determine the relative merits of the various conflicting thoughts on the subject and to establish a uniform accounting practice. I do not believe that it is practicable to incorporate such a system into a statute. The classification would be much shorter than would be necessary for many other types of business. Nevertheless, to insure substantial uniformity of results the classification would run at least the length of this statute. If several classifications were necessary, as I believe they are, for varying types of trusts, the incorporation in statutory form would be extremely bulky. Moreover, it would be necessary either to make the statute completely rigid, thus freezing accounting for investment trusts at their present level or at some agreed-upon level, or it would be necessary to leave to someone sufficient discretionary powers to adapt the classification to the course of development in accounting and financial thinking on the subject. To my mind, leaving such discretion in a regulatory body would fall little short of giving that same body power to prescribe a uniform classification after consultation with the industry and the accounting profession.

The accounting sections of this bill, in substance, do no more than give the Commission the power to prescribe classifications of accounts and accounting principles for the various classes of investment trusts and give the Commission sufficient powers to enforce the observance of these classifications. The language of section 31 which outlines the powers delegated with respect to classifications of accounts is in somewhat more detail than is found in many comparable situations. This detail in effect specifies many of the more important types of transactions, control over the recording of which is necessary to a proper presentation of financial statements. One thought occurs to me in connection with subsection (a). The phrase is there used: "Cost accounting procedures." It may seem strange to find such a phrase used in connection with an investment trust. However, I believe that phrase insures implementation of the Commission's powers under section 15 (e) and 22 (c) which permit or require the Commission to forbid a grossly excessive sales load and, in the case of affiliates, to require the rendering of managerial services at cost. I believe that, unless the Commission is in a position to determine or control what the elements of cost are and how they should be computed, it would not be in a position to enforce the observance of those sections by the investment companies affected.

Question may also be raised as to the subparagraph of section 31 which permits the Commission to forbid the keeping of double sets of books. As I view this section, it specifically does not cover the mechanical aspects of bookkeeping; that is, for example, whether you should use machine methods or hand methods; nor does it forbid the keeping of supplemental subclassifications or break-downs necessary or desired by particular companies. What it is meant to do, as I see it, is to prevent an investment trust from keeping its financial records on different and inconsistent bases. While one frequently hears of a company keeping two or three sets of books for use by different people, in fact what is generally meant is that there are certain classifications or subclassifications which are kept for informational or other special purposes. Normally these records for special purposes are easily and directly reconciled with what might be called the basic books of account. For example, it is not at all unusual to find a series of accounts which record assets at a written-up or written-down amount and which include supplemental records reflecting these same assets at the tax cost to the corporation. The intention of these sections, I believe, is to prevent the keeping of completely separate, unintegrated, or inconsistent sets of records.

I have mentioned previously the importance of uniformity in investment trust accounting when the investment trusts are of comparable types. The principles upon which their financial statements are based and upon which their reports to their stockholders are made should be sufficiently similar so that the reader of the financial statements of different companies will be able to obtain comparable information as to the companies without making a detailed study of the particular methods in use by the particular company and without the necessity of reconciling different methods to a common basis. If financial statements are to be used by substantially similar companies as a means of transmitting information about their condition and operations, they will, I think, fail if a company in recording its history and presenting its results follows methods that are incomparable with the methods employed by other companies. The methods now in use are frequently diametrically opposed even though, as I pointed out before, the number of problems involved is not nearly so great as in the case of industrial and commercial companies. It may be of interest to outline very briefly some of the principal problems which we find in reports filed with us or sent to stockholders by investment trusts at the present time.

I mentioned a while ago the varying methods in use to compute the profit or loss upon disposal of part of a block of securities. In glancing through a handful of annual reports recently issued to stockholders, I found that while the majority employed average cost, nevertheless some of them employed the specific certificate method, some employed the first-in, first-out method, and one at least utilized a replacement cost method.

