ADDRESS OF

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of the

SECURITIES AND EXCHANGE COMMISSION

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before the

ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

As most of you doubtless know, the Commission, shortly before the holidays, issued what is known as Form 10, with an accompanying instruction book, to be used for the registration under the Securities Exchange Act of 1934 of those issues of securities which have been temporarily registered under the provisions of that Act. Within the past week the Commission issued a corresponding form, referred to as Form A-2, and the accompanying instruction book, for registration under the Securities Act of 1933 of issues of securities of corporations which file profit and loss statements for three years and which have, in the past fifteen years, paid dividends upon any class of common stock for at least two consecutive years, except such statements as to which a special form is specifically prescribed. The questions which I have been asked to discuss this evening are very largely related to those forms and to the accompanying instructions. Inasmuch as neither form has yet been used by any registrant the Commission has had no occasion to issue interpretations or opinions dealing with either of them.

In order that my discussion this evening might be fully authoritative, it would be necessary that the Commission should have passed upon all the questions to which I shall refer. That has not been done. I cannot speak to you as either an attorney or an accountant and, except as I may indicate otherwise, I hope you will take what I have to say as an expression of my opinion only, which opinion is necessarily in many respects a non-expert one. I believe that the answers which I shall attempt to give are correct answers but they cannot carry the weight of an opinion of counsel nor of an official interpretation by the Commission.

Before I take up the specific questions which I have been asked to answer, I should like to say a few words regarding Form 10 and Form A-2, and regarding the purposes and hopes of the Commission in connection with

the use of those forms. First, as to Form 10. It has been the hope and purpose of the Commission that its requirements for permanent registration on national securities exchanges of those securities which have been admitted to temporary registration would not have the effect of causing any delistings but would in fact tend to encourage the permanent registration of those securities. The underlying thought has been that, regardless of what the situation may have been in the past as to the transaction of business on the exchanges, it is desirable to keep, for securities which have already been listed, the free and open market provided by the exchanges. One major objective of the Securities Exchange Act is the prevention of practices which have caused criticism of the exchanges and the limitation of the exchanges to the performance of their functions in furnishing an open market. If the accomplishment of this objective may be anticipated, I think no one would deny that it is generally in the public interest that securities which have heretofore been on the exchanges should become permanently registered so that trading on the exchanges may continue after July 1st. Any course of action which unnecessarily results in failure to secure registration of such securities, including any course of action which might impose unnecessary burdens in connection with registration, we think would be an action opposed to the public interest. Therefore, in the preparation of Form 10 and the accompanying instruction book, the Commission has availed itself freely of the opportunity to consult with corporation executives, with leaders in the accounting and legal professions, and with representatives of the exchanges. I think it is correct to say that the reception which has been given to Form 10 indicates that the requirements are not considered unreasonable or unnecessary.

As to the new form for registration under the Securities Act of securities issued by going concerns, the Commission adopted much the same course

of procedure that it did in the preparation of Form 10. The actual drafting of the requirements was done very largely by a committee embodying experience gained by its members in the work of one of the leading investment services, in the analysis of securities for an investment banking house, and in the experience and studies of a member of the faculty of Harvard Business School. Effort has been made as far as possible to make the accounting requirements for registration of securities of going concerns under the Securities Act consistent with those for the registration of securities on the exchanges. The same free use of the criticism and suggestions which could be offered by experts not on the staff of the Commission has been made. We believe that we have accomplished a substantial reduction in the amount of time and expense which will be required in furnishing the information for registration under the Securities Act and that the information which is called for is that which has a real bearing on the question of the merit of the offering.

I should like to point out that the Commission has carefully avoided requiring uniformity of accounting either as to matters of classification or as to matters of principle. It has provided for a degree of uniformity in methods of reporting the results of business operations and the financial condition of the business, but even here its requirements are not rigid. Let me read you from the instructions issued with Form 10, the following:

> "The registrant may file statements and schedules in such form, order and using such generally accepted terminology, as will best indicate their significance and character in the light of the instructions."

and further from the same form let me quote a paragraph:

> "If any change in accounting principle or practice has been made during the period covered by the profit and loss statements and such change substantially affects proper comparison with the preceding accounting period, give the necessary

explanation in a note attached to the balance sheet or profit and loss statement and referred to therein."

Those who asked me to speak here this evening have submitted a list of questions with the request that those questions be answered. Before I go into the specific questions which have been submitted, I feel that I should comment upon and explain a rule of the Commission which has just been amended, which rule in its original form caused a great deal of confusion and misunderstanding. As I read the questions which were submitted to me, it became apparent that a great many of them grew out of that rule and the misunderstanding to which I have referred. Section 13 of the Securities Exchange Act deals with the filing of reports with exchanges and with the Commission as referred to in two paragraphs of that section. The important parts of the section, for the purpose of the present discussion, are those which state the general character of the reports which the Commission may require to be filed with the exchanges and with it. The Commission may require such information and documents as are necessary to keep reasonably current the information and documents filed in the applications for registration and it may require the filing also of such annual and quarterly reports as it may prescribe. No direct requirement dealing with these matters has been made, but the Commission did issue what was known as Rule KC1, which, in its original form, read as follows:

"Reports by issuers of securities registered under Rule JE1.

