THE INFLUENCE OF THE AUTHORITY OF THE SECURITIES AND EXCHANGE COMMISSION ON THE DETERMINATION AND PRESENTATION OF INVENTORY AND FIXED ASSET VALUATIONS AND THE AUDITOR'S RESPONSIBILITIES FOR SUCH VALUES

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PREFACE

The writer feels that an intensive study of the subject of this thesis may be highly important to any young man or woman majoring in the field of accountancy. Government, through various commissions, has influenced accounting practices considerably, especially after the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The influence of governmental authority has been felt to such an extent that some colleges and universities have deemed it necessary to offer specialized courses dealing with accounting methodology or practice as promulgated under Commission requirements. Regardless of certain inherent defects arising from the diversity of subject matter within the scope of this thesis, it is felt that the reader will gain valuable knowledge as to the functions of the Securities and Exchange Commission and will also profit by a review of the sound accounting principles and auditing procedures presented herein as pertaining to inventories and fixed assets.

Grateful recognition and sincere appreciation is extended to Professors B. F. Harrison and G. B. McCowen for their constructive criticisms and suggestions made to the writer during the preparation of this thesis.

J.S.H.

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INTRODUCTION

CHAPTER I

PURPOSE AND JUSTIFICATION OF SUBJECT

Any wide awake young man seeking to make a place for himself in a modern, complex world by entering a profession, such as public accountancy, does not need an over-supply of mental acumen to realize that governmental forces are constantly limiting and directing individual and economic forces for the good of all. History and economic texts definitely show the trends away from the Laissez Faire of the nineteenth century to regulation and supervision by the State for the general welfare. It is not the purpose of this writing to argue the pro and cons of such trends, but to accept such as fact and to relate such trends to the field or fields in which they apply.

The past evolution of accounting practice and theory has been a slow and laborious process, relatively free from legal restraints. Such evolution has not been an exact science subject to mathematical formula and preciseness, nor has it been as unyielding and unchanging as the laws of physics or chemistry. Since our economic relationships have become so large and interwoven, accounting principles and practices have necessarily changed and are ever enlarging in scope to meet the needs of changing conditions. From the last half of the nineteenth century up to the present time many laws have been passed which have directly or indirectly prescribed or controlled the acts of so-called 'Big Business'. A review of history will easily show the need of some form of control over the shady, underhanded acts of large corporations which thrived on the public's eagerness to 'get rich quick' by investing their savings in any form of promotional scheme presented to them. In answer to the losses of millions by public investors, we have had several important pieces of Federal legislation passed, among which are the Federal Security Act of 1933 and Amendments of 1934. We are particularly interested in these laws because they relate to the field of accounting and to the central topic in this thesis.

Mr. J. N. Frank, the first chairman of the Security Exchange Commission which was created by the Act of 1934, has said in part, when he attempted to outline the functions of the Commission:

> "One of the most important functions of this commission is to maintain and improve the standards of accounting practice. Recent events make it a pressing problem in this field.
>
> Accounting is the language in which the corporation talks to its existing stockholders and to prospective investors. We want to be sure that the public never has reason to lose faith in the reports of public accountants.
>
> To this end the independence of the public accountant must be preserved and strengthened and standards of thoroughness and accuracy protected. I understand that certain groups in the profession are moving ahead in good stride. They will get all the help we can give them so long as they conscientiously attempt to clean house. But if we find that they are unwilling or unable because of the influence of their clients to do the job thoroughly, we won't hesitate to step in, to the full extent of our statutory powers."[1]

There is no question as to the sincerity and utter earnestness with which Mr. Frank spoke. The Commission was to be a positive force for the correct and proper disclosure of all material facts relating to corporations and their securities. There was to be no passivity on the part of the Commission; this has been borne out by the hundreds of stop-orders

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[1] Press Conference statement after his election as Chairman of the Securities and Exchange Commission. (June 1934).

placed against corporations trying to issue securities without full disclosure of material facts to prospective investors.

