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Outline of SEC Accounting Practice

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THE OBJECTIVE during the next hour is to tell you whatever you want to know about the Firm's SEC practice. Let us devote the first part of this hour to a discussion of what I believe all of you are interested in, and then we can give the rest of our time to any questions you may have, and to topics to which those questions may lead.

The Firm's SEC practice covers whatever accounting services are required by our clients under the various Acts administered by the Securities and Exchange Commission. What those Acts are we shall come to in a moment. It is perhaps important to emphasize first that the Firm's SEC practice, while in one sense a separate division of the Firm's general practice, is distinct from our general practice only in the kind of documents filed with the Securities and Exchange Commission and sometimes in the kind of financial statements and certificates filed in some documents, but it is not distinct from our general practice in the sense that the Firm renders SEC services for a client for which it does not also render audit services. At the same time it should be understood that in SEC practice the company filing the registration statement or other document is quite often not our client, the reason for our participation being that the financial statements of our client had been found to be required in that particular registration statement.

In the broadest sense, our SEC practice consists of certifying to financial statements needed under SEC requirements in two principal types of situations: The first is where a company wishes to make a public offering of securities; the second is where such a company is required to keep up to date the information filed at the time of making the public offering. The first type, that is, the public offering, comes under the Securities Act of 1933, whereas the second type, the annual or periodic reporting to the SEC, comes under the Securities Exchange Act of 1934.

Apart from some exceptions, which we can discuss later as time permits, if a company does not have its securities listed on a national securities exchange, such as the New York Stock Exchange or the

American Stock Exchange, then in the event of its wishing to make a public offering of securities, it would register for the first time with the SEC under the 1933 Act. Having once done so, and again disregarding some minor exceptions to the general rule, such a company is required, so long as its securities remain outstanding, to file certain reports with the SEC from time to time, and it is this latter group of reports that are filed under the 1934 Act. On the other hand, if a company not having its securities listed on any exchange, and not wishing to make a public offering of securities, wishes to have the prestige and other advantages that come from having its securities traded on an exchange, that company would make its first filing with the SEC under the 1934 Act; and that Act would require the company to keep information up to date in much the same manner as the company that had registered under the 1933 Act in advance of a public offering of securities.

There are certain types of companies, especially mutual funds, that are constantly offering new securities to the public even though their securities are not registered on any exchange. Such companies, which upon their initial public offering had to register under the 1933 Act, have to keep their reports up to date for the reason that a prospectus has to be made available to each person buying securities that have not been issued before, and such a prospectus is not permitted to become out of date. Accordingly, revised or so-called *bring-up* prospectuses are prepared each year and filed by companies such as mutual companies. *Mutual companies* is the everyday term for open-end investment trusts; there are also closed-end investment trusts which do not offer securities to the public after the initial public offering, and these companies are not required—absent any special situation such as outstanding warrants—to keep on filing under the 1933 Act.

ACTS OF CONGRESS ADMINISTERED BY THE SEC

The Acts of Congress administered by the SEC are as follows:

SECURITIES ACT OF 1933

This Act relates, essentially, to securities being offered publicly as contrasted with those offered privately and referred to as private placements. Private placements are made usually with life insurance companies or other such financial institutions. Offerings of securities under the 1933 Act, on the other hand, are usually new securities

being sold either to finance the issuing company or to enable stockholders to sell a part of their interest to the public in order to place themselves in a more liquid position. In addition, offerings under the 1933 Act are sometimes securities already outstanding, held in large amounts by stockholders whose holdings might constitute control of the company or which may be too large to sell readily through a stock exchange or in the over-the-counter market in the usual way; these offerings are referred to as secondary offerings.

In all such registration statements, the financial statements are required to be certified to by independent public accountants.

There are some public offerings that do not require certified financial statements, but even in these cases the offering circular often contains certified financial statements. Public offerings may be considered as being of three general types: those that require registration under the 1933 Act (and in this case the financial statements are required to be certified); those small enough in dollar amount to be exempt from the requirements of registration and that come under what is referred to as Regulation A and are for a total amount offered in any one year of not more than \$300,000 (at the present time financial statements in the *Offering Circulars* for these issues, as distinguished from the financial statements in *Prospectuses* where registration does apply under the 1933 Act, do not require certification by independent public accountants); and, finally, offerings exempt by the 1933 Act for such reasons, for example, as that the sale is not interstate or that the organization making the offering is, for example, a municipality (the financial statements in these offering circulars are often certified to, but this is not a requirement).

