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STANDARDS OF DISCLOSURE IN FINANCIAL STATEMENTS

ADDRESS

of

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Before the

MIDDLE ATLANTIC STATES ACCOUNTING CONFERENCE

at

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Being a fellow of the Virginia Society of Public Accountants I am happy to have the privilege of participating in this round table discussion of "Standards of Disclosure in Financial Statements". Your attendance at such meetings evidences a determination to explore the full extent of your responsibilities, and also indicates a desire to direct attention beyond the accounts themselves in order to obtain a fuller realization of the implications of accounts in present day society.

It would be idle for us to pretend that corporate reports in the past have always been truthful and revealing. There are, of course, outstanding exceptions in this field, but too often accounting practices have been employed for the purpose of concealing rather than of revealing the true situation to the investing public. Then again, much of the concealment has been due to a certain secretiveness on the part of corporation executives, based upon the theory that only their competitors would benefit from such disclosure as might be made by informative financial statements. It is my understanding that in the past scarcely more than sixty percent of the companies listed on national securities exchanges revealed to their stockholders anything more about the operating results of their companies than some general figures with respect to their operating income. Although, of course, in some instances there may be validity in this claim for privacy, there can be no doubt that in the majority of cases the idea cannot be seriously entertained that to give a fair and full report of corporate assets and profits will give an unfair advantage to competitors. Certainly, except in unusual instances, where such a claim is insisted upon one may well doubt the desirability of encouraging public investment in the enterprise.

Without adequate corporate disclosures the basis of stable investment is, of course, lacking. If the figure given as earnings in an income statement represents other than true earnings or includes without disclosure a non-recurring profit, the uselessness of estimating market value in terms of a ratio to earnings is only too apparent. And market values, to reflect accurately corporate success rather than mere market activity, must bear some relationship to earnings.

The Securities Act of 1933 and the Securities Exchange Act of 1934 give the Commission a great opportunity to deal with this problem so as to evolve standards of corporate reporting that shall be both adequate and consistent. As you are aware, one of the main objectives of these two Acts is to make available to investors significant information about issuers of corporate securities. This 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 insure 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"

At the time 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 a 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 issuers and their officers. In addition, it was required that independent accountants make a review of the accounting procedures followed by the registrant and its subsidiaries, and by appropriate measures satisfy themselves that such procedures were being followed, and state clearly their opinion in respect of the financial statements of and the accounting principles and procedures followed by the registrant and its subsidiaries.

The success of the application of the basic principle underlying the two Acts that complete and fair disclosure of material facts should be made, is dependent on no one more than on the accountant, and it would be unfair not to acknowledge the influence which the accounting profession has had in the improvement of conditions within its scope, but it would be fatuous to assume that because the profession exists there is no occasion to be critical of results produced and no need of taking stock of what remains to be done.

Granted that many people are unable to read statements and certificates intelligently, it seems to me that the aim of the accounting profession should be to make those statements and certificates as clear and unambiguous as their technical nature permits. Financial statements which conform to conventions and customs are not adequate if, in fact, they serve to conceal or fail to bring to light financial conditions or results which an intelligent investor needs to know in order to form a judgment. Certificates are not adequate if they evade expression of opinion regarding accounting practices which are not sound. I question how far an accountant may, in good conscience, resort to a multitude of notes attached to statements to explain unsound, questionable, or irregular practices where clarity of statement and of opinion would be better obtained by showing as a part of the statements themselves, the adjustments necessary to bring those statements into accord with sound practice.

However, experience with statements filed under these two Acts indicated that the profession had some way to go to meet its full responsibility. For example: The financial data of a registrant as originally presented by it included twenty-six pages of notes pertaining to the balance sheet and profit and loss statement. The certificate of the accountants included numerous qualifications and exceptions. The information presented in supplementary notes and in the accountants' qualifications was so complicated that it was next to impossible to get any adequate understanding of the facts. It appeared that in this case adequate disclosure could not be made without some adjustment in the financial statements themselves. To overcome this condition, the various financial statements were amended to give effect to many of the adjustments referred to in the accountants' certificate and in the footnotes. This was accomplished by reflecting in a columnar statement the figures as per the company's books, footnote adjustments, and amounts if adjusted as explained in footnotes. Through the footnote adjustments in columns 2 and 4 of the balance sheet, surplus was reduced from approximately \$126,000,000 to a deficit of approximately \$27,700,000 as at December 31, 1935. The final statements as drawn contained a large number of footnotes and the accountants' certificate was long and complicated, but it was felt that it was considerably simpler and more understandable to the investor than it was before the statements were required to be changed.