Thus public accountants who make and certify statements of corporations issuing securities in interstate commerce must have these statements examined by the Commission. Under such circumstances it is imperative that accountants be well versed in the decisions of this body.

To students and teachers of accounting, it can be pointed out that through the power of the Security Exchange Commission, corporations can be restricted in the sale of their securities unless the financial statements included in the prospectuses of said corporations are prepared in accordance with "recognized and generally accepted accounting principles." In effect the Commission can say that a principle is or is not 'recognized and generally accepted.'

One can easily see, because of the Commission's power over accounting practice and procedure, that teachers and students must give serious consideration to all declarations and rulings of this body. There is little doubt that accounting standards are much higher than previous. Such standards shall eventually be higher and more precise, and they will be determined in a large measure by the Commission working in conjunction with the professional societies and professional schools in accountancy. It can therefore be highly recommended that professors and students of accounting give careful and critical analysis to preparation of financial statements as desired by the S.E.C.

In partial fulfillment of requirements for the Master of Science Degree in Commerce this thesis titled, "The Influence of the Authority of the Security Exchange Commission on the Determination and Presentation of Inventory and Fixed Asset Valuations and the Auditor's Responsibilities for such Values," is presented. Because of the extensive work done by the Commission, this writing is limited to an analysis of cases and decisions concerning the balance sheet items of inventories, fixed assets and related topics, which are, in most instances, the largest asset items on corporation balance sheets.

Before proceeding to the central topics of this thesis, a general discussion of the history, purpose, and scope of the federal laws giving rise to this administrative body, the Securities and Exchange Commission, will be presented and the internal operations of the Commission which relate to this subject will be given.

CHAPTER II

HISTORY AND SCOPE OF S. E. A. OF 1933 AND 1934

> "The Securities Act of 1933 was launched by the Seventy-third Congress in an era in which disclosure in financial circles had shaken public confidence to its very foundations, and in which a considerable number of issuers were found to have grossly misrepresented values and concealed essential facts--often fraudulent or criminal transactions. It was actuated by the broad purpose of protecting investors and by a desire to restore public confidence to the investing public by a rigid surveillance both of instruments offered to them in new financing and of the methods by which existing securites were sold. It particularly sought to insure ethical practice to the end that each issue of new securites sold in interstate commerce should be accompanied by full publicity and information and that no important element concerning the issue should be concealed from the buying public."[1]

Thus the above paragraph gives a general picture of conditions preceding the year 1933 and presents the purpose of the commission to eradicate the evils and give full protection to the public investors. History bears out the fact that state laws, Blue-sky laws by name, had failed to curb the distribution of unsound, fraudulent securities which had fleeced an unwary yet eager public. Some states had no protective security legislation; in others the laws were very inadequate with no semblance of uniformity as between the various states. In many instances victims of fraudulent promotional schemes were often unwilling to push their case or were willing to accept a compromise settlement of the fraudulent act which had been practiced on them. Thus it happened after a prosecuting attorney had prepared a satisfactory case, the prosecuting witness would accept a refund or out of court settlement and drop the case.

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[1] J. K. Lasser and J. A. Gerardi, Federal Securities Act Procedure, pp. 1-2.

Many states, because of their desire to attract capital and promote industrial development, were particularly lax in enforcing laws which might have defeated this purpose.

The weakness of state regulation became more apparent. No matter how efficient or how extensive the laws of a state were in the protection of the investing public, there was a large field of needed regulation to which the state laws could not reach; that is, more and more securities were sold in interstate commerce beyond the reach of governments hampered by state boundaries. Such needed regulation could be supplied only through some kind of a federal law giving broad and discretionary powers to a commission President Roosevelt's "Letter to Congress" aptly described the need of such legislation:

> "I recommend to Congress legislation for federal supervision of traffic in investment securites in interstate commerce.
>
> In spite of many state statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securites.
>
> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn a profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accomplished by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> This proposal adds to the ancient rule of caveat emptor, the further doctrine, "let the seller also beware."
>
> It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealings and thereby bring back public confidence.
>
> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest

business. This is but one step in our broad purpose of protecting investors and depositors.