In addition, cost did not always mean the same thing. A considerable number of companies meant by cost the market price of the securities at some date in the past when a voluntary recapitalization of the company had taken place. In one case at least these write-downs to a lower level had been accomplished by vote of the directors without any approval whatever of the stockholders. No information was included to indicate what the real original cost to these companies had been and, since the dates as of which the market prices were taken were spread over a period of many years, it was impossible to compare the performance of the several trusts. Some of them apparently were fortunate enough to select the point at which market prices were very low, and as a result showed a market value in excess of the previous carrying value. Others still showed a depreciation from that original carrying value. In reporting the results of sales of some of these securities, the terminology was quite varied. Some called them profits, even though the selling price was less than original cost. Others labeled the gains over book values as merely recaptures of previously written-off amounts. Even in the method of reporting realized profits and losses on securities, differences occurred. Some reflected the realized profits in the income account, others carried the items through to earned surplus, and many of them carried the profits direct to the capital surplus account.

Variations in the method of computing profits and losses, in the methods of displaying the results of sales of securities, and in the dividend policies make for great complexity not only in determining what a particular trust has done during a given period but, more important, in comparing the results of different trusts.

It should also be noted that the method of determining the cost of securities sold has a reflex action on the carrying value of the securities that are left. In the example I mentioned earlier, the securities retained could be shown at $10,000, $15,000, or $20,000, depending on the method used.

If the use of the specific certificate or first-in-first-out method results in the elimination of the high-cost shares of a particular block, the excess of market values over carrying values is increased, or the excess of cost over market decreased. If low-cost securities are taken out by one of these methods, excess of market over cost is lessened or the excess of cost over market increased. To the extent that a dividend policy is keyed to the realization of appreciation, such methods enable the management to allocate profits and dividends to one period as compared to another.

This brings me to the display in the statements of the carrying values of securities. While most of the trusts carry them at cost and show market in a footnote or parenthetical explanation, some carry securities at market, and in a few cases at cost or market, whichever is lower. As pointed out above, many of the trusts have revalued their portfolios in past years, in most cases charging the decline to capital surplus, with the result that cost of the securities still held is not directly original cost but the chance market valuations at the date of the write-down. Thus, cost means market as of a particular date, with subsequent additions at cost, and there is no disclosure of the past performance of the trust. While it may be said that past cost is not of great importance to a person who is buying into an investment trust on the basis of the present market, it must be remembered that the present investor is entrusting his investments to a particular company; and I believe that a record of the past performance of that company is a significant factor in his choice of companies.

Variations also appear in the way in which depreciation of portfolio securities is accounted for. Some trusts provide a reserve charged to capital or to earned surplus to reduce the securities to market. Others carry the securities at market and show the deduction from cost to market as a deduction from earned surplus on the balance sheet or in a statement of surplus. Still others give both cost and market and include a discussion or display of unrealized appreciation and depreciation in some other part of the statement, perhaps coupled with a disclosure of the realized profit or loss during the period, and perhaps further coupled with a statement of the change since the preceding balance sheet.

Instances exist of varying interpretations of what the term "market" means. When there was no recent sale in the market, some have used the bid price, and some the average of the bid and asked for the day or over a short period. While in the case of active stocks listed on one of the larger exchanges, the difference between bid and asked prices may not be significant, nevertheless many trusts have a large volume of unlisted securities in their portfolios; and the spread between bid and asked price in the over-the-counter market is apt to be large in many cases, with the result that market in effect has no common meaning as between different trusts. Nonmarketable investments are carried sometimes at cost, sometimes at values set by the directors.

Turning to the income account for the moment, a review of recently issued annual reports indicated that some companies include dividends on their portfolio securities when declared, others not until received. While such items in the long run would make little difference perhaps, in either the aggregate income or the income for a particular period, there can easily be situations in which the treatment accorded becomes important. I recall a recent case in which a company took up dividends as income only when they were received in cash. This particular company went through a voluntary reorganization as of, let us say, July 1, writing down its portfolio securities by a very substantial portion of their carrying value, charging the write-off to earned surplus, thus eliminating that account, and charging the balance to capital surplus.