In one case a listed company reduced the net book value of its fixed assets as of a particular fiscal date from approximately \$19,000,000 to a nominal amount of \$1.00. Since that time it has been the policy of the company to maintain the fixed assets then in existence at a net book value of \$1.00 and to charge all provisions for renewals and replacements to profit and loss. The company capitalizes the cost of new property other than replacements of the old property and accrues depreciation on the newly capitalized property at what appear to be reasonable rates. In footnotes appended to the financial statements it was disclosed that depreciation claimed for income tax purposes during the period from 1933 to 1937 exceeded by approximately \$3,000,000 the amount charged to profit and loss over the same period for renewals and replacements of old property and depreciation of new property.

In another case a note was appended to the profit and loss statement of the registrant, indicating that in accordance with resolutions of the Board of Directors, losses on disposition of non-operating properties and investments for the year, aggregating \$134,000, which in the absence of such resolutions would have been charged to Profit and Loss or Earned Surplus Accounts, were charged to Capital Surplus - Appropriated for Losses on Disposition of Capital Assets.

In still another case the following note was appended to the balance sheet of a registrant: (X) Company, (a subsidiary) also acquired 100,000 shares of the capital stock of (Y) Company (its parent) in exchange for 1,501,000 shares of its capital stock, which investment is carried at the par value of said 1,501,000 shares, \$1,501,000, and is included in the item 'Investments in securities of affiliates'. The equity of (X) Company in the net assets of (Y) Company as shown by the books of the latter amounted to \$111,065.16 at December 31st. The accountants did not comment in their certificate with respect to security valuation. I might add that (Y) Company carried the investment in (X) Company at \$10,000.

I could cite a number of similar cases, but I shall not test your patience further because I am sure you will perceive from the above why the policy followed by the Commission at the outset was not entirely successful. A substantial number of the reports filed with the Commission revealed the application of a wide variety of accounting principles and practices, of more or less general acceptance but often highly contradictory, and the accompanying certificates showed that in many areas of accounting there exist nearly diametrically opposed theories.

It seems to me that one of the reasons why accountancy has not more nearly fulfilled its possibilities is the tendency to rely on precedent rather than on the scientific method. My observation of statements leads me to the conclusion that so-called standards in the field of accounting have been too frequently determined by what actually prevails in practice. Once a method has been followed there is a tendency to accept it without question or hesitancy. It becomes the proper thing to do because it has been done before or someone else is doing it. Too often it is accepted without inquiry as to the possible consequences. As a result it gradually develops into an accepted practice.

The need, therefore, for the development of uniform standards and practice in major accounting questions is clear. It is also clear that to be of service in the improvement of financial reporting, any statement of principle must avoid the pitfalls inherent in generalities.

As a result of the partial failure of its original policy the Commission found it necessary to take measures to implement 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 there was instituted a few years ago a series of accounting opinions of the Chief Accountant, which express a few standards as to principles which, it is believed, are accepted by a majority of accountants. The approach must, of course, be cautious, but I am convinced that accountants as a whole regret that standards are not more exactly defined. You are doubtless familiar with these opinions, some of which I shall refer to later. One issued in April 1938, I believe is worth repeating here since it suggests, in a broad way, the Commission's present approach to the problem of establishing uniform accounting procedure. It is Number 4 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."

While I believe it is recognized that the responsibility for furnishing fair and adequate information regarding a corporation is primarily the obligation of management, the independent accountant assumes the responsibility for reviewing the records and the reports of management for the purpose of expressing his professional opinion as to the fairness of the representations made in the financial statements.

