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## SECURITIES LEGISLATION - ACCOUNTING PRACTICE AND THE SECURITIES ACT OF 1933

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SECURITIES LEGISLATION — ACCOUNTING PRACTICE AND THE SECURITIES ACT OF 1933 — Item 25 of the registration regulations under the Securities Act of 1933 requires the registrant to “submit balance sheets . . . as of a date within ninety days of the filing of the registration statement.”<sup>1</sup> The approximate form which such balance sheets are to take is indicated in the regulations, as well as the manner of certification required. So far as the form of the balance sheet proper is concerned, it is doubtful whether item 54 presents any new or startling innovations, but when the balance sheet and the supplementary schedules required to be appended thereto are considered, it is apparent that the effect of item 54 on the accepted and conventional conception of what constitutes “full and fair disclosure” in a balance sheet has been considerable.

The modern balance sheet presents a condensed picture of corporate condition as of the day of its preparation, and to a certain extent may give some sort of an idea of prior corporate history. It is elemental that the maximum disclosure of corporate condition and activity would require a submission of all journals and ledgers to the prospective investor. From a theoretical standpoint, it may be admitted that an investor is entitled to such disclosure if he wishes it; but from a practical standpoint, it is obvious that such disclosure is impossible. Up to 1933, the extent of the disclosure of a corporation on its balance sheet, when issuing securities for sale to the public, was completely governed by the discretion and judgment of the corporation's management. While it is undoubtedly true that in the years prior to the Securities Act, affirmative misrepresentation on the balance sheet was the exception rather than the norm, it is equally true that there was room for many different opinions on the question of just what information should be available to the investing public. Balance sheets submitted

<sup>1</sup> 48 Stat. L. 90 (1933), 15 U. S. C. (1934), § 77aa, Schedule A(25). Subject to certain exceptions not important for purposes of this article.

under item 54 contain information the disclosure of which was formerly considered either unnecessary or unwise. It would be a mistake, however, to suppose that the whole effect of the Securities Act has been the alteration of practices formerly considered proper; much of the litigation before the commission has been concerned with the enforcement of practices always considered proper against those who have attempted to disregard them. In the following material, consideration of the commission's actions along the latter line will be subordinated or ignored entirely in favor of a consideration of the changes wrought in what was once considered normal practice among accountants in the publication of balance sheets and statements of profit and loss.

## THE BALANCE SHEET

### A. *Assets*

Speaking broadly and somewhat loosely, the problem of the asset has been the problem of valuation, not only in working out the requirements of the Securities Act, but also in working out any theory of accounting which will produce a statement of corporate assets as nearly accurate from the standpoint of valuation as possible. A statement of corporate assets from an accountant's standpoint is sometimes said to include all things owned by the business which possess monetary value and are available for the payment of debts. But such a statement is subject to qualification because it is only a partial definition of what may be found on the asset side of the balance sheet. Such a definition is valuable, however, to the extent that it indicates that, where there has been improper and incorrect valuation, the asset side of the balance sheet may show monetary value which is not available for the payment of debts due to the fact that it is non-existent.

As has been indicated, the maximum of full disclosure is impossible from a practical standpoint; but the regulations and decisions of the commission to date disclose a well-defined effort to force relatively full disclosure in certain directions and situations where such disclosure has been deemed particularly important. In the case of assets, such efforts may be listed as follows: (1) full disclosure of transactions and accounts arising from or connected with intercorporate activities with affiliates and subsidiaries; (2) full disclosure in relation to cost of acquisition of assets, exclusive of those acquired from affiliates and subsidiaries; (3) full disclosure of methods of computation of depreciation or amortization; (4) full disclosure of any differential between cost and ledger value resulting from appraisal or some form of reorganization. The skeleton form balance sheet and requirements for appendant schedules, to which the registrant is required to conform approximately in his financial statement, divides the assets into the customary six broad divisions: fixed assets, intangibles, investments,

current assets, deferred charges and other assets. Of these six divisions, the fixed assets have been most provocative of litigation before the commission and require a rather more extended treatment due to the peculiar problem of valuation that arises. In the case of current assets, this problem of valuation is often minimized by the existence of a highly liquid market for the asset, from which valuation can be made without much difficulty.

### 1. *Fixed Assets*

Fixed assets may be carried either at a cost figure or at some figure representing a revaluation, arrived at by some sort of appraisal. The prevailing view within the ranks of the accountants themselves has been that the proper basis for valuing fixed assets at the time of acquisition and throughout their life should be the actual cost of the asset less depreciation.<sup>2</sup> Agreement on this issue has not been unanimous, however, for there are reputable accounting authorities favoring the recognition of current replacement values as a basis for setting up fixed assets.<sup>3</sup> So far as the regulations and decisions show, the commission, in the administration of the act, has not gone one way or the other on this question. It is thus left to the discretion of management to decide on what basis the fixed assets will be carried, provided it is within reason. Cost, to the accountant, will normally be the consideration passing from the registrant to the vendor of the asset in the transaction of acquisition, and prior to the Securities Act, this figure was customarily spoken of by both accountants and management as the cost price of the asset. The administration of the Securities Act compels a re-definition of this customary conception of cost, however.