Every security registered pursuant to Rule JE1 (which was the rule providing for temporary registration) and the issuer thereof shall be exempt from the provisions of Section 13 upon condition that the issuer mails to the exchange and, in triplicate, to the Commission copies of all reports and financial statements which are made available to security

holders and/or the exchange at the time they are so made available."

Rule KC1 in the form which I have just quoted was commonly and erroneously understood to require issuers having securities temporarily registered to file with the Commission copies of all reports and financial statements which were made available to security holders or to the exchange. Actually, that was not the effect of the rule. The rule was issued in anticipation of requirements being promulgated under Section 13 to which I have referred, and provided, as you will have noted, that if issuers filed with the Commission the reports and statements covered by KC1 they would be exempt during the period of temporary registration from Section 13. But no requirements have been made under Section 13 and consequently there have been no requirements from which the filing of information under Rule KC1 could exempt an issuer.

Rule KC1, as I have said, was amended by the Commission yesterday, so that it now reads as follows:

> "Exemption of securities registered pursuant to Rule JE1 and issuers thereof from Section 13. Notwithstanding any provisions contained in applications for registration on Form 2, every security registered pursuant to Rule JE1 and the issuer thereof shall be exempt from the provisions of Section 13 for the duration of the period of temporary registration of such security."

Under the amended form of Rule KC1 there is no longer any doubt that the rule does not require that reports and statements furnished to stockholders be filed with the Commission in the cases of securities which are temporarily registered. Rule KC1 in its amended form also overrides a provision in the applications for temporary registration on Form 2 whereby issuers in substance have agreed to conform with the requirements of the old

Rule KC1. In addition to pointing out the clarification of Rule KC1, I might also say that Rule JF4 has been amended so that the exchanges are no longer required to file with the Commission annual reports and other statements of issuers whose securities are admitted to unlisted trading privileges.

The Commission has not yet issued its regulations governing permanent registrations on Form 10 and on the other forms which are contemplated, and therefore there are now no requirements for the filing of reports or other information by issuers whose securities become permanently registered. The Commission, of course, contemplates providing for periodic financial reports under Section 13. With the clear understanding that I am not in a position to express for the Commission its view on this subject, I think I may say that members of the Commission understand quite clearly that to require by rule or regulation, assuming that such power exists, that reports which are furnished to stockholders be filed with it, might result either in corporation concluding that they could not safely furnish to stockholders anything less than the full information required by Form 10, or by such form of annual report based on Form 10 as the Commission may prescribe under Section 13, or that those responsible might expose themselves to liability under Section 18 if they omitted from reports to stockholders information required in the registration statement or in other reports to be filed under Section 13.

Bear in mind that liabilities for misleading statements under the Securities Exchange Act arise only with respect to statements in any application, report or document filed pursuant to the Act or to any rule or regulation thereunder. It seems clear to me, therefore, that, unless the Commission has in effect a rule which requires that reports which are furnished to stockholders be filed with it, no liability can arise under the

Act on account of such reports to stockholders. This may be clearer if I make a comparison with requirements under the Securities Act of 1933. As you know, that Act requires not only that a registration statement be filed with the Commission, but also that a prospectus relating to that statement be furnished to the prospective investor. The Exchange Act, however, requires only the filing of certain statements and reports with the Commission. It does not have a further requirement for the actual delivery to investors of any reports or documents relating to the statements or reports so filed. Under the Securities Act liability arises both upon the registration statement and upon the prospectus; under the Exchange Act liability arises only upon the statements required to be filed with the Commission. Irrespective of any question as to the Commission's right to require by rule or regulation that reports which are made to stockholders be filed with it, I think that sound administrative policy obviously would indicate that such reports be not required to be filed with it by rule or regulation until the Commission should have determined either that those reports must contain all or substantially all of the information which might be required in reports prepared for filing under the provisions of Section 13, or that those who issue a more abbreviated report would not be exposed to liability under Section 18 because of the use of a more condensed form.

I think that what I have said makes it unnecessary to take up the considerable list of individual questions which have been submitted to me regarding what material should be included or might be omitted from reports to stockholders. The general question preceding the statement of the specific inquiries was:

"Regardless of whether the liabilities of directors and independent accountants are considered to exist under the specific provisions of the Securities Exchange Act or whether only the common law liability is deemed to apply in the case of annual reports to stockholders, does the fact that certain specific information is required to be filed with the Commission under Form 10 of the regulations recently issued by the Securities and Exchange Commission enlarge the scope of the information that should be furnished to stockholders?"