SECURITIES EXCHANGE ACT OF 1934

For a security to be listed on a stock exchange it is required that the issuing company be registered under the Securities Exchange Act of 1934, and that annual reports, distinct from those issued to the stockholders, be filed each year with the SEC to keep up to date the information filed when the company registered under the Securities Exchange Act of 1934.

Annual reports are also filed each year with the SEC by companies that have not registered under the 1934 Act but that have made a public offering under the 1933 Act (the securities being traded in the over-the-counter market) provided the securities are for a sufficiently large dollar aggregate amount to come within the requirements for this purpose.

Financial statements required at the time a company registers under the 1934 Act, and annual reports required to be filed thereafter with the SEC, are required to be certified to.

Our practice, then, under the Securities Exchange Act of 1934 has to do not with new securities but with what might be termed old securities, and concerns the following:

1) Registration under the 1934 Act—Form 10. The great majority of registrations under this Act took place shortly after the passage of the Act, and today, even in a very large accounting practice, it would be unusual to have more than a few such registrations in the course of an entire year.

2) Proxy statements. Companies registered under the 1934 Act, if required to issue proxy statements to stockholders, must comply with the SEC's proxy rules. In certain cases the proxy statements are required to include certain financial statements, most of which have to be certified to by independent public accountants.

3) Annual reports to be filed with the SEC. The majority of these reports are filed on Form 10-K.

4) There are many other reports that have to be filed with the SEC under the 1934 Act, but generally speaking they do not require financial statements and therefore do not occasion any participation on the part of our Firm. Such reports would include the monthly reports that companies which are registered under the 1934 Act have to send to the SEC when any one of a variety of specified events has occurred during the month. Other such reports are reports showing securities held, or changes in securities held by directors, officers, and stockholders having over 10 per cent of the stock of a company registered under the 1934 Act.

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

This Act is the equivalent of the 1934 Act, for Public Utility Holding Companies.

TRUST INDENTURE ACT OF 1939

INVESTMENT ADVISERS ACT OF 1940

INVESTMENT COMPANY ACT OF 1940

This Act is the equivalent of the 1934 Act, for investment companies. The Investment Company Act of 1940 requires investment companies to be registered even though their shares are not on any stock exchange, and at the time of registration the required financial statements have to be certified to by independent public accountants.

Companies registered under this Act that make a public offering of securities, file registration statements with the SEC under the 1933 Act and these registration statements also require certified financial statements.

The forms for registration of investment companies under the 1933 Act, because of the nature of the investment company business, are different from the forms used by industrial organizations, but the information and the financial statements required are the equivalent for investment companies of what is required from industrial companies.

ACCOUNTING REQUIREMENTS IN SEC PRACTICE

Regarding accounting requirements in SEC practice—and concerning ourselves now with the two Acts under which most of our practice is performed, namely, the 1933 Act and the 1934 Act—it is well to understand that the accounting principles that govern are the same, as are the auditing standards, under each Act. Furthermore, these accounting principles and auditing standards are the same in SEC practice as in general practice. The forms of financial statements and schedules are also the same under the two Acts, for any particular company, except as we shall discuss later. The difference between the two Acts with which we are concerned is mainly one of the kind of report that is required to be filed. The various reports to be filed are so numerous that we should not give much of our time now to a discussion of them, except as may be required to illustrate some particular point.

For example, an industrial company filing for the first time under the 1934 Act would furnish a certified balance sheet at a recent date and certified statements of income and surplus and supporting schedules for the three years then ended. This filing would be on Form 10. The annual report to be filed thereafter, also under the 1934 Act, would be on Form 10-K and financial statements would be given similar to those in the Form 10, but for only one year, and those financial statements would be supported by schedules. If, on the other hand, a document filed were under the 1933 Act for a public offering of securities, the type of document would be a registration statement, and would usually be on Form S-1. This form comprises two parts; Part I is the prospectus, and the second part is what is known as Part II of the registration statement. The financial statements would

be included in the prospectus, whereas the schedules would be in Part II, the essential difference between Parts I and II being that the prospectus goes to the public, whereas Part II stays in the office of the SEC in Washington, D. C., although it may be referred to there by anyone who wishes to see it. A further difference as to a registration statement, whether on Form S-1 or some other form, is that usually a summary of earnings is required for five years. The summary of earnings is included in what is spoken of as the narrative section or the company section of the prospectus. The summary of earnings usually does not need to be certified to but, at the same time, it usually is certified to, not because of the requirements of the SEC but because of the preference of the underwriters, who, having themselves purchased the securities from the company prior to a re-offering of the securities to the public, wish to have the protection they find in financial reports that are certified to.