It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clearer understanding of the truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others."[2]

The aims of such a proposal are clearly set forth: (1) every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information and that no material fact should be concealed from the buying public, (2) the Federal government does not approve or guarantee that newly issued securities are sound in the sense that their value will be maintained and increased by operations of the issuing company, (3) it holds up to agencies, using other peoples' money, their position of trusteeship.

When the Seventy-Third Congress finally passed a security law, the introduction read as follows:

"An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof, and for other purposes."[3]

Under this act a federal regulatory body known as the Federal Trade Commission was to partially concern itself with regulating the sale of new security issues to be sold in interstate and foreign commerce and through the mails to the public. It did not concern itself with those

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[2] Franklin D. Roosevelt, Letter to Congress (March 1933), p. 3.

[3] The Congress of the U. S., Securities Act of 1933, as amended, p. 1.

securities already in the hands of the public and those which were being actively traded-in on the various exchanges and over-the-counter markets. Certain types of securites were exempted from registration by the Act and by the discretionary powers granted to the Commission because the risk involved to the buying public was very small. A discussion of the types of exempted securities will follow in a succeeding chapter.

Section 7, Schedule A of the Act states certain requirements of which full disclosure must be made before any person or company has the right to sell securities to the public. This schedule requires that financial as well as non-financial data, concerning the company or corporation desiring to sell securities, be compiled in the form of a report known as a registration statement and presented to the Commission for examination and subsequent approval before any securities are sold.

The framers of the Act realizing that rigid requirements were too inflexible to apply to the many forms of business organizations, vested the Commission with broad, discretionary power to prescribe by various regulations and rules the form, content, and method of presentation of these data, both financial and non-financial, by the registrant. As a result of various needs the Commission has adopted two basic forms of registration statements: (1) Form A-1 which new corporations without any history as to operations and earnings must use; (2) Form A-2 which is appropriate for seasoned corporations which have been operating for a period of time. Both of these forms, accompanied by instruction books, have specific requirements concerning the accounting data and financial statements to be submitted.

The 1934 Act was passed to correct certain defects in the Act of 1933 and to take the administration of the Security Acts away from the control of the Federal Trade Commission to the supervision of a new regulation body called the Securities and Exchange Commission. Many business men were definitely opposed to the old law in that it was supposedly retarding and strangling recovery from depression by making security flotations difficult. Unwillingness on the part of directors, controllers, and accountants to accept the responsibilities imposed under the old act was emphatically stated. Under this law certain clarifying definitions of terms were made, additional exemptions of securities from registration were listed, and the liability of accountants, underwriters, experts, and officers of corporations was decreased slightly.

The Act of 1934 also enlarged the field of regulation for the newly created Commission. Heretofore only those companies issuing new securities were required to file a registration statement at the time of the public offering; under the new act all companies which had their stock listed on any exchange must file a report asking permission to keep their stock listed. Such a report was to constitute a registration statement which would adequately disclose all material facts and acquaint the investor with the current business conditions of the company. Discretionary power was also vested in the Commission to require periodic reports from companies as often as the Commission deemed necessary.

In December of 1934, the Commission prepared Form 10 which is to be used by those corporations applying for permission to permanently register their securities on an exchange. Form 10-K was prepared by the Commission as an annual report form to bring up to date the information given in Form 10. These forms and their accompanying instruction books require adequate disclosure of data, financial and non-financial, concerning the registrant's business. Here, as in the matter of the accounting requirements under the Act of 1933, certain of the accounting acquirements concerning the financial statements are definite while others are flexible and are left to the discretion of the administrative body or Commission.

After a discussion of the historical facts, a resume of the Commission's procedure in analyzing and examining the required registration statements is of interest. The description of this auditing procedure follows in the next chapter.