The commission has recognized two basic situations where the possibilities of collusive purchase or construction are sufficient to warrant a disclosure of more than the price paid for the asset: (1) where the asset was purchased from or constructed by an affiliated interest of the registrant, and (2) where the asset was purchased from the registrant's promoter. Where the asset was acquired from an affiliated interest, any portion of cost price representing profit to such affiliated interest must be disclosed.<sup>4</sup> Where the asset was acquired from the registrant's promoter, that portion of cost price representing legitimate promoter's profits must be segregated from cost price and carried on the balance sheet as an intangible.<sup>5</sup>

The net result of the latter requirement is, in effect, that cost by definition no longer includes profits given to the promoter for what-

<sup>2</sup> PATON, ACCOUNTANTS HANDBOOK, 2d ed., 735 (1936).

<sup>3</sup> PATON, ACCOUNTANTS HANDBOOK, 2d ed., 736 (1936).

<sup>4</sup> Balance Sheet Instruction 1, CCH SECURITIES ACT SERVICE, ¶ 6573.

<sup>5</sup> In the Matter of Unity Gold Corp., 1 S. E. C. 25 (1934); In the Matter of Continental Distillers & Importers Corp., 1 S. E. C. 54 (1935).

ever economic services he has rendered in connection with the acquisition of the asset. In this connection, problems arising where the fixed assets were purchased with part of an issue of par or no par stock and then purportedly set up at cost have proved a fruitful source of stop orders on registration statements. The accountant is ordinarily not in a position to dispute the initial values placed on the fixed assets by the directors, for the legal limits of their discretion are somewhat elastic. Thus in Delaware, by statute, where property is purchased for stock, the directors' valuation thereof is conclusive for certain purposes in the absence of fraud.<sup>6</sup> The commission has ruled that this statutory provision has no effect on the standard of disclosure required of a Delaware registrant, and where the valuation placed on the assets by the directors is deemed to be unreasonable by the commission a stop order will issue.<sup>7</sup> Where fixed assets are purchased with par stock and the cost value of the asset is set up on the basis of the par of such stock, there may be material misrepresentation on the part of the registrant if it can be inferred from available data, such as cash sales of the same stock issue, that the value of the stock is not in fact the par value assigned to it.<sup>8</sup> Similarly, setting up property at cost based on the par value of the stock issued therefor, where as part of the same transaction a portion of the stock was donated back and subsequently carried as capital surplus, is forbidden. Such stock donated back should result in a credit to the fixed asset account.<sup>9</sup> From these regulations and decisions it may be reasonably inferred that the accountant preparing a balance sheet for registration purposes should uncover all promoter's profits in so far as they appear on the registrant's books as a constituent element of the cost of fixed assets in order to comply with the requirements of the act. Where the registrant is an established business qualified to register under form A-2 instead of form A-1, the problem of promoter's profits has been viewed from a utilitarian standpoint. Where segregation or discovery of promoter's profits as a component part of cost is impossible, no segregation is required. But if an examination of the registrant's books discloses the presence of promoter's profits as a part of the cost price of a fixed asset, there should be a segregation.

<sup>6</sup> Cf. *Johnson v. Louisville Trust Co.*, (C. C. A. 6th, 1923) 293 F. 857.

<sup>7</sup> *In the Matter of Brandy-Wine Brewing Co.*, 1 S. E. C. 123 (1935).

<sup>8</sup> *In the Matter of Unity Gold Corp.*, 1 S. E. C. 25 (1935); *In the Matter of Canusa Gold Mines, Ltd.*, S. E. C. Securities Act Release No. 1507 (July 15, 1937); *In the Matter of Rickard Ramore Gold Mines*, S. E. C. Securities Act Release No. 1476 (June 16, 1937); *In the Matter of Queensboro Gold Mines*, S. E. C. Securities Act Release No. 1617 (Nov. 17, 1937); *In the Matter of Virginia City Gold Mining Co.*, S. E. C. Securities Act Release No. 1615 (Nov. 16, 1937).

<sup>9</sup> *In the Matter of Unity Gold Corp.*, 1 S. E. C. 25 (1935); *In the Matter of Bering Straits Tin Mines*, S. E. C. Securities Act Release No. 1498 (July 2, 1937).

In so far as the cost price of the asset is composed of capitalized development costs, abandoned property not yet written off, and profits to affiliated interests, these elements of cost may be carried as cost on the balance sheet proper; but they must be disclosed as being included in cost in the supplementary schedules to the balance sheet.<sup>10</sup>

To what extent have these requirements altered the accountant's customary conception of cost value as it existed prior to the Securities Act? Fixed assets are acquired for production, not to be held for sale, and in one sense they represent a prepaid expense which will be written off during productive life via annual depreciation charges into expense of production. Viewed in this light, the requirements of the commission that this charge be broken down into its constituent elements is not as radical or unusual as it might appear on first blush. The investor is almost universally held to be entitled to a statement of profit and loss in which gross cost of production is broken into its constituent elements, and such a breakdown has been common practice exclusive of the Securities Act. Carrying the asset at cost cannot be any representation of real value in view of a changing price level, and no good reasons appear why the breakdown of cost required by the commission should cause any apprehension in corporate circles.

