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Securities and Exchange Commission, the Accountant, and the Stock Exchange

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The Securities and Exchange Commission, the Accountant, and the Stock Exchange

BY JOHN HASKELL

MY TOPIC, "The S.E.C., the accountant, and the stock exchange," is fortunately broad enough to permit me, without presumption, to touch upon some aspects of the problems which the New York Stock Exchange has in common with accountants, and most of our real problems are of this kind. In so far as the objectives of the commission, the profession, and the exchange point toward a more informative and understandable portrayal to security holders and to the public of the pulsing, ever-changing flow of corporate business, these objectives are identical.

The Rôle of the Exchange

How does the New York Stock Exchange (which happens to be the stock exchange with the securities of most of our representative American corporations on its list) fit into this triangle? You are all familiar with its functions as an intermediary clearing house, receiving registration statements at the time it authorizes new listings, and acting as a liaison unit between the commission and corporations and their accountants in daily interchange of correspondence concerning the commission's comments, rulings, and requests as to registration statements and the various "K" reports. But, without minimizing the importance of this activity, the committee on stock list feels that this phase of its work is of the nature of a mopping-up action—vital, perhaps, to the attainment of our common objectives, but nevertheless devoid of the interest and action which characterize front-line progress.

The S.E.C. and the Exchange

I reiterate what representatives of the exchange have stated time and time again in the past, namely, that the listing requirements and the exchange's requirements for annual reports to stockholders are separate and distinct from the requirements of

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the S.E.C. as to the form of the registration statements and "K" reports filed pursuant to the securities-exchange act.

It is evident that government regulation of the form and detail of financial statements and the accounting principles upon which they are based must, of its very nature, establish minimum standards. The accounting profession goes further in its constant development of much higher standards, and we conceive that the important function of the exchange is to support the profession in obtaining from our listed corporations general acceptance of the highest standards of accounting and disclosure. This is the phase of the exchange's relations with the accountant that has been, and is today, the most interesting and dynamic. I believe that thoughtful observers, both in Washington and in business, agree that the function of the S.E.C. in this field should be of a residual or rear-guard nature—handling matters that can best be dealt with by governmental action. On the other hand, the exchange can by its very freedom from procedural delays act swiftly as new problems arise, and thus give advance-guard support to the forward strides of the accounting profession.

Activities of the Exchange

A recent example of action of this type in coöperation with accountants is the circular letter which the committee on stock list sent out to all listed corporations six weeks ago, dealing with the subject of commitments.

COMMITMENTS

The fall in commodity prices, starting last year, almost immediately raised questions in the minds of many accountants, analysts, and investors as to its repercussions on the affairs of the corporations in which they were interested: questions not only with respect to inventory positions, but more particularly as to commitments for the future purchase of raw materials. After a preliminary study by its own consulting accountants and conferences with many others, the committee sought and obtained the advice of the special committee on coöperation with stock exchanges of the American Institute of Accountants. A circular letter was then sent out, suggesting that each corporation should advise its stockholders whether or not it was the practice of the corporation to enter into commitments of this nature, and disclose directly in its financial statements the approximate amount of any unrealized loss existing on the date of the report. It was left to each corporation and its advisors to determine in what form this information and other pertinent data, such as any large or unusual commitments involving no present unrealized loss, should be disclosed.

Many inquiries resulted from this letter. We have been asked if a positive statement was desired in the annual reports of corporations which had no such commitments.

We have replied that, even where this was the case, it appeared desirable for the information of investors that some statement to this effect be included in the president's letter or in some other appropriate part of the report. However, the committee has indicated that a specific negative statement on this subject did not appear necessary in the reports of those railroad and utility companies which do not customarily have such future commitments for the purchase of commodities. I have seen dozens of the recently published 1937 reports of listed corporations and have been greatly impressed by the number that have accepted the principles suggested in this circular letter. Inasmuch as it was not mailed out until the middle of January, and some of the annual reports of corporations were published shortly thereafter, it is obvious that many had only a few days within which to weigh these suggestions and determine upon an appropriate manner of reflecting the facts in their reports to stockholders. The acceptance of this principle has the effect of extending the time-honored accounting procedure of the valuation of inventories to the analogous item of commitments.

DEPRECIATION POLICIES

An even more recent development of the exchange's listing policy occurred last month. For many years the committee has required that each listing application include a statement of the corporation's policy as to depreciation. Corporations applying for the listing of their securities have been required to enter into various agreements with the exchange, including, among others, the following:

"The corporation will not make any substantial change, nor will it permit any subsidiary directly or indirectly controlled by it to make any substantial change in accounting methods, or in policies as to depreciation and depletion, or in bases of valuation of inventories or other assets, without notifying the exchange and disclosing the effect of any such change in its next succeeding interim and annual report to its stockholders."

