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Speeches SEC Staff

"DISCUSSION OF THE DUTIES

OF THE

CHIEF ACCOUNTANT'S OFFICE"

ADDRESS

of

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Those of you who have attended the earlier sessions in this series of talks know that, as a rule, each of the major divisions of the Commission administers some one particular Act. The Chief Accountant's office, however, does not fit into this category. Instead it largely serves in an advisory capacity to the Commission and all of the divisions. In this respect it functions a good deal like the General Counsel's Office. I like to look upon our job as one of acting as consultants for anyone within or outside the Commission who has an accounting problem relating to the various Acts administered by the Commission.

The Second Annual Report of the Commission describes the scope of our activities briefly but with some particularity. It states that:

"THE CHIEF ACCOUNTANT of the Commission is responsible for the rendering of advisory service to the Commission in connection with accounting matters; for the conduct of studies, investigations, and researches involving accounting theory, policy and procedure; for the conduct of conferences with accounting authorities and members of the staff regarding matters involved in the drafting and interpretation of accounting rules and regulations; for the supervision of the accounting work of the Commission whenever unusual matters, new procedure, or new policies are concerned; for supervision over the promulgation and administration of rules regarding uniform classification of accounts; for drafting and establishing procedure to be followed in the conduct of audits and accounting investigations; for rendering advisory opinions and instructions to the accountants assigned to the various divisions and regional offices of the Commission in connection with the disposition of highly technical auditing and accounting questions; for the preparation of accounting briefs, reports and memoranda regarding accounting matters under the jurisdiction of the Commission in connection with the administration and enforcement of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935."

Many of these duties may be summarized under the single heading "the standardization of accounting principles and practices."

As you know, one of the primary purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to bring about the dissemination of significant information about issuers of corporate securities. This purpose is accomplished in part by requiring issuers of new securities and issuers of listed securities to file registration statements and periodic reports with the Commission and the exchanges. One of the most important parts of these filings is the financial information about the enterprise.

To ensure that reasonably comparable principles be followed in statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934 these Acts give the Commission extensive control not only over the form of financial statements but also over the principles to be followed in dealing with many types of financial facts. These Acts grant the Commission the power by rules and regulations "... to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion,

in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer..." 1/

It is thus up to the Commission to bring about standards of accounting and reporting practice which will result in adequate, informative and intelligible financial information being made available to investors under the requirements of these statutes. When these Acts were being considered by Congress these provisions were thought by some to permit the prescription of uniform accounting systems. Uniformity to this degree has its place. When applied to sufficiently homogeneous groups of companies, the uniform system of accounts can be effectively utilized, for example, the uniform classifications prescribed for various types of utility companies. Under the Public Utility Act of 1935 we have provided uniform classifications of accounts for electric and gas utility holding companies and for mutual service companies. On the other hand, the legislative discussion at the time the Securities Acts were before Congress indicated that uniform systems were not deemed essential in attaining the objectives of these Acts, applicable as they are to an infinite variety of issuers. Nor do I believe that it is necessary or desirable that fully standardized forms be prescribed for financial statements.

At the time when these Acts became law, accounting had developed to such a point that it was believed feasible to prescribe forms that in large part asked only for disclosure of some of the more significant principles upon which the statements were based and for disclosure of a certain amount of information believed to be of particular importance to investors. The form of presentation, the method of description, the inclusion of information beyond the minimum, and the fundamental responsibility for the quality of the statements were problems left on the shoulders of the issuer and its officers. In addition, it was required that independent accountants make a review and express their opinion of the accounting principles followed and the statements presented.

Pursuant to these requirements registrants submit financial statements accompanied by accountants' certificates which in their usual form state that:

"In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 19__, and the results of its operations for the year."