Where management carries fixed assets on a basis other than cost on the balance sheet, the registrant, under the act, must make numerous disclosures relating to the differential between cost and ledger value.<sup>11</sup> In most cases the difference between ledger and cost finds its origin in an appraisal of the property. Regardless of the requirements of the Securities Act, accountants generally indicate on the balance sheet in such cases the appreciation in value over cost, the date of the appraisal, and the procedure followed in writing up the value of the asset.<sup>12</sup> The appreciated value is also clearly distinguished from earned surplus in the surplus account. The requirements of the commission in respect to full disclosure in cases of appraisal are substantially the same set by the accountants themselves exclusive of the act, except in one important respect: the decisions to date establish beyond doubt that failure on the part of the registrant to follow appraisal bases which it purports to follow constitute misrepresentation and falsehood subjecting the registrant to a stop order.<sup>13</sup> The integrity of the appraiser has become of more concern to the accountant than formerly. In cases

<sup>10</sup> Balance Sheet Instruction I, CCH SECURITIES ACT SERVICE, ¶ 6573.

<sup>11</sup> Balance Sheet Instruction I, CCH SECURITIES ACT SERVICE, ¶ 6573.

<sup>12</sup> PATON, ACCOUNTANTS HANDBOOK, 2d ed., 752 (1936).

<sup>13</sup> In the Matter of Haddam Distillers Corp., 1 S. E. C. 37 (1934); In the Matter of Continental Distillers & Importers Corp., 1 S. E. C. 54 (1935); In the Matter of Lewis American Airways, 1 S. E. C. 330 (1936); In the Matter of Great Dike Gold Mines, 1 S. E. C. 621 (1936).

of appraisal, the name of the appraiser is required to be appended, a practice not ordinarily followed prior to the act.<sup>14</sup>

The characteristic practice of promoters of setting up assets on the basis of "prospective value" has been held misleading.<sup>15</sup> Unrealized appreciation resulting from merger, consolidation or reorganization must be compared in supplementary schedules with the recorded values on the books of the vendor corporation.<sup>16</sup> Here again, as in the case of cost price, the effect of the Securities Act has been to force the accountant to go behind the transaction of acquisition. The result of the disclosure required, in the case of appraised values, is to give the investor a comprehensive picture of cost and its component parts and a fairly complete picture of the origin of the difference between cost and ledger value, as well as the basis on which the ledger value was reached.

## 2. *Intangible Assets*

Intangible assets on the balance sheet include franchise, patents, trade-marks, good will, organization expenses and other similar items. Here, as in the case of the fixed asset, the commission has not definitely indicated that cost must be the basis of valuation of these intangibles; but where ledger value differs from cost value, the registrant is required to make a comparison between the two and make a complete explanation of the difference.<sup>17</sup> What constitutes a complete explanation is not indicated in either regulations or decisions to date. But on the basis of the disclosure required in connection with differences between cost and ledger value in the case of fixed assets,<sup>18</sup> it is probable that the accountant should explain fully the nature of the transaction or theory on which the intangible was revalued, and the method used in the revaluation.

Promoter's profits appear in this section of the balance sheet under the general heading of organization expenses. But where the amount paid the promoter is out of all proportion to the value of the services rendered, it is false and misleading to carry the item labeled "for promotional services"; it should be carried as "gifts to promoters."<sup>19</sup> The decisions relating to this particular section of the balance sheet are concerned largely with what may be charitably termed "optimistic" inflation of the value of these intangibles in a purely arbitrary manner.<sup>20</sup> In most of these cases, it will be found that the commission and reputable accountants in general see eye to eye on the commission's require-

<sup>14</sup> Balance Sheet Instruction 1, CCH SECURITIES ACT SERVICE, ¶ 6573.

<sup>15</sup> In the Matter of Unity Gold Corp., 1 S. E. C. 25 (1935).

<sup>16</sup> Balance Sheet Instruction 1, CCH SECURITIES ACT SERVICE, ¶ 6573.

<sup>17</sup> Balance Sheet Instruction 3, CCH SECURITIES ACT SERVICE, ¶ 6582.

<sup>18</sup> See supra, note 11.

<sup>19</sup> In the Matter of Brandy-Wine Brewing Co., 1 S. E. C. 123 (1935).

<sup>20</sup> In the Matter of American Gyro Co., 1 S. E. C. 83 (1935).

ments. Accountants and lawyers preparing registration statements should place particular emphasis on a detailed breakdown and classification of organization expenses in connection with this section of the balance sheet, for a consideration of the balance sheet requirements as a whole indicates that the investor is entitled to an accurate and extensive statement of organization expenses. Experience has shown that much of the "water" injected into a corporation originates at the inception of the business. It is doubtful whether an independent accountant, exclusive of the Securities Act, was in a position to make any extensive investigation of expense charges in connection with organization.

### 3. *Investments*

Investments in the nature of securities are divided into two broad classes: (1) securities of affiliated or subsidiary companies, and (2) securities of companies totally unrelated to the registrant. So far, the litigation arising before the commission over this section of the balance sheet has been confined to practices which never have been recognized in accepted accounting circles.<sup>21</sup>

In accordance with the accepted legal conception of the corporate entity as being separate and distinct from the stockholders thereof, normal accounting practice makes little distinction between securities of affiliates and securities of non-affiliates, although it was customary on the part of many accountants prior to the act to separate the two classes into different categories on the balance sheet. The requirements of the regulations under the Securities Act are more extensive, however. The balance sheet<sup>22</sup> must show the nature and amount of securities in affiliates, the names of the affiliates, and the ratio of the amount of such securities held to the total amount of securities of such affiliates which are outstanding.<sup>23</sup> The registrant will have the option of carrying such securities at any one of a number of values; thus, ledger value may be original cost value, present book value, or current market value. But in any event discrepancies between ledger value and cost value must be fully disclosed and explained.<sup>24</sup> Cost will ordinarily be the actual consideration passing in the transaction of acquisition, unless the securities of the affiliate were purchased from the same or another

<sup>21</sup> Cf. In the Matter of Plymouth Consolidated Gold Mines, 1 S. E. C. 139 (1935), where the registrant attempted to carry the capital stock of a wholly-owned subsidiary as an asset under the investment section of the balance sheet when the fixed assets of the subsidiary had been entered on the same balance sheet as a part of the parent company's fixed assets.