It is my understanding that the common law liability is not affected by the Securities Exchange Act. I think it is clear that there is no liability under the Act as matters stand now with reference to reports to stockholders. If I am correct as to both of these, the answer would be that the scope of the information that should be furnished to stockholders has not been enlarged. Understand that I am answering this question only with reference to the situation created by the Securities Exchange Act. I do not mean to be understood as saying that I think that reports which have actually been furnished to stockholders have always been what they should.

I think we may turn now to more specific questions which have been asked.

The first of these relates to the provision in reference to Form 10 that the information called for in that form is a minimum requirement to which the registrant may add such further information as will contribute to an understanding of its financial condition and operations. First the question is asked whether the use of the word

"may" conveys that the disclosure of additional information is optional to the registrant. The answer to that, as far as any requirement of the Commission is concerned, is "Yes". The disclosure of additional information is optional to the registrant. It is true that, aside from any requirement of the Commission, there may be instances in which it is necessary to furnish further information in order that that which has been given in response to the requirements of Form 10 is not misleading. I do not think that there should be any substantial difficulty in determining in most cases whether or not additional information ought to be given. It will usually be only that information which is clearly material, and I should say that if the registrant adopts the attitude that it wishes to give the information which is material rather than the attitude that it wishes to give as little information as it can and meet the technical requirements of registration, it should encounter no serious difficulty.

The question is then asked whether, if the registrant so interprets the phraseology, it will be protected under the Securities Exchange Act assuming that it has in good faith furnished in satisfactory form and content all of the information specified by the Commission in the registration form, or must other material facts be disclosed, such as those which I will mention. I do not know whether the framers of this question meant to alter its substance by making the reference to the necessity of including other material facts or not. The first specific question with reference to this is whether the registrant should show a surplus arising from donations by a parent company or by stockholders. I think there is no necessity of showing more as to surplus than the form requires; that is,

if the registrant has on its books separate balances in several surplus accounts those separate accounts should be carried forward in the registration statement. If it does not have on its books separate balances but carries all of its surplus in one account, all that it will be expected to do is to utilize that account for the opening balance and furnish an analysis for the year covered by the profit and loss statement. You will bear in mind in connection with this, however, that Form 10 calls for the submission of certain supplemental financial information dealing with investment, property plant and equipment, intangible assets, restatements of capital stock, and writing off of bond discount and expense ahead of the regular amortization program. This requirement will undoubtedly result in many cases in the registrant showing much that is important regarding the history of the surplus account.

The next question is whether the registrant should disclose, in addition to the information called for by the form, write-offs of operating deficits in prior years. I assume that reference is intended here to write-offs against other accounts than earned surplus, and I think the answer which I have just made covers the answer to this question also.

Another question dealing with whether or not additional information should be furnished has to do with the existence of large amounts of abandoned or obsolete property no longer used or useful which have not been eliminated from the property, plant and equipment account of the registrant. I think no all-inclusive answer can be given to that question. If reserves are adequate to take care of depreciation in used and useful property and in addition to absorb

the loss which would be accounted for by writing off the abandoned or obsolete property, I should say that the importance of showing the existence of such property would be much less than if reserves were not adequate. I think also that something will depend upon the type of business and the relative importance of the accuracy of a fixed capital statement to the investor. You will remember that the question related to "large amounts" of such property. No one could say as a general thing that the fact that such large amounts exist need not be shown, and certainly if they are of such magnitude as to appear to the registrant matters of importance they should be reported.

The fourth question having to do with the general topic of furnishing information not called for by the form relates to transactions which would require disclosure in accordance with the requirements of item 34, which is the historical survey to which I have referred, except for the fact that they occurred prior to January 1, 1925 and the specific question is whether the fact that the existence of these transactions prior to January 1, 1925 was known to the person certifying to the answers to item 34 would have any bearing with respect to the answer to this question. As a general matter, I do not think that it is necessary to report any of the sort of information called for by item 34 for any period prior to January 1, 1925, although I have no doubt that hypothetical cases might be set up and possibly some actual cases, in which the history of these accounts prior to January 1, 1925 might be of such significance to the investor that additional information should be furnished. I believe, however, that such cases would be quite exceptional and that the general answer to

the question is that there is no necessity of reporting as to these accounts more than is called for by item 34.

The next question asked I will read to you as it was presented to me:

"The instructions accompanying Form 10 with respect to the 'Supplemental Financial Information' (par. 6547-34) provide that the answers may be certified either by (a) the board of directors through its authorized agent or (b) the chief accounting officer of the registrant company or (c) independent public or independent certified public accountants. Assume that in accordance with these instructions the answers are prepared and certified by the chief accounting officer of the registrant and that the answers as thus prepared are later found to be false or misleading with respect to a material fact but that the directors and other officers of the company at the time of filing had no knowledge of the fact that the answers were false or misleading. Under such circumstances could the directors or other officers be held liable under the Securities Exchange Act?"