The policy followed by the Commission at the outset of the Acts has not been entirely successful. The reports filed with the Commission reveal the application of a wide variety of accounting principles and practices, of more or less general acceptance but often highly contradictory. A review of statements filed with us and the accompanying certificates shows that in many areas of accounting there exist nearly diametrically opposed theories. The need for the development of uniform standards and practice in major accounting questions is clear. I don't mean that financial

statements can be so drawn as to enable a casual reader to get a thorough knowledge of the enterprise. I do mean that financial statements and the accounting principles back of them ought to be such that a reader with moderate training or experience in business and finance can draw reasonable conclusions about the financial condition and operating results. This is the goal we have in mind and our efforts are largely devoted to getting more and more uniform standards and practice in major accounting questions and more informative and useful statements.

In part this original policy failed and the Commission found it necessary to take measures to implement directly the provisions of the statute dealing with the form and content of financial statements and with the accounting principles reflected therein. As a first step we started nearly two years ago a series of opinions of the Chief Accountant, for the purpose of contributing to the development of uniform standards and practice in major accounting questions.

The problems which become the subject of Accounting Series Releases are presented to us in various ways. The more important and controversial problems which may arise with respect to a particular set of financial statements probably will be known to the company or its accountants before the statements are actually filed. Under such circumstances, correspondence or in some cases informal discussions, in advance of filing have proved that a solution can generally be found which will be acceptable to the Commission, the company and its accountants. The advantages of such correspondence and round-table conferences are apparent -- not the least of them being that we get to know something of the company's problems while they see ours, often for the first time.

Once a filing has been made, an examination of the financial statements follows as a matter of course. Under the 1933 Act, each registration statement, as you have already been told, is assigned to a group consisting of an accountant, a lawyer, an analyst and appropriate assistants. A memorandum of deficiencies is prepared from reports of the several experts. As to accounting matters, the deficiency memorandum is then reviewed by a supervising accountant. Under the 1934 Act a comparable procedure is followed as to applications for registration and annual reports. Before forwarding the deficiency memorandum, however, novel and important questions of accounting policy and principle are expected to be taken up with the Chief Accountant, and in exceptional cases with the Commission.

If the registrant disagrees with any of the deficiencies cited and the matter is not satisfactorily settled by correspondence, a conference may be arranged between the registrant and members of the examining staff for the purpose of clarifying the issues involved and obtaining further information as to the facts and circumstances of the particular problem. If no solution can be reached as to the accounting difficulties and the matter is of sufficient importance, further discussion or correspondence with the Chief Accountant may be requested by the registrant, and again, if necessary, the staff may present the issues to the Commission for its consideration. Ordinarily, however, agreement is reached as to an appropriate method of correcting by change or disclosure the points which have been questioned. Here again getting the other fellow's point of view often irons out what appear at first to be major disputes.

If the subject of the controversy is of limited application, a decision made in the case may go no further. If the matter is one of broad application, it may be made the subject of a memorandum for the guidance of all members of the Commission's staff. If the issue involves a general principle of accounting, it may lead to a public release. The subject matter of these releases sometimes develops in the manner described from the problems of a particular registrant or may have been suggested in the course of a general survey of statements on file. In either case, the whole area in which the problem falls is first thoroughly canvassed by members of the staff. All available written material is consulted and registrations involving the question are reviewed. In some instances special opinions are obtained from accountants and others in much the same manner as in connection with the drafting of important forms. I think I may safely say, however, that not yet have we sought an opinion and received an unanimous answer. With these opinions digested, a general conclusion is reached and an appropriate release drafted. In not a few cases, the conclusion is that no release should be drawn.

One of the Accounting Series Releases issued last spring is worth repeating here since it suggests, in a broad way, our present approach to the problem of standardizing accounting. It is number four in the series of public releases announcing these opinions.

"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."

This release should result in a careful sifting of accounting principles and the isolation of controversial points. Amendments in which financial statements are changed will henceforth indicate the correction of violations of generally recognized accounting principles. Amendments resulting in disclosure as to the principle followed will indicate the areas in which the principles to be followed are in controversy. There will thus be available a valuable record of the development of accounting principles.