<sup>22</sup> The term "balance sheet" as here used refers to the balance sheet proper and all supplementary schedules required to be appended thereto under the Securities Act.

<sup>23</sup> Balance Sheet Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6586.

<sup>24</sup> Balance Sheet Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6586.



affiliate, in which case the registrant should make a comparison of respective costs to the registrant and to each such affiliate.<sup>25</sup>

It may be taken as a general proposition, in the case of all assets on the balance sheet prepared under the Securities Act, that wherever the registrant acquires an asset from an affiliate or subsidiary full disclosure includes an indication of whatever proportion of the cost consisted of profit to the affiliated corporation. This requirement is based on the idea that the controlling stockholding element in the registrant corporation who are also stockholders in the vendor-affiliate have conflicting interests which may well result in a sale not conducted at arm's length. The isolated shareholder, with no common stock ownership in the two corporations, is entitled to full disclosure of all the facts pertinent to the transaction. Prior to the Securities Act, the accountant proceeded on the assumption that such transactions were always at arm's length; or if he had any doubts on the score, he was scarcely in a position to make an exhaustive investigation of the facts. In any event, the conclusion is inescapable that accounting transactions arising from intercorporate activities of this sort should be supplemented by a very complete and accurate disclosure of the facts of the transaction. Subsidiary or affiliated companies within the meaning of the regulations are said to be companies directly or indirectly controlled, or controlling, by the issuer, or under direct or indirect common control with the issuer, as of the date of the balance sheet.<sup>26</sup> Control means effective control through whatever means exercised.

The commission has been very strict about the disclosure of any liens against securities held for investment. Failure to disclose that securities listed as investments of the registrant have been pledged is misleading; and where property on the balance sheet is indicated as pledged, failure to disclose that the debt secured is in default is misleading, regardless of the fact that the pledgee has indicated his intention not to foreclose or sue.<sup>27</sup> The debt which the pledge secures will appear on the liability side of the balance sheet. Prior to the Securities Act, accountants were not agreed as to whether the asset pledged as collateral for the debt should be indicated on the asset side. From the standpoint of a prospective investor in the capital stock of the corporation, this latter procedure would seem to be immaterial; he knows, presumably, that all creditors have prior claims on assets as to any claims he may have as a stockholder, and the fact that as between two creditors one of them has a preferred claim on a certain asset should not be of great interest to the prospective stockholder. In any event, the Securities Act has had the effect of standardizing the procedure in this

<sup>25</sup> Balance Sheet Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6587.

<sup>26</sup> Balance Sheet Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6588.

<sup>27</sup> In the Matter of Mining & Development Corp., 1 S. E. C. 786 (1936).

matter in the more desirable of the two ways of handling the situation.

In the case of securities of non-affiliates which were not purchased from affiliates, the important information demanded is a disclosure of cost price, ledger value and market value as of the date of the balance sheet or the nearest available date, and a statement of whether or not the securities are pledged.<sup>28</sup> Prior to the Securities Act, comparison of cost, ledger, and market price was not the ordinary procedure, either on the balance sheet proper or in attached schedules.

Non-current debts due the registrant from affiliates or subsidiaries may compose a part of the investment section of the balance sheet; and here again, as in other cases where there is any intercorporate activity reflected on the balance sheet, the amount of disclosure required is considerably more than that customarily given. The purpose of the creation of the debt, whether the debt is secured by collateral, and the rate of interest receivable on the debt are all required to appear in the supplementary schedule.<sup>29</sup>

#### 4. *Current Assets*

The highly liquid, current assets where the problem of valuation is practically non-existent are among the few accounts appearing on the face of the asset side of the balance sheet which are not required to be enlarged upon in supplementary schedules. Cash on demand, cash in time deposits, call loans, and notes and accounts receivable, all appear on the balance sheet in the ordinary manner, valued at their face, and with no disclosure of when, how or at what price they were acquired. There are, however, two exceptions in the case of assets of this type, both exceptions being accounts arising under circumstances where the possibilities of some sort of collusion are sufficient to warrant a more extended disclosure. These are current indebtedness of officers and directors of the registrant to the registrant, and current indebtedness of affiliates and subsidiaries of the registrant to the registrant. In both cases the registrant is required to disclose the purpose of the creation of such indebtedness, the rate of interest receivable thereon, and a description of collateral held, if any.<sup>30</sup> These requirements were substantially observed by reputable accountants prior to the Securities Act, and it is doubtful whether the requirements represent much of a departure from conventional practice.

Current assets include the inventory account, where the valuation problem again arises. The registrant is required to disclose the basis and method of valuation of inventory. If inventory contains as a com-

<sup>28</sup> Balance Sheet Instruction 6, CCH SECURITIES ACT SERVICE, ¶¶ 6592-6594.

<sup>29</sup> Balance Sheet Instruction 7, CCH SECURITIES ACT SERVICE, ¶ 6595.