I do not feel prepared to give a definite answer to this question but I direct your attention to the fact that under Section 18 of the Act the liabilities for false or misleading information arise "unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." This section refers, among other things, to the liability of persons (such as directors) who cause statements to be made. The answer to the question, therefore, really depends upon the proof that the directors are able to make. If, under the recognized standards of the common law, they acted in good faith without knowledge of the falsity or misleading character of the statement and can so prove, I am sure that they would not be liable. I think that attorneys will agree with me that, under the standards of the common law, it would be only in the most exceptional case that a director who relied in good faith upon such statements prepared by the controller or other chief accounting officer would be charged with knowledge of facts that he did not actually know. Or, to put it more plainly, I think that if directors or officers who took such action in good faith would be held liable in any case, it would be only in a very exceptional one involving gross negligence on their part.

The next question to which an answer is sought is illustrated by the following assumed state of facts: X company's total sales for the year 1934 were $1,000,000. Sales of $900,000 were made under private brand to one customer, which customer is still purchasing substantially the same amount of goods. The question seems directed toward the extent of disclosure required under the Securities Exchange Act by the use in that Act of the words "or misleading with respect to

any material fact" as compared with the language of the Securities Act which reads, "or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading". Specifically the question is: "Does the Securities Exchange Act of 1934 provide only that the material facts stated be not misleading or, like the Securities Act of 1933, must there be no omission of material facts?" Of course, the Exchange Act lacks the provision imposing liability for omissions of facts required to be stated by the Act or the rules of the Commission, but with respect to omissions to state a material fact necessary to make the statements made not misleading, I believe there is no substantial difference in the provisions of the two laws. The substance of the standards provided in both acts is that a half truth should not be told. In other words, if, under the Securities Act, it appeared necessary to state something in order that the statements made in response to the requirements of the Commission should not be misleading, I believe the same necessity would exist under the Exchange Act.

In the specific instance cited, which has to do with a substantial part of a concern's gross sales being made to one customer, I direct your attention to the fact that the instructions with reference to item 41 of Form A-2, which has to deal with information as to material contracts under the Securities Act, state "any contract for the purchase or sale of current assets for a consideration less than 3% of net sales as shown by the registrant's latest profit and loss statement for an annual period filed with the registration statement, or, if a consolidated statement is filed, in the latest consolidated

statement for such period so filed," is to be deemed to have been made in the ordinary course of business. This leaves open the question as to whether contracts for sales in excess of 3% of net sales are made in the ordinary course of business and whether, under the Securities Act, they might therefore have to be summarized as required by item 41 of Form A-2. Not every material contract is required to be summarized but only certain material contracts not made in the ordinary course of business. The standard of the Exchange Act is not the same. Under that Act only material bonus and profit-sharing, management and service contracts, are called for.

The question really is whether it would be necessary to qualify the financial statements by reference to a statement of the situation, or to item 41 in the case of registration under the Securities Act. If it would appear necessary to qualify the financial statements in a registration under the Securities Act, then I believe the statements should be qualified in a registration under the Exchange Act. Assuming that there is no contract covering these sales, there would still be the question as to whether the financial statements should be qualified in either case. Personally I think that in as extreme a case as the one cited it would always be well to qualify the financial statements, although I believe that necessity for qualification might be affected by the position of the issuer in the business, by the keenness of competition, by the extent to which patents enable the issuer to control his market. I think no one can express a general opinion as to whether the financial statements ought to be qualified in every such case. Certainly the safer policy would to make the qualification. As extreme a case as that cited in the question would, I think, un-

doubtedly be brought out by the answer to item 11 of Form 10, which calls for a brief description of the general character of the business. Having in mind the question asked by item 11 and that, in fact, financial statements might be misleading which were not qualified by reference to the condition in question, I should say that the registrant ought not to omit reference to the situation.

The next question directs attention to the fact that the Securities Exchange Act affords remedies both to sellers and purchasers of securities who have sold or purchased the securities in reliance upon a false or misleading statement. The question is whether, where directors in good faith have adopted a policy which they believe to the best interests of stockholders and have been actuated by no ulterior motives but where that policy has been ultra-conservative with reference, for instance, to such items as provision for depreciation, provision for bad debt losses, and provision for inventory losses, the directors and independent accountants (unless they take definite exception to such policies) would be subject to the liabilities provided by the Act. Here again we have a question which is so broad that I doubt if it can be answered flatly. In a given case the policy may be so conservative as to amount to a substantial misstatement of financial condition or of results of operation, or it may be conservative only within such limits as would ordinarily indicate that the officers and directors of the corporation were merely following prudent practices. I think the best answer that can be given is that, if the ultra-conservative accounting policies materially affect the financial statements, the policies followed should be clearly stated and the fact that they affect the financial statements should be brought out. I do not think that such