No recognition was given to nearly a million dollars in dividends which had been declared prior to July 1 but which would not be received until after that date. As a result, had the company's policy of accounting for dividends been followed, there would have appeared in the first few days of July a very large credit to income and earned surplus, although in fact these dividends were an asset of the company before the reorganization took place.

Another problem in this field is the question of the treatment of stock rights and stock dividends on portfolio securities. At least four methods are supported by various people. Some believe they should be taken in as received at market, others when received but at some other figure than market; still others believe no recognition should be given at the time of receipt but that if sold the proceeds should be treated as income. Still others believe that the cost of the stock upon which the stock dividends are declared should be spread over all of the stock owned after receiving the dividend or exercising the rights, and the cost of each share reduced accordingly. Then, upon sale of any particular share, the new cost would be compared with the selling price, and the difference treated as profit or loss. Thus, depending on the methods used, all the profit could be shown at once, even if followed later by a loss; or it might be spread over many periods as the securities were sold.

On the expense side of the income statement, different policies are in effect with respect to the amount of break-down given. Some give a particularly well-chosen break-down, although it is not always possible to determine whether the individual items are comparable with the items of other trusts, since many variations in the allocation of expenses may be hidden under the general titles used. Naturally, in appraising the efficiency of a particular trust, the cost of obtaining the investment service in the form of management fees and administrative expenses is a most important item. Yet we find cases in which the management fee is charged directly to surplus, sometimes in conjunction with other expenses. In other cases we find a break-down which does not disclose the management fee, although this is becoming increasingly rare. In some cases there appears to be no management fee, the manager expecting to receive his remuneration from brokerage fees or from the power which control of capital may give. Many of the better trusts give a clear disclosure in supplementary information of brokerage fees paid, and amounts paid to affiliates. Others do not.

One problem of particular difficulty in connection with the sale of shares by an open-end trust is the question of equalizing the interest of the income shareholders in the distribution account. Quite customarily there is added to the income available for distribution under the dividend policy of the company a pro rata part of the amount paid in by an incoming shareholder, so that when the first dividend is paid he, in effect, receives income on his investment only from the date of entry into the company. This is much the same as the theory upon which evidences of indebtedness are sold at a fixed price plus accrued interest to the date of sale. Yet these equalization credits, as they are called, are sometimes treated as an addition to the profit-and-loss account, in other cases as an adjustment of distribution account, and in still other cases as a credit to capital surplus, the subsequent dividend being sometimes charged entirely against the distribution account.

An even more complex problem arises upon the redemption of shares, and this is one point at which differences in treatment may well be justified between a closed-end company on the one hand and an open-end company on the other, in view of the fact that in the latter case the redemption is more or less obligatory and is required to be made at the market value as of the date of redemption, after certain adjustments. Yet, as between various types of companies we find extremely wide variations in the accounting for such transactions. In some cases at the time of redemption a pro rata portion of each of the net worth accounts is written off the books; so, if a company has a deficit due to security losses, either realized, or prospective, the amount paid in by the unit holder in excess of the amount received on redemption is treated as a direct offset to the deficit due to the security losses which resulted in the low redemption price. In others, this is treated as a capital surplus credit, the aggregate losses on sales of securities being retained as a cumulative deficit account. If the unit value has appreciated, the excess paid out is sometimes charged to earned surplus, sometimes to realized appreciation on security sales, sometimes merely to capital surplus. These differences make very complex an appraisal of the past results of the management's handling of the funds entrusted to them.

Another question is how to account for wide swings in the price level which result in a very great depression in security prices or possibly a very large appreciation. I mentioned these briefly as restatements of portfolio values above. This situation is not by any means peculiar to investment trusts, although certain of the problems of investment trusts will differ from those of the average industrial company. It seems to me that when a new cost basis is to be established for a particular company, through write-down of its securities, it is a matter which requires the consent of the stockholders, not merely of the management officials. In addition—and this is particularly true