<sup>30</sup> Balance Sheet Instructions 12 and 13, CCH SECURITIES ACT SERVICE, ¶¶ 6600,

ponent part any profit to affiliated or subsidiary interests, the approximate amounts thereof should be stated.<sup>31</sup>

Current assets composed of marketable securities held temporarily for resale may be carried at cost or market as the registrant chooses, but the basis of the valuation adopted must be disclosed as well as the market value as of the date of the balance sheet.<sup>32</sup> It may be said in this connection that the tendency of the commission to require comparison of different values reached on different bases is an extensive departure from what was formerly considered necessary. The science of accounting consists, in one sense, of skillfully painting an impression of the corporate condition. Accountants have not felt that it is either desirable or practical to present on the balance sheet all the alternative methods of valuation. In many cases the balance sheet will not even show which particular method was adopted. The requirements of the Securities Act that valuation of assets on various bases be presented in comparative form has had the effect of throwing on the investor the task of selecting whichever method he believes will result in the most accurate valuation, a burden formerly entrusted to the accountant. Whether or not the change has had the effect of placing the investor in a more advantageous buying position is a debatable matter.

### B. *Liabilities*

In the case of the registrant's long-term debt, represented by bonds, mortgages, notes and similar evidences of indebtedness, disclosure should be made of the nature and amount of the consideration received, the discounts suffered as a result of the sale, the amount of commissions paid and to whom, the purpose of the issue, the method employed in the disposition of the securities and, if disposed of through affiliates, a comparative statement of the amount received by the registrant and the amount received by the affiliate.<sup>33</sup> These requirements contain several innovations. The normal procedure is to carry prepaid interest, in the case of securities sold at a discount, on the asset side of the balance sheet, to be charged off by amortization over the period covered by the debt, the full face value of the indebtedness at maturity being carried on the liability side with no indication of the extent to which it is composed of interest expense. The same may be said of commissions on the flotation of the issue, for they constitute financial expense incidental to the raising of the money, and ordinarily would not appear on the balance sheet at all, except that they are paid in advance of the period to which they are allocable and for this reason are carried as an asset. The use of the conventional method permits the

<sup>31</sup> Balance Sheet Instruction 10, CCH SECURITIES ACT SERVICE, ¶ 6598.

<sup>32</sup> Balance Sheet Instruction 11, CCH SECURITIES ACT SERVICE, ¶ 6599.

<sup>33</sup> Balance Sheet Instruction 17, CCH SECURITIES ACT SERVICE, ¶ 6607.

prospective investor to ascertain from an examination of the balance sheet the expense incidental to the flotation of the securities only to the extent of unamortized prepaid charges; the balance sheet and supplementary schedule as required under the Securities Act will at all times indicate this expense in full until the long-term debt is paid off and is no longer a factor in the registrant's financial condition.

The disclosure of the method used in the disposal of the securities and the nature and amount of the consideration received therefor is also an innovation, for this information does not normally appear on the balance sheet.

The comparative statement required when the securities were disposed of through an affiliate is another indication of the scrupulous supervision exercised over intercorporate activities under the Securities Act. The problem is identical to that encountered where an affiliate is the vendor of assets to the registrant, except that in this case the registrant is paying an affiliate for services rendered.

Non-current indebtedness to affiliates or subsidiaries presents the same picture. The purpose of the creation of the debt, rate of interest, and collateral pledged to secure the debt, all must be disclosed in a supplementary schedule.<sup>34</sup> The same information is required in the case of accounts and notes payable to directors, officers and employees of the registrant, both current and non-current, as well as current accounts payable to affiliates.<sup>35</sup> Such requirements are substantially the same as those in connection with claims, current and non-current, against affiliates, subsidiaries, officers, directors and employees which appear on the asset side of the sheet.<sup>36</sup> A safe rule to follow in the preparation of the balance sheet would seem to be to disclose all facts remotely material and pertinent in cases where any transaction between the registrant and either affiliate, subsidiary or agent is reflected in the balance sheet accounts.

### C. *Surplus*

Surplus, on the balance sheet, is required to be divided into the following: paid-in surplus, capital surplus, unrealized appreciation arising from revaluation of capital assets, undistributed profits or surplus of subsidiaries and earned surplus.<sup>37</sup> Paid-in surplus is defined by the regulations as the excess of the proceeds from the sales of capital stock over the par or stated value thereof.<sup>38</sup> Earned surplus should include

<sup>34</sup> Balance Sheet Instruction 18, CCH SECURITIES ACT SERVICE, ¶ 6608.

<sup>35</sup> Balance Sheet Instructions 19 and 20, CCH SECURITIES ACT SERVICE, ¶¶ 6609, 6610.

<sup>36</sup> Cf. note 28, *supra*.

<sup>37</sup> Cf. Balance Sheet Instructions 22, 23, 24, 25 and 26, CCH SECURITIES ACT SERVICE, ¶¶ 6612-6619.