qualifications should be limited only to those cases in which independent accountants might feel justified in taking definite exception to the policies. Let me illustrate. In public utility accounting it is common practice to make provision for retirement of property on a basis which falls far short of accepted depreciation accounting in industry generally. I do not regard it as the accountant's duty to take exception to that policy. I believe he should state what the policy has been and the nature of the effect which that policy has upon the financial statements. If the policy has been ultra-conservative, on the other hand, I think the accountant should likewise state the policy and the nature of its effects. In making this general answer I am not prepared to say that there may not be cases so extreme that the accountant should definitely take exception to the practice followed. I am merely trying to indicate that in my opinion the fact that ultra-conservative accounting policies have been followed and the nature of the effects flowing therefrom should be stated just as should be done if a policy which was not sufficiently conservative with reference to accounting for depreciation had been followed.

Form 10 provides for the furnishing in the application proper of certain schedules, such as schedules dealing with funded debt of the registrant and funded debt of subsidiaries included in the consolidated balance sheet. The question is whether it should be understood that independent accountants should certify to such schedules. There are no specific instructions dealing with this subject in connection with Form 10. We have, however, similar schedules provided in Form A-2 for registration under the Securities Act. In both forms these schedules

are really in support of the balance sheet and in the instructions on the use of Form A-2 it is provided that "the certificate of the accountant or accountants shall be applicable to the matter in the registration statement proper to which a reference is required on the balance sheet." Reference to the schedules in question is required on the balance sheet both in the use of Form A-2 and in the use of Form 10, although the instructions as to covering the schedules by the certificate are lacking in connection with Form 10. The instructions ought to be the same on both forms and the schedules in support of the financial statements should be certified by the independent accountants. This includes those schedules which are included in the body of the form and those schedules which are covered in connection with the instructions as to financial statements.

The next question in substance may be stated as follows: Corporation A constructed a building in 1928 at a cost of $5,000,000. Its balance sheet correctly shows the cost of the building. The building today may not be worth a million dollars. What would be the obligation to disclose the fact that the value at which the fixed assets are carried is in excess of present value, provided that the balance sheet states the basis on which the asset is carried? I would say that if the balance sheet shows correctly that the building is carried at cost and if the income statements correctly reflect the decline in earnings which has probably accompanied the decline in value, all the disclosure contemplated by the Act had been made unless there are circumstances not included within the question. As to fixed assets, I do not think that a balance sheet may properly nor practically attempt to reflect

current values. Anyone who would attempt to have a balance sheet from year to year reflect the value of fixed assets must indulge in conjecture, must be constantly changing the statement of his fixed capital accounts, and I should say must run a substantial risk of making misleading statements. If the extreme case which I have cited were the typical case, it might appear that the registrant should assume some duty of expressly notifying the public that in its judgment values had declined, but if it is to be expected to assume such a duty I do not know whore the line would be drawn. It might even follow that, if in the judgment of the registrant's directors, values had increased above the cost, they would be obliged to so state. My opinion is that nothing of this sort was intended, that we must recognize the limitations on financial statements, and that there is no obligation on the registrant or its officers or directors to express their opinion on the question of value in such cases. Their obligation is to show the basis on which the company has done its accounting and not to attempt to adjust each financial statement, either on its face or by means of accompanying statements, to changes in current value.

The next question has to do with the situation of a corporation having fixed assets of a ledger value of $25,000,000, of which $5,000,000 represents investment in plants not now used and which will not be required until business conditions show a material improvement. Is it necessary that this condition be stated? While I believe that in most instances the accompanying statement of income is normally sufficient to prevent a statement which does not direct specific attention to the facts quoted from being misleading, it may be that under

item 11 of Form 10 such information should be furnished. I am inclined to the belief that the registrant would do best to state the situation in his response to item 11, or it might be stated in some instances in response to item 12, which has to do with the general character and location of principal plants. I have no difficulty in thinking of cases where I believe that facts analogous to these stated in the question would be so decidedly material that failure to state them would be misleading. For instance, I know a street railway company which has abandoned the use of tracks and street cars almost entirely and has turned to busses. Its income account has not been very seriously affected by the change. It is possible that it might return to street railway operation under more favorable conditions, as the present situation is largely the result of ruinous taxicab competition. It is true that in such a case item 11 would develop the material information but even if item 11 were not in the form, it seems to me that such a street railway could not think of registering without making a disclosure of the facts. While my answer is, therefore, that in a great many cases I do not believe that disclosure is necessary, I must recognize that there will be cases where the failure to make disclosure would be serious.