It is apparent, therefore, that Release No. 4 is a prescription for curing some of the accounting ills. It is an effort to preserve and make effective those practices recognized as sound. It flows from the desire to improve and assist the profession in maintaining a high standard by adjusting where adjusting is required to reflect the application of sound practice, and disclosing where disclosing is required to reflect those pertinent facts and events essential to a clear understanding of the statements. Unless this is accomplished the aim of the profession will be defeated. For it is one of the primary purposes of disclosure to reveal such information regarding the condition and operations of a business as will enable a prospective investor to form intelligent conclusions regarding its affairs. Obviously it is the very availability of such information that distinguishes a good from a mediocre or poor report. The quality of the information which the average investor receives in forming his judgment of values becomes a matter of importance because it is intended to bring home to him better knowledge of what he is doing and to furnish him with better norms by which to estimate the character and quality of the security he is buying, holding or selling, a task which the accounting profession must work toward to accomplish its aims.

In considering when and where to make disclosure, care should be taken that the accountants' certificate contains a clear disclosure of the facts required therein, that the financial statements have been drawn to include such disclosure as is appropriate, that supplemental schedules which are submitted, when this method of disclosure is necessary to bring out the desired facts, are not too complex, that the required footnotes to the financial statements are not too vague and indefinite but do explain the point clearly, and that meaningless and unnecessary notes which tend to obscure rather than disclose are omitted. The inclusion of numerous comments concerning items of little or no importance, with only a few that are material, is confusing rather than enlightening and tends to bury those items that have real significance. Furthermore, no amount of contradiction in footnotes can avoid the effect of improperly applied principles in the preparation of the statements themselves. Footnotes should contain explanatory material, but not qualifications and exceptions which of course belong in the certificate itself.

As you are aware, considerable effort has been made in the past to stimulate the recognition and adoption of some basic standards of disclosure in financial statements. Accounting texts and publications by the American Institute of Accountants and other groups have advocated, recommended, and suggested certain disclosures which should be made, but the adoption of these suggestions was left to the voluntary action of the practitioners and their clients, which, in the absence of definite requirements, naturally resulted in the lack of uniformity in disclosing pertinent financial information. These efforts, however, were important contributions to the development of standards and paved the way for subsequent advances.

Standards of disclosure may be said to be concepts which are not finished concepts, but are still evolving. When the Commission promulgated its rules governing the financial statements required to be filed under the two Acts, a forward step was taken in establishing certain standards as requirements. As a part of its program of seeking simplification of its accounting requirements, after a comprehensive study the Commission, in February of last year, made certain changes in, and combined under one pamphlet, the rules and regulations applicable to various registration statement and annual report forms, and designated it as "Regulation S-X", which sets up standards of disclosure in financial statements required by such forms.

While most of you are probably familiar with these standards, for the benefit of those who may not have had occasion to refer to Regulation S-X, I shall make a general review, particularly of those standards which are most frequently omitted in financial statements, and of others which I believe it is important to repeat to impress upon members of the profession the fact that they are recognized as actual standards. First, I shall review the disclosure requirements with respect to certain of the items required to be reflected in the balance sheets of commercial and industrial companies. Rule 5-02 under the indicated sub-paragraphs provides that, among other things there shall be disclosed:

- (2) The basis of determining the amount at which marketable securities are carried, and parenthetically or otherwise, the aggregate cost and aggregate amount on the basis of current market quotations.
- (6) The major classes of inventory, the basis of determining the amount, and, to the extent practicable, a general indication of the method of determining the "cost" or "market": e.g., "average cost" or "first-in, first-out".
- (11) The basis of determining the amount of "Other Security Investments" and parenthetically or otherwise, if available, the aggregate amount on the basis of market quotations.
- (19) The method used in amortizing debt discount and expense and;
- (20) What provisions have been made for writing off "Commissions and Expense on Capital Shares."