<sup>38</sup> Balance Sheet Instruction 22, CCH SECURITIES ACT SERVICE, ¶ 6612.

only actual earnings from operations.<sup>39</sup> Included in the capital surplus is a donated surplus account, and the decisions have established beyond a doubt that it is false and misleading to pad earned surplus with donations.<sup>40</sup> It is important in this connection to note the decisions relating to cases where assets have been purchased with stock and, either concurrently or subsequently, the vendor of the asset has donated the stock back. Where the donation may be said really to have been a part of the original transaction of sale, even though such donation back came later in point of time, it is misleading to credit either earned surplus or donated surplus with the donation. The proper credit is to the asset purchased to reduce the valuation thereof.<sup>41</sup> Where, however, the donation is not a part of the transaction of acquisition of the asset, the proper credit is to donated surplus, and never to earned surplus.<sup>42</sup>

Surplus will normally reflect expenses carried as assets because prepaid, which have not yet been amortized. The registrant is required to disclose in another section of the balance sheet the method of amortization adopted. No positive rules as to what method of amortization should be used have been made by the commission. It has been ruled, however, that in cases where surplus represents and reflects prepaid expenses in the nature of development work under a lease, which has no present-day value, such amount should be eliminated from the surplus account in the preparation of the balance sheet.<sup>43</sup> It would seem that these prepaid expenses should be charged off through amortization as rapidly as possible to avoid all possibility of a stop order based on fictitious value reflected in surplus. The impropriety of carrying assets at inflated values has been discussed in connection with the fixed asset section of the balance sheet.<sup>44</sup> Such practices will be reflected in the surplus account to the extent that it will be swollen by the fictitious value. A disclosure of the impropriety of this inflation should be indicated in the schedules in connection with the surplus, and it may be, in view of some recent rulings from the commission, that these inflated values should be eliminated entirely, full disclosure of their presence without elimination not being sufficient.<sup>45</sup>

Capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable against income and reflected on the balance sheet as a deduction from

<sup>39</sup> Balance Sheet Instruction 26, CCH SECURITIES ACT SERVICE, ¶ 6619.

<sup>40</sup> In the Matter of National Educators Mutual Assn., Inc., 1 S. E. C. 208 (1935).

<sup>41</sup> In the Matter of Rickard Ramore Gold Mines, Ltd., S. E. C. Securities Act Release No. 1476 (June 16, 1937).

<sup>42</sup> In the Matter of National Educators Mutual Assn., Inc., 1 S. E. C. 208 (1935).

<sup>43</sup> In the Matter of Great Dike Gold Mines, 1 S. E. C. 621 (1936).

<sup>44</sup> See *supra*, under the heading of "fixed assets."

<sup>45</sup> S. E. C. Accounting Release No. 4 (April 25, 1938).

earned surplus.<sup>46</sup> The capital surplus account is required to be supported by a supplementary schedule setting forth the nature and amount of the items included therein, including donated surplus, discount on capital stock reacquired, and any other surplus items not properly included in other specific surplus accounts appearing on the balance sheet.<sup>47</sup>

In connection with the handling of the surplus accounts, it is interesting to note that the enforcement of full disclosure on the part of the registrant may of necessity result at times in laying down substantive accounting procedure. In theory, at least until very recently, the purpose of the Securities Act has been to compel full disclosure, and the commission has not purported to set up a standard accounting procedure which must be followed by all who register under the act. In the case of surplus, however, the efforts of the commission to require full disclosure have resulted in a standardization of substantive accounting procedure, and this is true to a limited extent in some other sections of the balance sheet.

Book increment arising from revaluation of capital assets and undistributed profits or surplus of subsidiaries is required to be set forth separately on the balance sheet.<sup>48</sup> No serious objection can be made to this requirement; it is wise procedure to distinguish between surplus actually realized and that portion of surplus representing unrealized assets, even though there is strong indication that the latter type of asset will eventually be realized. In the case of unrealized appreciation or write-down resulting from revaluation as a constituent element in surplus, a supporting schedule containing the same information as that required in the case of revaluation on the asset side of the sheet should be submitted.<sup>49</sup>

So far as the decisions go relating to surplus, the principal difficulty which registrants have had has been in connection with donated surplus. It is very doubtful if any certified public accountant would ever condone "window dressing" by donations carried as surplus without an indication of the fact that such portion of surplus was not profit earned from operations. Unfortunately, donations may enter earned surplus via the statement of profit and loss in what purports to be profit on a bona fide transaction; and when such is the case, they may be extremely hard to locate and segregate from earned surplus. Nevertheless, donations to surplus which are charged in this round-

<sup>46</sup> S. E. C. Securities Act Release No. 1353 (April 1, 1937) (Accounting Series, No. 1).

<sup>47</sup> Balance Sheet Instruction 23, CCH SECURITIES ACT SERVICE, ¶ 6613.

<sup>48</sup> Balance Sheet Instruction 25, CCH SECURITIES ACT SERVICE, ¶ 6616.

<sup>49</sup> See *supra*, under the heading of "fixed assets."

about fashion are misleading under the requirements of the act.<sup>50</sup> The problem of the paid-in surplus presents no such difficulties, but the accountant preparing a registration statement should check the sources of earned surplus as carefully as possible. In short, the familiar picture is presented here: where attempts are made to inflate earned surplus via the profit statement by what purports to be a bona fide transaction, the source of the difficulty will be found to be a transaction which was not conducted at arm's length. As indicated in connection with other sections of the balance sheet, such transactions must be laid completely open on the balance sheet as enlarged by supplementary schedules.

#### D. *Capital Stock*

The supplementary schedule to the capital stock section of the balance sheet should indicate for each class of stock the par or assigned value, the number of shares authorized, with dates, the number of shares nominally issued and the number of shares reacquired and in the treasury, if any.<sup>51</sup> All this information will be listed on the capital stock section of the balance sheet exclusive of the requirements of the Securities Act, with the possible exception of the disclosure of the amount of treasury stock held by the registrant. While not exactly customary, there were accountants prior to the act who carried treasury stock as an asset instead of as a deduction on the liability side. Such procedure would not necessarily be misleading to one examining the balance sheet as a whole, but the capital stock account so carried on the balance sheet, taken alone, might be misleading.

