

THE CORPORATE CONTROLLER'S RELATION  
TO THE SECURITIES AND EXCHANGE COMMISSION

Address of

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of the

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The Securities and Exchange Commission, as you may know, is charged with the administration of several statutes, principal among which are the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940. Each of these statutes requires that certain financial statements be filed with the Commission. Thus accounting and accountants play an extremely important role in the work of the Commission.

The Congress did not, so far as I am aware, in any of these statutes lay down specific principles or standards to be followed in the preparation of financial statements filed pursuant thereto. However, it did not leave the way open for those responsible for the preparation of such statements to rely solely upon their own judgment as to the manner in which they should be presented; for in addition to requiring the Commission to obtain balance sheets, income statements and other data in certain data in certain circumstances, in most instances the nature and details of the items comprising these statements are specified by statute.

Furthermore, the Securities Act provides that the required financial statements shall be certified by "an independent public or certified accountant" and the other three statutes provide that the Commission may require that such statements be accompanied by a certificate of "independent public accountants." The Commission's rules require that statements filed pursuant to the Securities Exchange Act and the Investment Company Act be so certified.

In addition to the foregoing statutory restrictions upon the indiscriminate use of accounting concepts in financial statements made public through filings with the Commission, each of the statutes charges the Commission with making certain that such statements contain all information necessary or appropriate in the public interest or for the protection of investors; and in order that the Commission may be in a position to carry out this mandate both the Securities Act and the Securities Exchange Act authorize the Commission, among other things, to "prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer . . ."<sup>1</sup>

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<sup>1</sup> Securities Act, Section 19(a); Securities Exchange Act, Section 13(c).

It will be seen from the foregoing that the Commission definitely is empowered to establish principles and standards to be followed in the preparation and presentation of financial statements filed with it.

In arriving at a solution to the accounting problems confronting it in connection with these two statutes, several lines of approach were open to the Commission. It might have attempted to promulgate definite rules and regulations relating to all accounting matters involved in financial statements filed with the Commission. Such procedure, it seems to me, would have been impracticable and certainly undesirable, for the ramifications of accounting are so extensive that to have attempted to establish what would amount to a body of accounting principles would have constituted an almost impossible task and could not have resulted other than in the formulation of a series of rules which, in many instances, would have been premature or unsound.

The Commission could have considered each set of financial statements filed with a view to having such data presented in a manner deemed preferable in the individual case. I am convinced that this approach would have resulted in inconsistencies which would have detracted from the comparability of statements and could only have added to the then existing lack of uniformity in accounting practice.

Still another approach was to study the individual statements as filed to determine whether the accounting principles reflected therein and the methods followed in their preparation were generally recognized and, if not, to require that the statements be amended in accordance with sound and generally accepted accounting principles. It is this latter course which the Commission chose to follow and, as a consequence, we have refrained, so far as possible, from prescribing specific accounting rules, and statements may, generally speaking, to quote Rule 3-01 of the Commission's Regulation S-X, be filed "in such form and order, and may use such generally accepted terminology, as will best indicate their significance and character in light of the provisions applicable thereto."

In the early days of the Commission such rules and regulations pertaining to accounting matters as it was found necessary to promulgate were contained in the numerous forms prescribed for use under various circumstances or in the Commission's general rules and regulations applicable to each statute. Beginning in 1937 these rules and regulations were implemented by the issuance of the Accounting Series Releases. The first of these releases, of which there are now sixty-eight (68) was dated April 1, 1937 and was announced as the beginning of "a program for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practices in major accounting questions."

One of these Accounting Series Releases – No. 4, dated April 25, 1938 – announced as an administrative policy of the Commission that:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no

substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.”

In February of 1940 the Commission issued Regulation S-X, previously referred to, which gathered together the various rules, regulations and instructions pertaining to the form and content of financial statements which had previously been contained in the various forms and general rules and regulations of the Commission. While this regulation has been amended from time to time no substantial change has been made in the section (Article 5) applicable to commercial and industrial companies, which includes public utilities, or in the sections (Article 1 through 4) having general applicability to all types of companies.

Many accounting and reporting problems have arisen during the ten years that have elapsed since the adoption of Regulation S-X and their solution has resulted in changed viewpoints, not only on the part of industry and the accounting profession, but also the Commission. Furthermore, entirely new situations have come up requiring the establishment of new procedures. It is for this reason that it has been thought desirable to amend or revise Regulation S-X, a project upon which the staff of the Commission has been engaged for some months past.

From the foregoing it will be seen that the Commission, in determining whether financial statements contained in registration statements and other reports filed with it accomplish the purpose intended by the applicable statutes, has depended, in a large measure, upon the accounting profession to establish and make use of accounting principles which are sound and which may be considered to be the generally accepted accounting principles underlying the preparation and presentation of financial statements.