The next question relates to a corporation which has an investment of $15,000,000 in fixed assets, of which $5,000,000 represents a plant used in a department that shows a loss for the year. Is this material information that should be disclosed in the statement? I do not regard it as such. It is true that if that same plant were owned by an uncolsolidated subsidiary, the balance sheet and results

of operation of that subsidiary would have to be separately disclosed. There is no requirement in the form, however, for such disclosure in case the plant is owned by the registrant or by a consolidated subsidiary. Here again I think one can anticipate that there may be situations where disclosure should be made. If the loss has been due to changes in the industry which make the plant in question unable to keep its place and show a profit, I should think that fact should be shown. For instance, there have been recent developments in the steel industry which have made properties obsolete and, I should assume, have caused large plants to operate at a loss because they could not meet the competition of more modern methods. Here the problem is not merely that of bridging a period of depression but of being permanently out of the field unless new equipment and new methods are adopted.

We come next to a question which has no accounting significance. The question is: Under what conditions does the Commission permit securities to be withdrawn from listing? The answer is that there have been no cases involving questions of policy which have had to be decided. The only questions presented so far have been procedural ones. Consequently I am not able to outline for you anything as to the Commission's opinion regarding the conditions under which securities may be withdrawn from listing where any real issue is raised in connection with an application for withdrawal.

The next question is, in substance, whether the definition of an exchange as included in the Act includes over-the-counter transactions. Obviously it was not intended to do so and I think it does not. It is true that there may be borderline cases in which it is hard to state

whether the characteristics of an exchange are or are not present. In such cases the answer probably cannot be obtained by applying any single form.

Coming back now to questions dealing with accounting, we have this one. Many companies maintain a system of internal check but no staff of internal auditors. The Commission's regulations provide that accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The question is: May accountants give due weight to a system of internal check where no staff of internal auditors is employed? I do not know what "due weight" would be in such a case and consequently I cannot definitely answer the question. It may be answered in part by the instructions as to the accountants' certificate in connection with Form 10. The language is: "Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit." I do not suppose that any two firms of accountants would have the same definition of the words "due weight" as applied to a system of internal check. I think the question is one of what constitutes due weight to be given to a system of internal check rather than whether or not any weight may be given to such a system.

The question is next asked what constitutes non-recurring income within the meaning of the regulations, and certain specific questions to which I will later refer are asked in connection with it. I cannot attempt a comprehensive definition of what constitutes non-

recurring income. My conception of the term, however, is that it was meant to include items which might be passed through the income account but which I think would generally be more properly entered directly in the surplus account. Such items would include profits on sale of capital assets and profits on sale of the corporation's own securities. This statement of my opinion is concurred in by the Commission. I would not classify as non-recurring income income which had been received in the ordinary course of business from a customer, even though a very large customer had been lost.

We come now to the specific questions. The first: Utility A suffered a rate reduction in September 1934. Must this fact be disclosed by the independent public accountants or by the registrant? I should say that there is no obligation on the independent accountants with reference to such a situation. Whether there is an obligation on the registrant I think depends on the circumstances. Many rate reductions are made in the ordinary course of business. The fact that they may have been made by order of public authority does not in my opinion alter that fact. Many such reductions are overcome by increasing business. I think clearly there is a class of rate reductions to which attention would not need to be called. On the other hand, there may be rate reductions of so serious a character that they are likely to have a substantial effect upon the securities of the company. There is no absolute test that I know of that can be set up for such cases and I think a good policy would be for the registrant to adopt a liberal construction of its obligation to make disclosure and to make such disclosure even though in an individual case the clear necessity therefor might not appear.

The next question I can only answer in about the same way. This relates to the case where a customer was lost at the end of November 1934, which customer's purchases from the registrant amounted to 30% of its total sales and yielded a margin of gross profit commensurate with that of the other business of the registrant.

The next question deals with the obligation to make a disclosure which would probably enhance the value of the securities. Company X operates a gold mine. It has struck a new vein which will greatly increase the productivity of the mine. Should disclosure of this be made? I would say that ordinarily such disclosure should be made if there had been sufficient exploration so that it had been determined that the productivity of the mine would be greatly increased. It is probable that the element of good faith would be involved here. If the information were withheld and, following that, insiders used the information to their own advantage, it may very well be that liability would arise from failure to make the disclosure. On the other hand, if the information were withheld in good faith rather from a desire not to magnify unduly the prospects of the company than from any sinister motive, I would question whether there would be any liability.

Next we turn to the instructions dealing with the disclosure of defaults in principal, interest, or sinking fund provisions. The question is: Is it intended that default in other specific covenants need not be disclosed? In answering this I should like first of all to call your attention to the technical nature of many defaults and the fact that to state whether such defaults exist often calls for

conclusions of law. It was not the intention of the Commission to provide that other defaults must be disclosed. The question in the form has reference to the balance sheet only and is obviously intended to elicit information only as to such defaults as to which failure of disclosure might make the balance sheet misleading. The instruction is that the facts and amounts with respect to any default in principal, interest, or sinking fund provisions shall be stated in a balance sheet note if not shown in the balance sheet.