For the period commencing January 1, 1922, the registrant is required to indicate the net number of shares actually outstanding, the nature and amounts of consideration received, commissions paid and to whom, the expenses of the issue, the net proceeds of the issue, the purpose of the issue, and the methods employed in the disposition of the stock.<sup>52</sup> While the sale of stock is the sale of a proprietorship interest and not, as in the case of bonds, merely the creation of indebtedness, nevertheless in one sense the capital stock account represents the purchase of capital. Viewed in this light, the requirements as to disclosure in connection with this account present a picture quite similar to the requirements of disclosure in connection with most assets. The effect of the required disclosure will be to segregate in the supplementary schedule those portions of the par or assigned value of the stock which were given for services or other intangibles and not for cash. This information does not ordinarily appear on this section of

<sup>50</sup> By definition, the earned surplus account is restricted to earned surplus only. See Balance Sheet Instruction 26, CCH SECURITIES ACT SERVICE, ¶ 6619.

<sup>51</sup> Balance Sheet Instruction 16, CCH SECURITIES ACT SERVICE, ¶ 6605.

<sup>52</sup> Balance Sheet Instruction 16, CCH SECURITIES ACT SERVICE, ¶ 6606.

the balance sheet, for the normal procedure would seem to be a credit of the par or assigned value to the capital stock account and two corresponding charges to intangible assets of one kind or another and to cash. The latter procedure results in leaving no record in the capital stock account of the material required by the regulations.

If the issue of capital stock is viewed as a transaction amounting to a purchase of capital in cash for a consideration of stock, the commission could be expected to inquire rather closely into flotations handled through affiliates in view of the close scrutiny given similar situations in the case of assets of all sorts. Such is the case, for if sales of stock issues were made through affiliates, the registrant is required to give full details of such transactions and indicate the respective amounts received by the issuer and affiliated interests.<sup>53</sup>

### *E. Contingent Liabilities*

The registrant's contingent liabilities appearing on the face of the balance sheet proper are required to be broken down and segregated in the supplementary schedule according to type and kind.<sup>54</sup> The suggested types of contingent liabilities in the instructions are guaranties of bonds and mortgages, indorsement of unrelated commercial paper, notes receivable discounted, unfulfilled contracts which in the judgment of the registrant's management may adversely affect the registrant, amounts claimed in pending litigation, and federal income and other taxes. The requirements as to the method of setting up these liabilities and what contingent liabilities must be set up are not dissimilar from the requirements of standard accounting practice. Some possible contingent liabilities will be so remote as to render inadvisable their recording on the balance sheet. Essentially the accountant here is faced with a question which calls for an exercise of his judgment. There may well be disagreement between the commission and the accountant as to just when a contingent liability becomes material and when it is immaterial; but any changes which the commission may make in standard accounting practice along this line will essentially affect the question of what is to be set up as a contingent liability, rather than how it is to be set up.

### *F. Depreciation and Amortization*

Prior to the Securities Act, information relating to the mechanics of computing depreciation and amortization, or the method used in figuring depreciation and amortization, did not appear on the face of the balance sheet and was not available in supplementary schedules. Under the Securities Act, however, wherever reserves for depreciation

<sup>53</sup> Balance Sheet Instruction 16, CCH SECURITIES ACT SERVICE, ¶ 6606.

<sup>54</sup> Balance Sheet Instruction 27, CCH SECURITIES ACT SERVICE, ¶ 6621.



exist, the registrant is asked to state the depreciation or depletion or amortization rules followed in computing the amounts charged off for depreciation.<sup>55</sup> In the case of depreciation reserves for fixed assets, the registrant is asked to make a comparison between the depreciation or depletion claimed to have been sustained for the purpose of federal income taxes and the amounts accrued through actual charges to surplus or income.<sup>56</sup> This information is required to be given for each and every year for which federal income taxes have been paid. Undoubtedly the practical effect of the requirement is to carry over into the registration statement the substantive rules of depreciation set up by the Bureau of Internal Revenue in connection with the income tax, for while it is not required that depreciation actually charged be the same as that claimed for purposes of the federal income tax, discrepancies would be difficult to explain. In any event, the requirement rather effectually nullifies attempts on the part of a registrant to carry a double set of books—one for the Bureau of Internal Revenue and the other for prospective investors.

In connection with the reserve for doubtful notes and accounts, the registrant is asked to state in the supplementary schedules whether, in its opinion, all notes and accounts known to be uncollectible have been charged off and whether adequate reserves have been provided for doubtful accounts.<sup>57</sup> Presumably this does not alter standard accounting procedure, as a reputable accountant would endeavor to charge off all uncollectibles, when convinced of their invalidity, and the theory of reserves for bad debts is rendered ineffective unless the reserves are sufficient.

In the case of depreciation, as in the case of contingent liabilities, the only effect of the act has been to force a disclosure of method, with no attempt made, within reasonable bounds, to force the registrant to comply with any concrete system for charging off depreciation.

### *The Statement of Profit and Loss*

The profit and loss statement required under the Securities Act is in the usual form, indicating income and expense for the registrant's fiscal year. It is to be observed that in the case of the profit and loss statement, as well as in the case of the balance sheet, scrupulous attention is given to such transactions reflected thereon as have arisen in connection with dealings between the registrant and an affiliate.