The promulgation of the Commission's first forms and general rules and regulations, insofar as they pertained to financial statement requirements, was a joint project upon which accountants in public practice and in industry, and educators specializing in accounting and kindred subjects worked closely with the Commission's staff. Controllers individually, and as a group, played an important part in accomplishing the task.

The first Accounting Series Release and all subsequent releases relating to matters involving accounting principles or the form and content of financial statements were submitted to representative individuals and groups who were identified with or directly interested in the preparation of financial statements for public use, for their comments and recommendation. These included individual certified public accountants, controllers (some who were C.P.A.'s and some who were not) and teachers, the American Accounting Association, the American Institute

of Accountants and the Controllers Institute. Many of the recommendations of these persons or groups are reflected in the releases as finally adopted. In addition a number of proposed releases were never issued because of meritorious objections received from those asked to comment upon them.

Regulation S-X was issued only after similar review, numerous conferences (which included the Controllers Institute's Committee on Cooperation with the S.E.C.) and many drafts. Our requests for comment upon this regulation were addressed to more than 100 individuals, exclusive of those reached through professional organizations.

It will be noted that this procedure whereby the interested public has always been invited - - indeed expected - - to participate through letters or by conference, in the promulgation of rules and regulations affecting the presentation of financial statements, is now required by the Administrative Procedure Act which was enacted in 1946.

When the present proposal to amend Regulation S-X was made in September 1949, copies of the preliminary draft were sent to 325 persons and an additional 75 or more were sent to persons who requested copies, mostly as a result of an item in the October 1949 JOURNAL OF ACCOUNTANCY which invited readers to obtain and comment upon the preliminary draft. Also several accounting firms and professional groups requested additional copies; so that, in all, approximately 600 copies were sent out. Approximately 175 persons, including 46 controllers or principal accounting officers of corporations, submitted comments.

Because of the large number of comments and recommendations received - - including criticisms both constructive and otherwise - - the task of revising the proposed amendment has not been easy. It is expected, however, that a new draft will be ready by July 1<sup>st</sup> of this year which will go through the same review procedure as the preliminary draft. The Administrative Procedure Act previously referred to requires that such draft be published in the Federal Register at least thirty days before it may become effective "to afford interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . ."; and you may be assured that all interested persons will be permitted all the time necessary to present their views before the regulation is finally amended.

On May 15, 1939, Commissioner Robert E. Healy, of the S.E.C., stated in an address before the Mid-Western Conference of the Controllers Institute:

"What we need, it seems to me, is a return to the recognition that the primary responsibility for proper accounting rests on the corporate management in the person of the controller. Whether the books are audited or not, the stockholder has a right to look to the corporation's own accounting system for an adequate, intelligible and honest reporting of its affairs. Unless in its daily bookkeeping the corporation recognizes a responsibility to stockholders and investors, the most conscientious audits lose much of their meaning."

Inasmuch as the primary responsibility for proper accounting does rest on corporate management and, more specifically, on the controller, it follows that the controller must have

complete knowledge, and be expert in the application, of the principles underlying the recording and reporting of financial transactions.

Furthermore the controller's responsibility with respect to the propriety of financial statements becomes very definite and personal when applied to statements filed with the S.E.C.; for under the Securities Act of 1933<sup>2</sup> a registration statement is required to be signed by its officers including the "comptroller or principal accounting officer" and each signer thereof may be sued by any person acquiring securities covered by the registration statement "in case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ."<sup>3</sup>

Under the Securities Exchange Act of 1934<sup>4</sup> any one who furnishes data to be included in a statement filed with the Commission "which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false and misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false and misleading."

Both the 1933<sup>5</sup> and 1934<sup>6</sup> Acts impose criminal responsibilities upon any person who willfully commits violations of the type just mentioned.

In the January 1950 issue of THE CONTROLLER there appeared a very interesting and informative article by Mayo A. Shattuck entitled "Legal Aspects of the Controller's Position." Wherein the writer suggested that the S.E.C. is quite content to have, by reason of the statutory responsibilities placed upon the corporate controller, "some precise and easily definable individual" on whom it "can put the finger" if the Commission "is on the spot" because of "any accident or miscarriage in its territory." Mr. Shattuck urged that controllers should "resist collateral and artificial pressures to take the wrong road. The attempted utilization by the Securities and Exchange Commission of the controller as a supplement to that branch of government is the sort of collateral and artificial pressure which I have in mind."