CHAPTER III

COMMISSION PROCEDURE IN THE EXAMINATION OF REGISTRATION STATEMENTS

The Registration Division is charged with the examination of the financial and non-financial data presented in the various forms of registration statements required of companies wishing to issue new securities or list their outstanding securities on a security market. This division examines all forms filed with the Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934 to determine whether full compliance has been made with those sections of the Acts and supplemental rules and regulations which govern registration. At the head of this division is a "Director" assisted by three "Assistant Directors," who are in charge of the examination of registration statements filed under the Act of 1933 and two other "Assistant Directors" charged with the examination of statements presented under the Act of 1934.

One of the "Assistant Directors" in each group is charged with the interpretation of the rules and regulations and the dissemination of any information relating to registration when requested by members of the Commission, registrants, and any other interested persons. The other "Assistant Directors" supervise the work of the examining groups which are composed of a senior analyst, an accountant, an attorney, and five to six general examiners.

When a registration statement is received it is stamped with the date when received and then turned over to the proper examining group. This statement is then subjected to a close scrutiny by the accounting and legal examiners of the group. One accountant checks the history, organization, and management of the corporation along with the description of the security, purpose of the issue, and general legal and accounting data disclosed in the registration form. The attorney in charge devotes time to a study of the legal aspects of the proposed issue. The contents and provisions of the various agreements, options, and contracts with underwriters and promoters, are closely examined as to their legality bearing on the proposed issue. Other examiners or accountants are charged with the detailed examination of the financial statements presented along with the registration form. These statements must be submitted in the proper form. The assets, liabilities, and capital items must be properly presented and classified so as to conform to generally recognized and accepted accounting principles and practices. Profit and loss items are examined, accompanying schedules and footnotes to the financial statements are analyzed, and the form, content, and adequacy of the independent certifying accountant's certificate are carefully checked.

During the examination of the registration statement by the various group examiners, notations are made of any omissions, misstatements, or irregularities. After these deficiency memos have been prepared by the various group examiners, they are presented to the senior analyst in charge of that particular group for careful examination. If the deficiencies are determined to be material, a "Deficiency Letter" is prepared. This letter is then submitted to an "Assistant Director" for a complete review and for an appraisal of the various deficiencies. This procedure assures uniformity in the work of the examining group and permits uniformity and coordination of procedures among the various groups.

When a particular accounting point is raised in one of these examinations, for which no precedent has been established by the Commission, the "Supervising Accounting" of the Division is called upon for an expression of his opinion. This supervising accountant coordinates the work of the accountants in the various groups, and promotes uniformity and consistency concerning principles, methods, and procedures to be followed. When disagreement occurs between the group accountants and supervising accountant, the point in question is referred to the Chief Accountant for final settlement. The Chief Accountant and his staff serve as advisors to the various divisions of the Commission and have final say in all matters of accountancy.

Under ordinary circumstances a registration statement becomes effective 20 days after the date when received. After the passing of the 20 days, the registrant is free to sell new securities or engage in active trading on an exchange, depending on the purpose of his registration. When a "Deficiency Letter" is mailed to the registrant requiring him to amend his statements or produce added information, the effective date is moved ahead 20 days from the filing of the last amendment.

When corrected registration statements or amendments are received, they are subjected to the same close examination that the original registration statement received. If all the deficiencies previously cited have been satisfactorily corrected, a "Clearance Memo" is prepared by the group examiners. This memo along with the registration statement is finally turned over to the Director of the Registration Division who, after examination, turns it over to the General Commissioners. The Commissioners then issue the order permitting the registration to go into effect.

Section 8(d) of the Act of 1933 provides that if, at any time after the registration statement becomes effective, the Commission finds untrue or omitted statements of material fact concerning full and adequate disclosure in the registration statement, it may call for a formal hearing from the registrant to review and discuss the discovered deficiencies. If the registrant refuses to correct the deficiencies cited, the Commission will issue a "Stop-order" which suspends the effectiveness of the registration statement, makes illegal the sale of securities through the mails or interstate commerce, and prohibits trading in said security on any exchange.