Development of this sort is necessarily a slow process. It is a matter of growth. Not only must we carefully study each problem ourselves but we also consult with representatives of groups that would be affected. Prior to final approval and publication of a release, the views of

cooperating committees of the American Institute of Accountants, the Controllers Institute of America and the American Accounting Association are also obtained. We think that this procedure gets a better acceptance of our views and makes our releases, and rules and regulations, more effective.

These duties are perhaps our most important functions with relation to the several Acts but they are often pushed into the background by the press of more current problems. You have learned from Mr. Lane how the General Counsel's office serves all of the other divisions of the Commission in regard to legal problems. In somewhat the same way we are called upon from time to time to participate in activities assigned in the first instance to another division. Right now, for example, most of the staff which I am supposed to have is on the West Coast engaged in the investigation of a large bank holding company. When I try to use the remainder I find half of them are assigned to some of the other cases you have been reading about. This is because in connection with the enforcement work under the two Acts we are frequently called upon to participate in various types of hearings or assist in the preparation of the cases. Where in hearings under the Securities Acts accountants are found to have violated rules of ethics, to have certified false financial statements and not to have been independent, it becomes our duty to take their cases up with the state boards of accountancy to whose jurisdiction they are subject. Sometimes we take an active part in the conduct of the hearings. You doubtless have heard of the recent phantom drug company which involved some serious questions from our point of view as to the auditing procedures followed by the public accountants certifying to the financial statements for use under the Securities and Exchange Act. Because of working on this case you may recall I had to postpone until now the privilege of talking to you about our work. In that case we organized and conducted the portion of the hearings dealing directly with finding out what accepted auditing practice is at the present time.

When hearings have been completed we are ordinarily asked to assist in the drafting of an opinion so far as it concerns accounting problems. Occasionally, our participation goes even further. Recently in a case where a stop order issued, one of our men who assisted in the preparation of the stop order opinion went before the Grand Jury in connection with criminal charges brought against officers of the registrant.

I think I have indicated most of the points on which we try to be of some assistance to the Registration Division and the General Counsel's Office. As to the Public Utilities Division, you have already learned of the general scope and nature of the problems which confront them. You may recall that many of the evils alleged to have existed in public utility holding companies prior to the passage of the Act had their genesis in the accounting practices of those companies. It is not surprising therefore to find that the Public Utility Holding Company Act included broad powers of control over the accounts and accounting methods of the subject companies. In connection with this work under the direction of my predecessor uniform systems of accounts and reports were prescribed both for pure holding companies and for mutual and subsidiary service companies. Naturally the substantive requirements of these reports follow pretty closely the uniform classifications of accounts prescribed by the various state commissions.

They were, however, drawn up to take care of the possibility of abuses peculiar to holding companies and contain specific rules on such matters as the treatment of transactions in holding company stock, the question of dividends on subsidiary's securities, the amount at which the investments may be carried and the like. While there is a large staff of accountants assigned to the Utilities Division who work exclusively on these matters, there are, from time to time, many questions involving problems of policy and problems not directly covered by the classification. In the discussion and solution of these we spend a good part of our time.

As to the other divisions of the Commission, such as the Reorganization Division and the Investment Trust Study, we offer service in the nature of special studies and comment and conference on accounting problems arising in their work.

From what I have said before, it may seem to you that very little of our work has to do with people outside of the Commission. However, in that direction it seems to me sometimes as if we were looked upon by the public as a sort of information bureau on accounting. In addition, of course, our work on accounting problems involving registrants and our work on the releases as to accounting principles naturally bring us into direct contact with the accountants and, less frequently, the attorneys representing particular registrants. Then too at the present time the professional societies are very actively studying ways and means to improve both accounting and auditing. This, of course, is one of our chief interests as well. In connection with it, we are constantly giving, as well as receiving, cooperation.

I think it is probably apparent, from what other speakers on your program have said, that a knowledge of finance and of law is essential to those who seek the fullest progress possible within the Commission. I hope that what I have said has indicated somewhat the importance of accounting for this purpose since accounting is the language in which are written many of the problems with which the Commission is faced.