- (30) Whether "Other Long-Term Debt" is secured and the total amount by years of the respective maturities for the succeeding five years.
- (33) For each class of "Capital Shares" the title of issue, the number authorized and outstanding, the capital share liability thereof, the dollar amount subscribed but unissued and subscriptions receivable thereon, and, unless required to be shown as a deduction from surplus, the amount reacquired.
- (34) As to surplus, the rule requires that it be segregated into the usual categories of earned, paid-in, other capital surplus, and also surplus arising from revaluation of assets. This is subject to the exception that if in the accounts separate balances for these classes of surplus are not maintained the unsegregated items may be stated in one amount, in which case the account titles used shall be such as will indicate the general type of surplus included therein. Furthermore, if undistributed earnings of subsidiaries are included, the amount shall be disclosed.

To supplement certain of the major items reflected in the balance sheet, Rule 5-04 requires that schedules be furnished to disclose the additions and deductions during the period, and in some cases, other pertinent information.

Turning to the profit and loss statement -- The disclosure requirements are in general similar to those recommended by the American Institute. Rule 5-03 requires disclosure of the usual major items--Sales, Cost of Sales, Other Operating Expenses, Selling, General and Administrative Expenses, and, in reasonable detail, the financial and miscellaneous items of income and expense. In addition, it requires disclosure in the statement, or in a note therein referred to, of the amounts and the basis of determining such amounts, of inventories used in computing cost of goods sold and, where profits or losses on securities are reflected, a statement of the principles followed in determining the cost of securities sold, e.g., average cost or first-in and first-out.

The details of such items as depreciation, taxes, maintenance and repairs, rents and royalties, and the amount of dividends received from subsidiaries, together with the equity in earnings in such subsidiaries, are required to be disclosed in the two schedules prescribed by Rules 12-16 and 12-17.

Next, I should like to cite some of the further disclosures which are required to give a clearer understanding of the accounting policies pursued and of those significant items of financial information which are not usually indicated in the face of the statements. Perhaps I should mention, before proceeding further, that the Commission, realizing that simplification, where feasible, contributes to a clarification, particularly in those cases where notes bulk large, adopted Rule 3-08 which suggests but does not require that footnotes be collected in an integrated statement of accounting policies to which appropriate cross reference from the pertinent captions may easily be made. Continuing, there is Rule 3-18 which provides that, if present in the accounts, there shall be disclosed in the balance sheet or in notes thereto:

- (a) The amounts of assets mortgaged, pledged, or otherwise subject to a lien, and the obligations secured. However, this requirement need not be followed with respect to assets (other than current assets and securities) given as security for funded debt.
- (b) If practicable, the amount of any significant inter-company profits or losses included in inventory.
- (c) The facts and amounts with respect to any default in principal, interest, sinking fund, or redemption provisions of any issue of securities.
- (d)
 - (1) If preferred shares are callable, the date or dates and the amount per share and in total at which such shares are callable.
 - (2) The arrears in cumulative dividends per share and in total for each class of shares.
 - (3) The preferences on involuntary liquidation, if other than par or stated value, and when the excess is significant
 - (i) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value;
 - (ii) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case;
 - (iii) a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value;

and lastly,

- (e) A brief statement as to significant contingent liabilities.

Turning again to the profit and loss statement, there is Rule 3-19 which provides that, if present in the accounts, there shall be disclosed in the profit and loss statement or in notes thereto:

- (a) The basis of taking profits on instalment sales into income;
- (b) The amount, if practicable, of any significant inter-company profits or losses included in the statement; and
- (c) The policy followed during the period with respect to--(1) and (2) The provision for depreciation, depletion and obsolescence of physical properties and/or intangibles, or reserves created in lieu thereof, including the method and, if practicable, the rates used;

(3) The accounting treatment for maintenance, repairs, renewals, and betterments; and

(4) The adjustment of the accumulated reserves for depreciation, depletion and obsolescence, amortization, or reserves in lieu thereof, at the time properties are retired or otherwise disposed of.

A further disclosure is required by Rule 3-07 which provides that a statement shall be given in a note to the appropriate statement of any change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years made at the beginning of or during any period covered by the profit and loss statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.

Then there are the rules governing disclosure in connection with consolidated or combined statements. For instance, Rule 4-04 requires that the principle adopted in determining the inclusion and exclusion of subsidiaries in each consolidated and combined balance sheet, and whether there have been included or excluded any persons (naming them) not similarly treated in the corresponding statements for the preceding year, shall be stated in a note to the respective balance sheet.