To touch briefly on some of the forms we are concerned with in our SEC practice besides Form S-1, we should mention Form S-8, which is a simplified version of Form S-1 but is limited in its use generally to the offering of securities to employees. The financial statements in a Form S-8 can be thought of as comprising (a) a copy of the company's annual report to stockholders, and (b) a one-page summary of earnings for five years. Another special form of registration statement is a Form S-9, which may be availed of by seasoned companies that meet certain tests prescribed in Form S-9 and that are offering bonds or debentures bearing a fixed rate of interest. The principal difference between a Form S-9 and a Form S-1 is that the prospectus in a Form S-9 may be confined to fewer topics than the prospectus in a Form S-1, and, secondly, that the schedules required in a registration statement on Form S-1 need not be furnished in a Form S-9.

Two other special types of registration statements might be mentioned: The first is that for investment companies, usually filed on a Form S-5 or a Form S-4. The type of financial statements required in these cases is governed by Article 6 of Regulation S-X. The other special type of registration statement is that for companies (commercial, industrial, and mining) in the promotional, exploratory, or development stage. The requirements of these financial statements are governed by Article 5A of Regulation S-X, and their special features, from our standpoint, are that (a) receipts and disbursements are shown, rather than income and expenses, (b) in setting forth the assets

on the balance sheet, dollar amounts are shown only for cash transactions, and no amounts are shown where the assets have been received in exchange for shares issued, and (c) because the financial statements show only assets, liabilities, capital shares, etc., and not all of these in dollar amounts, the financial statements do not purport to show the *financial position* of the company, and so the accountant's opinion is confined to the presentation of assets, liabilities, and so forth, without reference whatsoever to the financial position of the company.

IMPORTANCE OF SEC PRACTICE

The SEC can suspend an accounting firm from practicing before it. This can be done in connection with any certificate filed with the Commission, not merely in connection with the sale of securities under the 1933 Act. Hence we must be able to show among other things, that we have observed generally accepted auditing standards and generally accepted accounting principles. As a practical matter this is one of the important differences between SEC practice and our professional practice in general; in SEC practice there is a Government agency interested that may challenge our work.

The SEC forms of themselves are, comparatively speaking, of secondary importance. The general rules, on the other hand, for SEC practice are very important. These rules may be thought of in this way:

1) Regulation S-X covers the form and content of all financial statements filed with the SEC. This Regulation, however, does not show what financial statements have to be filed; that is something shown by the various SEC forms.

2) The opinions of the Chief Accountant of the SEC that have been published from time to time are in the form of Accounting Series Releases. These are available in convenient book form. It is generally considered that Accounting Series Release No. 4 is the most fundamental and important of all these Releases. This release is as follows:

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.

3) The printed requirements for financial statements in the SEC forms must be thought of as the minimum requirements in each case, for the financial information to be given. This applies perhaps particularly in the case of proxy statements, the financial-statement requirements of which today go far beyond what is to be found in the SEC's printed proxy rules. Many of today's SEC requirements that affect our work are not available in printed form. It is therefore imperative when we participate in any SEC engagement to go beyond a reading of the printed requirements for financial statements, and, among other things, to observe what the prevailing pattern is of information being furnished. One way that this can be done is by referring to recent registration statements and proxy statements.

4) It is a good general rule to assume that nothing is a generally accepted accounting principle unless the SEC accepts it as such. By and large, what this means is that the Bulletins on accounting matters and the Statements on auditing procedure of the American Institute are accepted by the SEC. It is therefore important to keep abreast of these Bulletins and Statements.