In connection with the next question a number of illustrative cases were cited and the question raised as to whether or not certain corporations are subsidiaries of other corporations for the purpose of item 10. I think I can give a general answer to this. The question of whether a corporation is or is not "controlled by" another is not entirely answered on any percentage basis. Where there is a clear majority of voting stock of one corporation owned directly or indirectly by another, I should say that it would be a very unusual case in which there was not actual control, but there may be actual control in many cases accompanying only a minority stock holding. The question is not how large a percentage of the stock is held but whether there is actual control. In all those cases where control may be associated with the ownership of a minority interest in voting stock, the answer must be based upon the realities of the situation and no general answer to hypothetical questions can be given. For determining the necessity of furnishing financial statements under Form 10, and also under A-2, the test is the ownership of more than half of the shares of stock normally entitled to vote.

The next question is one with reference to which I think Form 10 is not entirely clear. The question is stated as follows:

> "Many corporations have types of operations which are merely incidental to their principal business and the cost of such operations is often charged to clearing accounts, from which it is distributed to primary operating accounts on some proper basis. An example of the foregoing would be the automobile expense of a public utility operating company. Such expense, of course, would include elements of maintenance, depreciation and taxes. Under the foregoing conditions, is it necessary to attempt to break down both the character of the cost and the distribution thereof to primary accounts for the purpose of complying with Schedule VIII accompanying the financial statements?"

I direct your attention to the difference between Schedule VIII of Form A-2 and Schedule VIII of Form 10, both of which deal with the same subject matter, which is the distribution of the total charges for maintenance and repairs, depreciation, depletion, and amortization, property taxes, management and service contract fees, and rents and royalties. In Form 10, as to each of these major classes, it is required that there be shown the amount charged to costs, the amount charged to profit and loss, and the amount charged to other accounts, naming the accounts and specifying the amounts. In Form A-2, the distribution is among the amounts charged to costs, the amounts charged to profit and loss, and the amounts charged to other accounts, without specifying as to each account the amounts charged. It is my understanding that Form A-2 would be complied with if the total charged to such clearing accounts as those for automobile expense were shown without any further distribution. It

is not so clear that such an answer would meet the requirements of Form 10. This may be a defect in Form 10, as A-2, I think, contains all that the Commission considers essential in this respect.

The next questions asked involve the Commission's interpretation of the exemption from the registration requirements of the Securities Act provided by Section 77 B of the Bankruptcy Act. I shall take up together the problems involved in soliciting consents to a plan of reorganization under Section 77 B as well as those involved in a solicitation of deposits in connection with such a plan. This question is one which has given rise to considerable difficulty and is strictly a matter of legal interpretation upon which I am not fully qualified to speak. The exemption afforded by paragraph (h) of Section 77 B of the Bankruptcy Act is believed, with certain immaterial exceptions, to apply only to securities issued subsequent to a court's confirmation of a plan of reorganization, and since a certificate of deposit normally is a security within the meaning of the Securities Act, the exemption is, therefore, not applicable, generally speaking, to certificates of deposit which are offered prior to such confirmation of a plan.

Before a plan may be proposed to the court in 77 B proceedings, it must have been proposed by the debtor or approved by a certain percentage of the debtor corporation's creditors and security holders. Confirmation of a plan which has been proposed to the court in accordance with this Section is conditioned upon the acceptance thereof by a larger percentage of creditors and security holders.

Assuming that a plan of reorganization meets the requirements of paragraph (b) of Section 77 B, I understand that Judge Burns, General Counsel to the Commission, has stated as his opinion:

1. That a reorganization committee may solicit from creditors and stockholders by mail or by use of interstate commerce, approvals of a plan necessary in order to authorize its proposal to the court pursuant to paragraph (d) of Section 77 B, without there being in effect any registration statement in connection with the plan or the securities of the new company to be issued thereunder.

2. That similarly no registration statement is required prior to the solicitation of acceptances of such a proposed plan pursuant to the provisions of paragraph (e) (1) of Section 77 B in order that such plan may be confirmed by the court in conformity with the provisions of that paragraph.

Following out these opinions I understand that the General Cousel to the Commission has also rendered his opinion that, assuming a plan of reorganization is one which meets the requirements of paragraph (b) of Section 77 B of the Bankruptcy Act, the deposit of outstanding securities, or the presentation of the same for stamping, may be solicited to evidence the approval or acceptance of the plan by the security holders, even though such solicitation takes place prior to confirmation of the plan, provided:

(1) that any general power of the reorganization committee under the plan is or will be limited to the power, subject to the provisions of Section 77 B, to take such steps and action as may be incidental to the carrying out of the plan in accordance with the provisions of that Section;

(2) that holders of stamped or deposited securities will not become liable individually, nor their securities be subjected to any lien, to pay any expenses or fees in connection with the reorganization, except to the extent that the court may order payments to be made out of the debtor's assets in accordance with Section 77 B; and

(3) that the effect of the deposit or stamping of securities does not create any greater substantive rights, powers or obligations than those involved in the giving of approvals or consents such as I have already outlined.