Although the placing of the heavy responsibilities to which I have just referred upon corporate controllers was done by the Congress and not by the S.E.C., there can be no doubt that we are content with the arrangement but not because of any desire to have someone to "put the finger on" or to "make the goat." We look upon the controller, or the officer who acts in that capacity, as the one member of corporate management who, above all others, is completely

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2 Section 6(a)

3 Section 11(a)(1)

4 Section 18(a)

5 Section 24

6 Section 32(a)

familiar with the financial statements; who knows not only what the statements contain but also why they contain what they do. That is why we are interested in being assured that when financial statements are presented to us the controller has had a hand, either directly or indirectly, in their preparation.

And I think it has been demonstrated quite clearly that we have not “had our money on the wrong horse.” In the period of more than fifteen years that the Commission has been in existence thousands upon thousands of reports containing financial statements have been filed. During the fiscal year ended June 30, 1949, for example, more than 400 such reports were filed pursuant to the 1933 Act and more than 2000 under the 1934 Act. Yet during all these years only one controller, to my knowledge, has suffered the penalties prescribed by the statutes. This occurred in 1940 in the McKesson & Robbins, Inc. case.

While the controller first establishes a direct relationship with the Commission when he signs a registration statement or furnishes data included in other reports filed with the Commission, he should be interested in the Commission – or at least in our activities pertaining to accounting – from the making of the very first entry for which he is responsible in his company’s accounts; for he will, or should, want to know what our requirements are with respect to the reporting of the transactions recorded under his jurisdiction and if, in his opinion, these requirements are unrealistic or improper, he should make an effort to have them reconsidered.

As new or novel situations arise or conditions change, the controller should be among the first to recognize the necessity or desirability of adopting accounting procedures to keep step with such changes; and he should take an active part in the development of new, or the reconsideration of old, principles in order that this purpose may be accomplished.

This you have done and are continuing to do either through actions taken by individuals with respect to the accounts of their respective companies or in articles published in THE CONTROLLER, or by concerted action through the Controllers Institute in the form of recommendations in connection with, or criticism of, proposals of other groups or Federal or State bodies involving new or changed concepts of accounting.

However, I feel that as a body you have not been as forceful in making your views known as your position in the accounting profession warrants. This is especially true, I think, with respect to the development of uniform principles of accounting. In Commissioner Healy’s 1939 address previously referred to he made the following statement:

“The business of keeping track of a corporation’s financial life and financial health, however, requires a good deal more than the establishment of adequate mechanics for recording events. If the data accumulated is to be useful it must serve to convey information to those who study it. In this sense it is a language. And unless, like a language, it employs uniform definitions and is based on uniform principles it has not attained the greatest possible value, either to the management, or to those on the outside who seek to compare the results of different years or the results of different companies.

“To me one of the most surprising facts about present day accounting is its lack of a reasonably well formulated body of basic principles, or axioms, or hypotheses. The answer that I have been given over and over again upon questioning public and private accountants on this point is that such a body of principles is implicit in accounting and that many principles are so well accepted that expression and adoption of them in written form is not necessary. I do not believe that this is the fact. Instead, when I press the point I find considerable disagreement as to what is an elementary principle. And there is very little agreement as to what is the proper principle to be applied in situations which are admittedly elementary.”

Although the Commissioner’s remarks were made almost exactly eleven years ago, we still lack a substantial body of basic accounting principles which have become generally accepted.

What can be done to correct this undesirable situation? I should like to make some suggestions.

To begin with, I do not think that the Controllers Institute and the Commission’s staff see enough of each other. Your Committee on Cooperation with the S.E.C. dates back to the very beginning of the Commission and in the early days took a very active part in the formulation of the Commission’s forms, rules and regulations. Subsequent to 1943 and especially since 1946, although the Committee has made helpful suggestions with respect to new, or changes in old, forms, etc., there have been few if any conferences between the Committee and the Commission’s staff notwithstanding that we have had to give consideration to such problems as the propriety of charging to current income amounts in excess of depreciation based on cost of plant facilities provided and their replacement at higher prices; presentation in financial statements of appropriations for future inventory losses and contingencies; the accounting for pensions; the accounting for compensation of officers and employees in the form of stock options; the treatment of transactions under “buy-build-sell-lease” arrangements; and adjustments resulting from the devaluation of foreign currencies. Many of these problems could have and, I think, should have been the basis for discussions with the Institute’s Committee. I should like to suggest that the Committee or its representatives meet with the staff of the Commission occasionally for the purpose of exchanging views on current matters of mutual interest.

Furthermore, we do not have enough direct contact with controllers individually. Rarely does a controller or principal financial officer confer with the staff concerning problems involved in statements filed or to be filed with the Commission by his company. Even when conferences are had by the company with the Commission’s staff, it is by no means the rule that the controller or his representative is present; in such conferences, even though they may involve only accounting problems, it is not unusual for the company to be represented by a non-accounting officer, an attorney, and, sometimes, by a representative of the company’s independent accountant. Much time and expense would be saved and many misunderstandings could be avoided if the controller or his representative and a representative of the certifying public accountant attended all such conferences.