CHAPTER IV

SECURITIES EXEMPTED FROM REGISTRATION

In order to close this particular section and to thwart any impression from the foregoing discussion that all security issues must be registered with the Commission, a brief discussion now ensues of the various security issues exempted from registration procedures. One should realize by this time that the security Acts are intended to be remedial and protective in nature. Those securities and security transactions in which there is little danger of material and fraudulent misrepresentations are not considered as falling within the scope of the Act. Some security issues are controlled by pre-existing governmental agencies such as the Interstate Commerce Commission; so it has been unnecessary for the Commission to supervise the securities of such issuers already regulated. The Commission is delegated broad and discretionary powers by the Act of 1933 and 1934 so that security control in the interest of the public investor is flexible. Following is a list of the various types of securities which have been declared exempt by the original law or by the discretionary powers vested in the Commission:

(1) <u>Securities offered or sold prior to or within sixty days after passage of the 1933 Act</u>—The Commission does not require registration of those securities actually offered for sale within sixty days after passage of the Law. Any securities which were really offered for sale might be sold many months subsequent to the passage of the act just as long as the securities so offered were a part of the block advertised for

sale in the sixty day period. The Commission holds that new offerings of past authorized stock must be registered. If the offering of securiti(is a part of the original block which was offered within the sixty day period, but at different terms than the original offer, a registration statement must be prepared by the issuer.

(2) Governmental Issue and guarantee of securities--Governmental issues are not subject to the risks attendant to many private issues of securities. The constitutional inhibition against burdening of State instrumentalities by the federal government provides a sound basis for the exemption of such securities. Securities issued or guaranteed by the United States, any State, Territory, the District of Columbia, or by a political subdivision of a State or Territory are exempt. The exemption granted to governmental securities does not include those issued by foreign governments.

(3) Securities issued or guaranteed by public instrumentalities of States and Territories--Security exemption from registration are afforded to some instrumentalities which are not engaged in exclusive governmental functions. For example, state or territorial owned public utilities are not required to file a statement with the Commission since the risk involved is slight.

(4) Corporations acting as instruments or agents of the United States Government--When corporations such as the Reconstruction Finance Corporation and Federal Depositors Insurance Corporation, which are indirectly controlled by the government, issue securities, no registration statement is necessary.

(5) Exemption of bank securities--Bank securities are free from registration requirements when: (1) issued or guaranteed by any National

Bank, (2) issued by a banking institution organized under the laws of any State, Territory, or District of Columbia, provided that its business is substantially confined to banking and is supervised by some form of banking commission, (3) issued by a Federal Reserve Bank and represents an interest in or an obligation of such bank such as stocks and bonds.

(6) Short-term commercial paper--The law provides that any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, need not be registered. The term "current transaction" means the use of commercial paper to finance ordinary operations of a business over a relative short period of time as contrasted with long-term funding such as the issuance of stocks and bonds to provide capital.

(7) Securities of Non-profit organizations--Institutions which meet the following four tests need not file a registration statement: (1) be fully organized and operating at the time of issuance, (2) be operated exclusively for religious, benevolent, fraternal, charitable, or reformatory purposes, (3) operate without expectation of profit and, (4) be non-remunerative to the special benefit of any person, private stockholder or individual.

(8) Exchange of securities with present security holders--Securities may be exchanged directly with existing security holders of the corporation without registration provided that no commission or other remuneration is given for soliciting the exchange. Payments to bankers or to other underwriters in effecting the transaction makes registration with the Commission necessary. The term "commission or other remuneration"

is not applied to payments for advertising or for the services of accountants, engineers, attorneys, or similar activities necessary for such transfers.

In such cases of reorganization, the only exempt exchange is that in which the issuer exchanges directly its own securities for some other securities issued by it. The new security issued does not necessarily have to be like the old security retired, but stock may be issued for bonds, preferred stock for common stock and etc.