Similarly, Rule 4-05 (a) calls for a statement, in a note to each consolidated balance sheet, of any difference between the investment in subsidiaries consolidated, as shown by the parent's books, and the parent's equity in the net assets of such subsidiaries, as shown by the books of the latter, and the disposition made of such difference in preparing the consolidated statements, naming the balance sheet captions and stating the amounts included in each.

Not wishing to tire you with too much detail, I shall pass over a number of the rules and refer at this point to a few of the additional disclosures called for in several of the Accounting Series releases.

In Release No. 15, dealing with quasi-reorganizations, the opinion is expressed that in addition to designating the point of time from which earned surplus dates, any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate for at least three years the total amount of the deficit and any charges that were made to capital surplus in the course of such reorganization which would otherwise have been required to be made against income or earned surplus.

In connection with quasi-reorganizations the question will occasionally arise as to what disclosure is necessary for the investor when a legally permissible course of action is not in accord with sound accounting. I have reference to the case where, under a company's charter and the applicable state of law, it is permissible to effect this type of reorganization without approval of stockholders. Accounting Series Release No. 16 deals with this problem and concludes with the opinion that it is necessary to make a complete disclosure of all of the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement filed thereafter. For a description of the details required to be reflected in the balance sheet I refer you to this release.

Moving on to the accountants' certificate, I believe I can safely state that one of the functions of the public accountant (to suggest to an impartial mind the accounting practices and policies of issuers) has often been lost sight of by his failure to furnish that protection to investors which might be afforded by disclosure in the accountants' certificate. Too often the accountant has been inclined to follow the easy course by stating the facts in general terms, leaving the reader to his own interpretation, and contenting himself with the use of the phrase, "subject to the foregoing" or some other equivocal phrase. It is this course which must be resisted if advancement is to be made. Effective resistance must take the form of constantly re-appraising and testing the soundness and propriety of those conventions which tradition and practice have fashioned, but which experience and the protection of investors frequently prove to be not only inadequate, but meaningless. As a consequence, the revised rule regarding accountants' certificates, known as Rule 2-02, was issued on February 5, 1941, effective as of March 1, 1941. This rule sets up the standards of disclosure for accountants' certificates accompanying financial statements filed with the Commission. I shall refrain from reciting the details required by this rule, because it has been clearly explained in the releases announcing its adoption, as well as in Bulletins Nos. 5 and 6 -- "Statements on Auditing Procedure" -- issued by the Committee on Auditing Procedure of the American Institute of Accountants. Believing, however, that you will be interested in the type of certificate now being submitted under this rule, I shall read excerpts from one recently received, which includes the opinion of the accountants with respect to changes in accounting principles or practices or adjustments of accounts, required to be set forth by Rule 3-07.

"In connection with the examination of such financial statements and supplemental schedules, we reviewed the system of internal control and the accounting procedures of the Companies, and examined or tested accounting records and other supporting evidence by methods and to the extent which we deemed appropriate, but we did not make a detailed audit of the operations or cash transactions for the period. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances, and included all procedures which we considered necessary.

.....

"During the year, the company reduced from 22-1/2% to 7-1/2% the portion of the net finance charge on discounts receivable which is taken into income in the month of acquisition as an offset to acquisition costs; in our opinion, this was a change from one acceptable practice to an equally acceptable one. The change has the effect of postponing the taking up of income; it was impracticable to determine its effect on the net income for the year.

"During the year an amount of \$55,816.17 was transferred from the loss reserve to income to adjust the reserve on October 31, 1940 to 2.25% of discount receivables on that date; and \$78,116.47 was charged to income in adjustment of the cost of insurance placed with _____ Insurance Company during the six months ended _____

November 30, 1940. In our opinion, such adjustments were proper except that, since the original provisions for the loss reserve and the insurance cost were made from gross finance charges, and since a portion of such gross finance charges remained as deferred income on November 30, 1940, the adjustments should preferably have been prorated between income and deferred income; however, such prorations would have involved so many computations as to render them impracticable, and since the adjustments tend to offset one another, the omission of the proration had no material effect upon income.