And, finally, it would be extremely helpful, I think, if your Committee on Cooperation with the S.E.C. and the similar committee of the American Institute of Accountants, or representatives of these committees, could, from time to time, meet informally with representatives of the Commission's staff and discuss "with our hair down" our mutual accounting and reporting problems. Certainly, had such a meeting been held back in the early part of 1947 before the problem of depreciation on cost versus replacement became acute, many of the headaches suffered by all of us could have been avoided and the investing public would have been spared the confusion which resulted from the issuance of annual reports to stockholders in which the financial statements, and especially the profit and loss statements, differed materially in many instances from those subsequently made public through reports filed with the Commission. At present there are several important accounting matters, e.g., our proposed amendment to Regulation S-X, which could be the subject of discussion at such a conference.

Since Regulation S-X is highly important to all persons who have any part in the preparation of financial statements filed with the Commission, it seems appropriate to indicate generally what we have attempted to accomplish in revising it and to mention briefly the points in the preliminary draft which have elicited the most comment.

It has often been suggested that our rules and regulations pertaining to financial statements are not to be found in one place; that it is necessary to read the Commission's published opinions, the Accounting Series Releases and even speeches of the Commissioners and the staff to determine what administrative policies may have been adopted which are not contained in specific rules and regulations. We have sought to comply with these suggestions by including in the preliminary draft all pertinent data contained in the Accounting Series Releases, such accounting principles as we feel have received general acceptance and requirements with respect to certain matters which have been followed as administrative policy but which may have been expressed only in deficiency memoranda pertaining to individual cases or in the Commission's annual report.

For example, the policy expressed in Accounting Series Release No. 4, previously referred to, is included, as are the matters referred to in Release No. 10 (treatment of unamortized discount and expense applicable to bonds refunded) and Release No. 25 (quasi-reorganization procedure). Among several principles which we think have become generally accepted and which therefore have been included in the draft are:

(1) Proposed Rule 3-12. Valuation of Assets.

"Except as otherwise specifically provided, accounting for all assets shall be based on cost. However, due consideration shall be given to evidence of probable loss and, where such evidence indicates an apparently permanent decline, recognition thereof shall be made by means of an appropriate write-down or by the establishment of an appropriate reserve; and

(2) Proposed Rule 3-21. Stock Dividends.

“Earned Surplus shall be charged with an amount reasonably representative of the fair value of capital shares issued as a stock dividend. The basis used in determining the amount so charged shall be stated in the balance sheet or in a footnote thereto.”

A Commission policy not previously announced in any rule is that concerning the accounting for pension and retirement plans which was dealt with in Proposed Rule 3-24(e) as follows:

“The terms and conditions of any employee pension or retirement plan shall be stated. Provision for the estimated unpaid cost of the benefits accruing to employees eligible under the plan shall be made in the balance sheet, and the basis for determining the amount therefor shall be stated.”

Although several of the amendments were commented upon unfavorably the latter one pertaining to pensions was the one most criticized or questioned. Perhaps the proposed rule needs clarification. It was intended to reflect our policy that when a pension plan has been adopted, if it is not then funded, a reserve or liability covering the estimated cost thereof, determined upon an actuarial or other appropriate basis, should be established by systematic charges to income so that there will be provided the amount necessary to meet each employee's pension claims on his retirement.

It is, in any event, our policy to require the inclusion, in balance sheets filed with us, of the reserve or liability so determined with respect to employees who (1) have retired, and (2) have an irrevocable right to pensions and are eligible to retire, but have not retired.

As to those plans which legally may be discontinued at will by the registrant, although we feel, and I think it is generally recognized, that once a plan has been entered into, in the absence of serious economic reverses or other unusual situations it will have to be continued, it has not been our practice to require that the liability or reserve therefor be shown in the balance sheet. Instead we have required that the amount that otherwise would have been included in the balance sheet as a liability or reserve be disclosed in a footnote to the balance sheet together with the amount estimated to be the annual cost of the plan and a brief statement concerning the details of the plan.

Other comments were directed at the proposals with respect to accounting for or disclosing differences between estimated replacement cost and book cost of “Lifo” inventories, foreign exchange losses or gains, and status of income tax returns.

I hope that when the next draft is distributed for comment each and every one of you will let me know, either directly or through the Institute Committee, just what you think of it.

In closing I should like to make it clear that the Commission's staff is at all times available for the discussion of accounting problems whether they pertain to statements filed or to be filed or to matters of general interest. It is only through a frank exchange of views and ideas that we can ever hope to attain a reasonable degree of uniformity in financial statements – statements without which our economic system would be in chaos.