Stock dividends or stock split-ups are exempt from registration, unless such is in effect a "sale."

(9) <u>Securities exchanged by official permission</u>--Section 3, 10-A of the Security Act of 1934 reads as follows:

> "Any security which is issued in exchange for one or more bona-fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States Government, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval does not need to be registered."[1]

According to the Act, registration may be waived provided that security holders who are directly affected shall have the right to be heard at hearings, after which the approval of any court, or authority authorized to grant such approval is given.

(10) <u>Securities sold intrastate</u>--Exemption from registration is afforded to corporations who are residents in the state in which the

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[1] The Congress of the U. S., <u>Security Act of 1934</u>, p. 23.

securities are offered for sale. The very fact that a corporation sells securities to state residents does not prohibit them (residents) from selling the shares to non-residents later. The initial sale must be made to residents, and as long as there is independence in fact between buyer and seller, the exemption applies. The Security Act holds that:

> "Sales cannot be made by the corporation to residents with a view to their distribution in other jurisdictions. If later, however, the purchaser resells outside of the state, the corporation will not be liable as has been indicated and the purchaser will not violate the act in view of the exemption provided---."[2]

An exempted issuer advertising in a newspaper, circulating beyond state borders is still free from registration requirements; however, any advertisements in interstate newspapers or periodicals should be so worded that the prospective investor would know that the offer was being made only to those persons residing in the corporation's home state.

In summary, the Act of 1934, Section 3(b) gives the Commission the express power to exempt other classes of securities which it feels that the public interest does not require protection by law because of the small amount involved or the limited character of the public offering. The Commission's power of exemption is limited to those issues which in the aggregate is $100,000 or less. Section 3(b) states:

> "The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of the title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offerings; but no issue of securities shall be exempted under this

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[2] *Ibid.*, p. 24.

> subsection where the aggregate amount at which such issue is offered to the public exceeds $100,000."[3]

The author feels that the volume of writing introduced here has been desirable in order to present a general background for the sections on the determination and presentation of inventory and fixed asset values and related auditing procedures that immediately follow.

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[3] *Ibid.*, p. 26.

INVENTORIES

CHAPTER V

INVENTORY ON THE BALANCE SHEET

The exact wording and the extent of detail to be shown on the balance sheet in describing and presenting the inventory as required by the Commission in its various registration forms, must depend largely upon the purpose for which the statement is prepared, the character of the business, and other attendant circumstances. The single word "inventory" is indicative of the general nature of the asset, but in many cases reveals nothing descriptive and informative of the materials and products comprising it, or their basis of valuation. In many past cases of published statements, the amounts of various elements of the inventory have not been shown, but only indicated in one lump sum. Along this line the Commission has demanded and obtained full and adequate disclosures concerning inventories on statements presented to it by various registrants.

Regulation S-X of the Securities and Exchange Commission, which sets forth the accounting requirements applying to the majority of the Commission's registration and report forms under the Securities Act of 1933 and 1934, provides for the showing of inventories as follows:

> (a) State separately in the balance sheet, or in a note therein referred to, major classes of inventory such as (1) finished goods; (2) work in process; (3) raw materials; and (4) supplies. Any other classification that is reasonably informative may be used.
>
> (b) The basis of determining the amounts shown in the balance sheet shall be stated. If a basis such as "cost", "market", or "cost or market whichever is lower" is given, there shall also be given, to the extent practicable, a general in-

dication of the method of determining the "cost" or "market": e.g., "average cost", or "first-in, first-out".[1]

The Commission as yet has adopted no exact rules on inventory valuation other than to require a statement of the method of valuation adopted by the company. William Werntz, Chief Accountant for the S.E.C., reports that practically all of the generally recognized methods of inventory valuation have been used by one company or another in the statements filed, and that the Commission seldom had found occasion to object to the use of any particular system.