The disclosure required in connection with gross sales, cost of goods sold and resulting operating revenue has been a source of some

<sup>55</sup> Cf. Balance Sheet Instructions 2, 4, 8, 9, 14, CCH SECURITIES ACT SERVICE, ¶¶ 6578, 6584, 6596, 6597, 6602.

<sup>56</sup> Balance Sheet Instruction 2, CCH SECURITIES ACT SERVICE, ¶ 6579.

<sup>57</sup> Balance Sheet Instruction 9, CCH SECURITIES ACT SERVICE, ¶ 6597.

anxiety to those registering under the act, but the information which is required presents little that is new in the way of accounting practice. In the schedule of major classes of gross sales, the registrant is required to make a distinction between sales to affiliates and sales to non-affiliates.<sup>58</sup> In the statement of cost of goods sold, all intercompany profits should be segregated or eliminated.<sup>59</sup> The difficulty is that most competitive businessmen are reluctant to make any public disclosure of a detailed analysis of costs and the margin of operating profit. While profits arising from intercompany transactions are as welcome to the investor with an eye on prospective dividends as any other kind of profits, the segregation of such profits in the registration statement may be justified on the ground that the main value of this information is its use as an indication of probable future earnings based on the registrant's past record. Profits arising under strictly competitive conditions and resulting from transactions conducted at arm's length are, in theory, a better basis for making decisions as to future earnings.

Expenses in the nature of commissions and fees are required to be enlarged on in a supplementary schedule with an indication of to whom the fees were paid, whether for management, engineering, underwriting, financial or other supervisory services.<sup>60</sup> The amount of the charge made and the basis thereof should also be given. Most of this information ordinarily remains buried in the corporate books and does not appear on the statement of profit and loss. The same information is required in connection with income in the nature of commissions and fees received. The explanation for the extent of the disclosure required in connection with these items probably lies in the fact that the transaction involved is the sale or purchase of an intangible service where the possibility of inflated value is rather great.

To the extent that income consists of dividends on stock held by the registrant, a division should be made between income in the nature of dividends received on the stock of affiliates and that received on the stock of non-affiliates.<sup>61</sup> Another problem which arises in this connection concerns valuation of stock dividends. Where the registrant has received stock dividends from an affiliate, a disclosure of the basis of valuation used should be given, as well as the value assigned to the stock so paid out by the issuing company when charging it against surplus.<sup>62</sup> An indication of the class of surplus which the affiliate charged the stock dividend against should also be made. The latter

<sup>58</sup> Income Account Instruction I, CCH SECURITIES ACT SERVICE, ¶ 6626.

<sup>59</sup> Income Account Instruction I, CCH SECURITIES ACT SERVICE, ¶ 6626.

<sup>60</sup> Income Account Instructions 4 and 7, CCH SECURITIES ACT SERVICE, ¶¶ 6629, 6632.

<sup>61</sup> Income Account Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6630.

<sup>62</sup> Income Account Instruction 5, CCH SECURITIES ACT SERVICE, ¶ 6630.

requirement is probably directed towards a disclosure of any facts indicating "window trimming" on the part of the registrant. A disclosure is required to be made of all donated surplus of the registrant; this takes care of direct donations but does not cover the possible case where donations are made to an affiliate and are subsequently reflected in the registrant's financial statements as dividends on the stock of the affiliate.

Non-recurring expenses and income are often the result of sale or purchase of fixed or current assets exclusive of those articles which the registrant is engaged in manufacturing and selling or dealing in generally. The problem here is essentially the same as that encountered in connection with the valuation of assets on the balance sheet and the information required is practically the same. Where such sales are to affiliates, the cost to the registrant, the consideration received and nature thereof, and the profits recorded should all be disclosed.<sup>68</sup>

The original purpose of the regulation of securities issues was to force a full and fair disclosure of all facts material to the risk which the prospective investor in the securities was being asked to assume. Substantive regulation of internal accounting methods was never intended. Theoretically no particular system of accounting was required, provided the whole effect of the system used was to disclose those facts which were, in the opinion of the commission, material. Inevitably, however, the efforts of the commission to force adequate disclosure have resulted in more and more substantive accounting rules. A recent release announced an administrative policy in connection with accounting which marks a substantial departure from the original conception in this respect:<sup>64</sup>

"In cases where financial statements . . . 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."

This new declaration represents the logical development of any effort substantially and effectually to force a full and fair disclosure of material facts. Simply from the standpoint of administrative convenience and necessity, it would seem that some form of standardized accounting procedure would be imperative. To allow the registrant the use of non-authoritative accounting methods, provided explanation is made to the effect that the accounting method used does not truly

<sup>68</sup> Income Account Instruction 8, CCH SECURITIES ACT SERVICE, ¶ 6633.

<sup>64</sup> S. E. C. Accounting Release No. 4 (April 25, 1938).

represent the situation, is a much more cumbersome method of forcing the disclosure desired than a standardization of accounting procedure under the act would be. It is believed that the future decisions will show a substantial abandonment of the former conception, based on a realization that the standardization of accounting procedure by commission regulation is the only practical method of insuring the full and fair disclosure which is deemed desirable according to the terms of the act. The wise and judicious administration of the act along these lines may well result in a substantial benefit, not only to the investing public, but to the accountants themselves.

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