Some corporations, and they have not all been railroads and utilities, have been unable to describe their practice as to depreciation as a policy, for the simple reason that they had none. I do not mean necessarily that they made no charge against earnings for depreciation, but the charge shown in the reports to stockholders, at least, did not purport to bear any particular relation to the expected useful lives of the fixed assets, to volume of production or to anything else. It is clearly not the function of the exchange to determine *what amount* should be charged against earnings by any particular company to amortize its investment in capital assets and it is not its function to determine *what* policy the corporation, with its expert engineering, appraising, and accounting advisors, should decide upon. It *does* believe that a corporation eligible to have its securities on the New York Stock Exchange, with the implied invitation to the public to invest and trade in them, should have some depreciation policy which, in its essential particulars, follows one of the several policies which are commonly regarded as finding general acceptance among engineers and accountants, or a policy which, if novel, is sound and logical.

Investors in the stocks of industrial enterprises do not think of their plant and property as an exhaustible mine whose store of wealth is to be returned in full by distributions representing a return of capital as the ore is extracted and sold. Accepted practice in the past has led them to expect, barring a great change in price levels or a reorganization or capital readjustment, that the dividends they receive and the current earnings that are reported to them are *after* provision for maintaining the integrity of their capital investment. Only a Ponzi gaily paying out dividends from his capital or a rabid supporter of the surtax on so-called undistributed income might hold otherwise.

Therefore, last month, on the recommendation of Mr. Hoxsey, who has given years of study to this particular subject, the committee determined that, in the future, it would require a clear-cut statement of depreciation policy in all new listing applications for securities of industrial companies, and endeavor gradually, in the light of further experience, to have the few already-listed companies which have no such policy recognize this principle which has proved sound for the great majority. In reporting the committee's views on this matter, I emphasize that this extension of our listing requirements is not designed to induce any corporation to adopt any particular method, such as the straight-line, sinking-fund, adjusted-production or other specific system.

At present it is not intended to apply this requirement to utility and railroad companies. Until the basic problems of these sick brethren are solved, it does not seem to us practical or advisable to revolutionize their accounting practice in this respect. However, we cannot fail to observe in passing that these two great industries which are today suffering such grief have been in the past among the most unorthodox and cavalier in their consideration of the necessity of providing for the amortization of their capital assets. This, notwithstanding, and possibly even because of, the fact that in perhaps no other fields of business activity have accounting and reporting methods been subject to such variegated and detailed regulation by nonprofessional and nonbusiness regulatory agencies. Of course, it would be ridiculous to attribute the difficulties of our railroads and utilities solely to the accounting principles that they follow or to hazard an opinion as to whether doubtful accounting procedures result in business difficulties or vice versa. Whether the hen or the egg comes first I do not know, but there is no doubt that there is a close relationship between them.

The Exchange and the Accountant

I have endeavored to philosophize upon and to give examples of the relations existing between the S.E.C., the stock exchange, and the accountant. The letter on commitments and the new requirement as to depreciation policy are only two of the numerous progressive moves the exchange has taken in recent years step by step with the accounting profession. Mr. Hoxsey's appeal to the accounting profession in his address before the Institute in 1930 was the signal rocket, starting the advance. There is no time nor need to mention each forward move, but we cannot overlook either their number or the broad front they covered.

Many of the most important developments have occurred within the last five years. You will remember that it was only in 1933 that the exchange announced its requirement that financial statements included in listing applications and in the reports to stockholders of all companies except those under the direct supervision of established governmental agencies, such as the Interstate Commerce Commission, must be audited by independent public accountants qualified under the laws of some state or country.

Such rapid advances have been made that it seems time to stop for a moment and take stock. While the vast majority of listed companies have adopted these higher standards of disclosure and these advanced accounting principles, there have been some laggards.

Corporate Stragglers

For example, the great majority of our listed corporations today publish reports to their stockholders with a degree of disclosure that is unequaled in England or in any other country, as far as I know. The great majority of these reports are not only informative and clear, but are based upon the soundest of existing accounting principles.

Nevertheless, there are some corporations, and I regret to say that among them are a handful of the largest, whose balance-sheets and income statements are as outmoded as the clothes of the "Gay Nineties." The annual reports of some are so brief that they could be printed on a postage stamp. Others are almost as voluminous as the dictionary, but in their balance-sheets they do not even separate tangibles from intangibles, nor disclose the basis of valuation of their assets. In some such cases, the income account, which is of such vital importance to the investor, consists of only an item or two, such as "net earnings from all sources," or possibly this item and the amount of depreciation and provision for taxes. Other companies, whose reporting and disclosure are adequate, tenaciously hold on to archaic accounting principles in the report itself, accompanied by voluminous footnotes or accountants' certificates screaming with qualifications. Why should we ask more and more of the coöperative companies, while these laggards hang far behind?

Other Weak Spots

Nor is it helpful to security holders and the public for accounting standards to get too far ahead of those of the other professions. As pointed out in the recently publicized report of the Conway committee, appointed for the study of the organization and administration of the exchange, there has been a tendency to hold the exchange responsible for the acts of some corporations taken in accordance with lax corporation law. The exchange where the investor purchased his security, and which flaunts its changing prices before him daily in the headlines, is naturally a more tangible and personified subject for criticism than the legislature of some faraway state which enacted some antisocial corporate law.