In other words, any receipts which may be issued prior to the court's confirmation of the plan of reorganization proposed in connection with Section 77 B proceedings do not need to be registered if, and only if, their legal effect is equivalent solely to "approval" or "acceptance" of a plan of reorganization in those proceedings.

The next question asked is as follows:

> "In cases where properties are acquired as an entirety for a total consideration payable either in cash or securities it is, of course, impossible for an accountant to segregate the amount of the total consideration which may be applicable to tangible and intangible properties. Under these conditions should the applicant state either in his certificate or in the financial statements that it is impossible to make such a segregation?"

My answer to this question is, generally, "Yes". I anticipate that in some cases it may be difficult if not impossible for the accountant to

determine whether or not any part of the purchase price was paid for intangibles. I direct your attention to notes on Schedule IV of the instructions to Form 10. Schedule IV is a schedule of the changes during the period in the asset accounts for intangibles. The note is: "Where, in the accounts of the registrant, it is not practicable to separate intangible assets from property, plant and equipment, the information here required may be included in Schedule II." Schedule II is the schedule for property, plant and equipment. I recognize that there will be a great many cases in which corporations have actually expended money for the acquisition of intangible assets where it will be impracticable to identify the cost of such assets and the practical limitations are, I think, adequately recognized in the form.

The nest question is:

> "In cases where a considerable number of companies are involved as well as a very detailed classification of property, plant and equipment, how much detail should be presented in complying with Schedule II accompanying the financial statements? In connection with the foregoing it should also be noted that in a great many instances detailed classifications of properties shown on the company's records will be meaningless due to the fact that there are considerable amounts of unclassified property acquisitions, etc. and also to the fact that retirements of properties which were included in such unclassified balances have been credited to the primary classified accounts rather than to the undistributed balances previously referred to."

It is not intended that Schedule II should be answered with reference to a very detailed subdivision of property. For instance, in the case of public utilities it would be sufficient to show the primary accounts of generation, transmission, distribution, etc., and a corresponding degree of subdivision should be sufficient in the case of other companies. Where there are unclassified balances on the company's books, it will often be impracticable to break them down by primary accounts, and in that event the unclassified balance should be carried into Schedule II as such. I agree that where there are considerable amounts of unclassified property any classification in Schedule II will be necessarily inadequate, both because the classification itself is not comprehensive and because the cost of property retired may have been charged to the unclassified balance or to the primary classified accounts without relationship to whether the property actually retired was included within the one or the other, and in many cases without the possibility of making such determination.

The question is asked whether the exemption which extends under certain circumstances to the exchange of a company's securities with those of its own security holders, extends also to an exchange of the securities of a wholly owned subsidiary with the holders of a company's own securities. Section 3 (a) (9) of the Securities Act provides an exemption for "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." The answer to the specific question is "No".

The next question has to deal with who is an independent accountant within the meaning of the Act. I am asked whether I would consider a public accountant independent if a member of his family or a partner

owned a small block of the securities of the registrant. I do not think that an adequate answer can be made to the question as framed. Perhaps the best way to answer the question is to quote from a letter which was sent by the Chief of the Securities Division of the Federal Trade Commission, at the time that that Commission administered the Act, to a firm of accountants. I am quoting from the letter:

> "With respect to the question of stock ownership, I do not believe that this can be answered categorically either with regard to the amount of stock which may be held or with regard to the persons by whom it may be held. A nominal stock holding which obviously would not influence the judgment of an accountant, would not, I believe, affect the accountant's independence. Certainly an employe of a firm of accountants who has no connection with a particular client might hold considerably more stock in that client without affecting the independence of the firm of accountants than could a partner of the firm directly in charge of the work for that client. In any case, I believe that the stock holdings of all persons, either partners or employes, who are concerned with work for a particular client of an accounting firm, should be taken into consideration and I do not believe that a firm can be deemed independent if such stock holdings in any case, either directly or indirectly, are more than nominal in amount."

I would like to direct your attention also to a change in Form A-2 from what appeared in Form A-1 which may be taken to indicate something of what the Commission has in mind, although it does not answer the specific

question. Item 50 of Form A-1 provided that "If any statement contained herein purporting to have been prepared by an expert has been prepared by a person who has any interest in or is to receive an interest in the issuer as a payment for such statement or has been or is employed by the issuer or a subsidiary or affiliate thereof or has been employed upon a contingent basis, a full explanation of the circumstances." Item 44 of Form A-2, in calling for the corresponding disclosure of relationship, does not call for a statement of facts where the expert has or is to receive any interest, but only where he has or is to receive an interest of a substantial nature.

I think it would be clear that the mere holding of a small interest does not destroy the independence of the accountant or other expert but there may be facts associated with such holding which will destroy his independence for the purposes of the Acts.

Geo. C. Mathews
Illinois Society of Certified Public Accountants
January 18, 1935.