5) When financial statements are prepared, they should be checked against the requirements of Regulation S-X to be sure that requirements that may not appear important have not been overlooked, such as: stating the basis of property, explaining the valuation basis of inventories, and meeting every requirement of the information regarding options.

6) As to working papers, no open questions should be left in the working papers. The papers should show that a satisfactory disposition has been made of questions shown by the working papers to have been raised by the accountants on the engagement. Similarly, superseded

drafts of certificates and financial statements and of notes to financial statements should generally be destroyed rather than left to provide a record of opinions that we may feel we have improved upon in the course of our work but that others may feel should have been left unchanged.

7) In order to feel familiar with SEC practice it is well to have read Form 10-K, Form S-1, Form S-8, and Form S-9; and, preferably, to have studied some completed forms of these types, as well as the SEC's proxy rules, and some representative proxy statements.

EXECUTIVE OFFICE REVIEW

Because of the Firm's responsibilities in SEC practice, especially under the 1933 Act, it is our practice for a concurring review to be made in the Executive Office of any registration statements filed containing certified financial statements of a client. Similarly, where a filing with the SEC under the 1934 Act may soon lead to a filing under the 1933 Act, the Executive Office endeavors to make its review at the time of the first of these filings. An example is to be found in the case of proxy statements filed by clients, or by others, under the 1934 Act when shares or assets are to be exchanged for the shares of another company. The proxy statement is filed for the purpose of informing the stockholders prior to their voting one way or another on the contemplated transaction, at a stockholders meeting. If the company is registered under the 1934 Act, its proxy statement has to be prepared in compliance with the proxy rules of the SEC, and these rules provide that in cases of this kind certain certified financial statements must be included in the proxy statement. Later, a somewhat similar filing in the form of a registration statement under the 1933 Act would be required (if the stockholders give their approval to the proposed transaction) provided it is not possible for the surviving company to obtain assurance from all persons receiving the shares given in exchange in the transaction, that they will not fail to hold such shares *for investment*. If, as often happens, some of the persons receiving such shares wish to sell their shares, then a registration statement would be filed under the 1933 Act. Foreseeing a possibility such as this, our Firm would endeavor to make in the Executive Office the same type of review of the proxy statement that would normally be made of the registration statement. More specifically, there is an Executive Office review of proxy statements if they contain certified financial statements; and if the proxy statement is likely to

lead soon to a registration statement then there is also an Executive Office review of working papers.

The Executive Office review of working papers is to see, for one thing, that the representations in the registration statement (or proxy statement, where applicable) appearing in the financial statements and their notes, and in the Firm's *opinion*, are properly supported. As to the financial statements and their supporting schedules and the *certificates* and *consents*, the purpose of the Executive Office review is also to ascertain that generally accepted accounting principles and auditing standards have been followed, that the presentation of the financial statements is a fair presentation, and that the application of generally accepted accounting principles has been consistent. As to the remainder of the registration statement, the purpose of the Executive Office review includes seeing (a) that there is no conflict as between what is said in the narrative or company section and what is said in the financial statements to which we are certifying, and (b) that the references to our Firm are accurate wherever we are mentioned in the registration statement, such as (1) in the introductory paragraphs to a summary of earnings or in the section known as the *experts* section, in which latter section it is stated which accounting firms are certifying to the various financial statements, or (2) in Part II of the registration statement where the company discloses, as required by SEC rules, the relationships existing between experts named in the registration statement and the registrant, that is, the company filing the registration statement. An additional reason for the Executive Office review is to achieve the greatest possible uniformity in treatment and presentation.

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The Executive Office maintains extensive files, not only of registration statements of our own clients and other reports filed with the SEC, but of prospectuses of other companies. By means of these files it is usually possible for a practice office to obtain precedents or guides whenever a report has to be prepared for filing with the SEC, whether that report be a registration statement, a proxy statement, a registration under the 1934 Act, or some other SEC requirement. The Executive Office also renders other services relating to our SEC practice, such as conferring, as required, with the staff of the SEC, and also the informing of offices as to the needs of the Firm from the standpoint of independence. In this latter respect, as you are perhaps aware, neither the Firm nor any of its partners may hold securities in any

company whose financial statements the Firm is certifying to, or in any company controlling that company, or controlled by that company. The SEC's rule as to independence is to be found in Regulation S-X, as supplemented from time to time by Accounting Series Releases of the SEC.