While many lawyers and bankers individually have helped the exchange as much as accountants have to develop higher standards of corporate procedure, no profession has given as dependable and effective coöperation as yours. Perhaps it is more our fault than that of the other professions. We have not organized our relations and linked our efforts with those other groups in equally as practical and satisfactory a fashion as we have with yours.

New Requirements

The committee on stock list within the last few months has conducted special studies and adopted new requirements having to do with the terms of corporate indentures, and with charter and by-law provisions for the percentage of stockholders necessary for quorums at annual meetings. This, together with the increasing attention the committee is giving to statutory provisions affecting the rights, privileges, and voting powers of preferred and common stocks, indicates a recognition that there is still much to be done in the field of law as it affects the exchange. I cite this comparative weakness in the field of law as an example of the desirability of consolidating past progress, preparatory to further advances.

Therefore, before pressing on too rapidly to new objectives, the present appears to be a fitting time to consolidate the great advances made by your profession. There seem to me to be two excellent reasons why this should be done now. In the first place, we have the recently published outstanding report of Professor Sanders, of the Harvard University Graduate School of Business Administration, and his associates, Professor Hatfield of the University of California and Professor Moore of the Yale University School of Law.

"A Statement of Accounting Principles"

It has become increasingly apparent that, in order to clarify the public's understanding and to insure the effectiveness of the usual statement in the accountant's certificate, the position of the company and the results of its operations have been reported in accordance with accepted accounting principles. There was a real need for a codification and description of these principles. In my opinion, Professor Sanders' report accomplishes this purpose in a brilliant manner, at the same time carefully avoiding slipping into the dangers of dogmatism or petrifying the living art of accountancy in its present state.

This thorough, lucid, and illuminating statement of accounting principles, published early this year, marks a milestone in the development of the art. The temperance and the breadth of its scope cut through the fog of petty detail to fundamentals. Just as the floodlight of the airport helps the pilot to a happy landing, so this report should aid the accountant in the exercise of his expert knowledge to bring his task to a successful conclusion. The report itself states that the existence of a body of generally accepted accounting principles does not mean that there is only one proper accounting treatment for every situation with which the accountant must deal. No statement of principles can replace the good judgment and integrity of the professional accountant any more than floodlights and the radio beacon can be substituted for the experience and skill of the pilot. They can both serve as great aids to him.

Like an army after a series of victories, it seems to me that the exchange and the accounting profession now find the reports and accounting of listed corporations somewhat spread out and disorganized. Some elements are far to the front; others are over on one side; and a few lag miles to the rear. Sound judgment requires the consolidation of the lines at this point to meet new problems as they will surely arise. Here Professor Sanders' work will prove of invaluable assistance to many groups, and particularly to the S.E.C., the stock exchange, and the accountant.

The Market for New Capital

There is a second and perhaps a more vital reason to consolidate now the great advances of recent years. Today we are faced with a problem of greater significance. The accountant, the S.E.C., and the exchange cannot arrest this depression. We cannot restore the confidence of our people in the future. But we can all bring our influence to bear on one very sick spot. That one—of many sore spots in the present picture—is the stagnation of the capital markets, and particularly the market for new capital.

According to *The Commercial & Financial Chronicle*, public offerings of all corporate securities for new capital during the months of November, December, and January shrank to the infinitesimal average of less than $40,000,000 a month from an average of about $100,000,000 a month in 1936 and 1937. As a matter of historical interest, the *Chronicle* figures show that offerings of this nature in 1929 averaged over $700,000,000 a month. Our stock-exchange figures show that funds raised by listed companies as a result of issuing rights amounted to over $200,000,000 a month in 1929, over $50,000,000 a month during the first ten months of 1937, but averaged only $2,000,000 a month during last November, December, and January.

Consider what these figures mean to our country's corporations and business. Without new capital, and with the surtax on undistributed profits still effective, how can business maintain its scientific technical progress and sustain employment, much less expand its activities to result in higher standards of living?

I believe that the S.E.C., the accountant and the exchange can all in our respective and overlapping fields do our part to ameliorate this situation. While the fundamental factors and the great forces that are involved may be only slightly and indirectly influenced by our efforts, still we should excuse ourselves from no efforts to restore confidence by keeping the parts of business mechanism we touch clean and primed for recovery when it comes. I would not presume to point out just how the S.E.C. can do its part or what can be done by the accountant. We in the exchange feel that it is our part to simplify our procedure in every way, and particularly in the field of listing new securities to prepare the way for the flow of new capital into business. We have done much already and we will do more to review our requirements, to avoid a mass of voluminous nonessential detail, and to slash all kinds of red tape. In this way, the committee on stock list in its sphere can continue to be truly liberal and progressive and thus avoid the danger that all of us interested in higher standards must fear, namely, that an excess of uncoördinated reform will react as a boomerang to the defeat of its very purpose.