"In our opinion, the accompanying statements and schedules with the notes appended thereto, fairly present, in accordance with accepted principles maintained consistently by the Companies during the year (except as noted in the immediately preceding paragraphs), the financial condition of the Companies on November 30, 1940 and the results of their operations for the year ended that date."

I need not go into the details of the reasons which underlie these requirements, first, because every rule of substantial importance evolves from observation, research, and consultation with outside experts, and second, because I am sure you will agree that investors are entitled to have all the facts necessary to make an intelligent appraisal of the information given in the financial reports. Moreover, it must be realized that standards of disclosure cannot be molded into a fixed formula but must remain flexible to take care of events that occur under varying circumstances. For this reason and to retain this flexibility, there is Rule 3-06 which states:

"The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. This rule shall be applicable to all statements required to be filed, including copies of statements required to be filed in the first instance with other governmental agencies."

In many cases there may be no ready standard of measurement for gauging the materiality of information to determine whether it should be disclosed. In such cases, if any doubt exists that its omission would leave a gap in the information needed for a clear understanding of the report or would lead to an incorrect interpretation of the data furnished, it is my opinion that disclosure should be made in the statements. In order to shed further light on this subject I think it worth while to cite from a few of the Commission's decisions some of the opinions expressed therein with respect to certain disclosures in financial statements. For example, in the case of Mining and Development Corporation the Commission held that where property was set up as an asset, with disclosure that it secured a debt but without disclosure that default on the debt had taken place, it was misleading despite the fact that at the hearing creditors asserted that they had no present intention of foreclosing if the registrant could float sufficient securities to repay the loan. 1/

Then in the case of Bankers Union Life Company the Commission said:

"The balance sheet is misleading in other respects. Claimed as an asset is the item \$666,073.41, representing 'deferred payment - 12-year endowment bonds'. This sum represents the total amount payable on subscriptions to bonds and five times as many shares of capital stock, in accordance with the subscription agreement already referred to. This asset item does not represent obligations legally enforceable against subscribers, for they may, at any time, in accordance with the subscription agreement, discontinue payments and surrender their endowment bonds without subjecting themselves to any further liability to the registrant. It is misleading to claim this amount as an asset without indicating by a footnote or otherwise that the amount may be reduced at the election of a subscriber who fails to make payments." 2/

In the same case the Commission also stated:

"It is clearly misleading to represent as a general asset of the company bonds which have been pledged for the benefit of special classes of purchasers of endowment bonds. To fail to indicate that certain of the assets stated in the balance sheet were thus not available to the class of investor to whom the balance sheet is addressed is deceptive." 3/

In the matter of Canusa Gold Mines, Ltd. the Commission took the position that where an underwriter had sold and distributed stock in apparent violation of the Securities Act of 1933, and where minutes of the board of directors showed that the corporation had full knowledge of such distribution by an underwriter, and where no exemption under Section 3 of the Securities Act appeared applicable, that while the Commission would not adjudicate the question of civil liability provisions of Sections 11 and 12 of the Securities Act of 1933, a possible contingent liability existed and that a failure to disclose such contingent liability on a balance sheet and a statement that there were "no known contingent liabilities" rendered the financial statements untrue. 4/

Also in the Canusa opinion the Commission said,

"The registrant has clearly shown under both the assets and the liabilities on the face of the balance sheet, as well as in the footnotes thereto and in a supporting schedule, that 'mining properties' includes the six claims held on option and that the amount of \$115,000 is yet to be paid thereunder. Nevertheless, it seems to us that the failure to follow proper accounting practice makes the balance sheet materially deficient in this respect.

2/ 2 S.E.C. 68 and 69

3/ 2 S.E.C. 69

4/ 2 S.E.C. 549

"At no place in the financial statements or in the footnote related thereto is there any indication of the amount of other assets that would be lost to the registrant if the remaining payments provided for under the option should not be made. This we also deem to be a material deficiency." 5/

While in the matter of Metropolitan Personal Loan Company the Commission held that the failure to disclose the lack of a necessary reserve for re-possessed cars, in the light of registrant's previous losses on such cars, constituted an omission of a material fact. 6/ In that case the Commission also took the position that inclusion in notes and accounts receivable of items, substantial amounts of which were known to be uncollectible or doubtful, without disclosing that an adequate reserve had not been provided, was grossly misleading. 7/

In the Queensboro Gold Mines decision the Commission enunciated the principle that the face of the balance sheet containing untrue and misleading statements through overvaluation was not cured by a footnote disclosing the stated value to have been arbitrarily fixed by the buyer's board of directors controlled by seller. 8/ This case should be particularly noted for the points set out in that portion of the Commission's opinion which I now quote:

"The balance sheet submitted, moreover, is itself deficient. While custom permits an enterprise to set up its property in its balance sheet at cost, we have repeatedly held that the arbitrary valuation of assets at the par value of stock issued in their purchase is not such a cost and is misleading when, as appears here, the actual value of the stock at the time of the acquisition was substantially less than par. (*In the matter of Unity Gold Corp.*, 1 S.E.C. 25, 33 (1934); *in the matter of Canusa Gold Mines, Limited*, 2 S.E.C., 548 (1937).) Nor is the mischief fully cured by an explanatory note revealing that the figure is 'purely arbitrary' and that the vendor who purchased the property 'at a nominal cost' to himself, 'controlled the board who valued' the property. (*In the matter of Mining and Development Corp.*, 1 S.E.C. 786, 799 (1936).) Such disclosure, while helpful, is not sufficient. If, as asserted in the explanatory note the 'actual value is not known,' the investor is at least entitled to know the cost, in this case, the actual value of the stock issued, as measured by all available standards; and this both the balance sheet and the explanatory note fail to show." 9/

In the Potrero Sugar Company decision the Commission characterized as misleading a note explaining an asset described in a balance sheet because of inclusion of optimistic statements therein without disclosure of other factors having an adverse effect. 10/ And in the Oklahoma Hotel Building

5/ 2 S.E.C. 556

6/ 2 S.E.C. 803

7/ 2 S.E.C. 804

8/ 2 S.E.C. 860

9/ 2 S.E.C. 862

10/ 5 S.E.C. 983

Company proceeding the Commission pointed out that failure of a registrant to make the required monthly deposits under a sinking fund arrangement must be disclosed in the balance sheet or by way of a note thereto. 11/

Finally, there is the important problem of determining what disclosure should be made of events occurring between the date of the balance sheet and the date of the accountants' certificate. However, since this problem is an unsettled one, I shall dwell upon it only long enough to state that it is obvious that there is no need for the accountant to comment upon events subsequent to the date of the balance sheet if the effect is not significant. On the other hand, there is no question in my mind but that the accountant should disclose known happenings after the date of the balance sheet if disclosure will serve the interest of the investor and, at the same time, preserve the qualities of impartiality and reliability required of the independent accountant.

In this connection the language of the Commission in the Oklahoma Hotel Building Company case is significant. I quote:

"It is true that although a large interest payment was due the next day it was not necessary to indicate the pendency of this obligation on the face of a balance sheet dated November 30, 1938.

"However, the accountant was charged with the duty of disclosing in the balance sheet or by way of a note thereto any material defaults in interest payments occurring before the date of the certificate. This duty rests both on accepted accounting standards (See Proceedings of American Institute of Accountants [Fiftieth Anniversary Celebration, 1937], 317.) and on the requirements of full disclosure under the Securities Act. Such a default did occur. It was admitted by counsel for the registrant that the interest due December 1 on the second mortgage bonds was not met between that date and January 10, the date of the certificate. The failure of the accountant to disclose this fact was a material omission." 12/

It is hoped that this paper will stimulate increased interest in the subject and lead to its further development. In facing the work that is yet to be done, let us hope that in the troublesome days which lie ahead, the profession, responsive to experience and sensitive to the insistent demands of public interest, will set even higher standards of disclosure in financial statements than those now enduring.

11/ 4 S.E.C. 580

12/ 4 S.E.C. 583-584