In view of the fact that the method of inventory valuation is important in the analysis of current credit positions and in the determination of income, full disclosure of information as to inventories is of material benefit to the investor-analyst. In view of the important differences in the statement of income resulting from the adoption of one method rather than the other, an investor cannot give the same weights to profits of companies in the same business without knowing whether the profits to which their calculations are applied have been computed on the same basis or how great the effect of a difference of method might be. Few investors seem to realize this fact. A "cost" of an individual item in the inventory seems a simple matter to determine, but so simple a word turns out to be the most comprehensive of concepts, and its estimation leads to moot questions which must be decided by the accountant.

There is no question as to whether the mere designation of the method or basis followed as "cost or market", for example, constitutes

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[1] Security and Exchange Commission, Regulation S-X--Form and Content of Financial Statements, p. 18.

sufficient disclosure. The apparent solution is to call for more detail, but the problem is not so easily disposed of. As Werntz reports:

> "When a requirement was proposed calling for a clear indication of what was meant by "cost or market", numerous commentators made the point that if the operations of a company were at all complex, several pages of explanation would be required by reason of the use of diverse methods. Others indicated that not much less than a text on cost accounting would suffice to fully disclose the costing system."[2]

Perhaps consistency in the application of a particular method from year to year and a clear indication in the company's accounting statements of any changes in method may provide more protection to the investor than attempts at detailed description of the method of valuation employed. Investors are interested in a method of inventorying which reflects most fairly the income for the particular year since they may decide to buy or sell on the basis of the income statement for that particular year. Furthermore, they are interested in a greater uniformity of inventory methods from corporation to like corporation and more detailed disclosure of the methods followed so that a basis of comparison of current position and operating results of various corporations is available.

In view of the requirements stated in the above S-X regulation, it would be proper to consider cases in which the Commission held that the inventory values disclosed in the financial statements were deficient as to classification and evidence or information relating to their basis of valuation.

<u>CASE I</u>[3]

The Murray Ohio Manufacturing Company in its original balance sheet,

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[2] Security and Exchange Commission, <u>Accounting Series Release No. 11</u>, p. 2.

[3] B. Bernard Greidinger, <u>Accounting Requirements of the S.E.C.</u>, p. 137

presented its major classes of inventory as follows:

Raw Materials and Supplies		xxxxx
Finished Goods and In Process		xxxxx
In Transit		xxxxx
	Total	$ XXXXX

Although three separate valuations were given, an analysis of the title designations shows that there are really five separate classes of items. The above presentation failed to meet the Commission's requirements; so on the amended statement, the Inventories were presented as follows: Raw Materials, In Process, Finished, Factory Supplies, and Goods in Transit with corresponding dollar amounts.

CASE II[4]

The above rule requires that where a registrant finds it impossible or impracticable to state the major classes of inventory separately, the reason or full explanation for such a condition must be given. No doubt the Commission realized that under certain circumstances in various types of industries it would be exceedingly difficult if not impossible for the registrant to fulfill this requirement. This inability to present separate amounts may be due to a number of reasons. One of the most prominent being that the company's accounting system is so set up that inventory costs are all thrown together into one account. Where such a condition exists, the Commission allows the registrant to fulfill the requirement by "any other classification which is reasonably informative."

Where inventories are not stated separately, the needed explanation may be stated in a footnote. This method was followed in the amended balance sheet of the E. G. Budd Manufacturing Company. In its original

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[4] Ibid., pp. 138-139.

statement the inventories were presented as follows:

> Inventories (certified by responsible officials as to quantities and conditions at cost not in excess of market)
> Finished Stock, Raw Materials, Work in Process.............xxxxx

The reason for classifying the inventories into one figure was not disclosed; so the statement was held to be deficient.

In the amended statement Budd Company re-submitted the original presentation with an asterisk placed before the words "Finished Stock" which refers the reader to an appended footnote reading:

> "Under the company's system of cost accounting and perpetual inventories, separate accounts are not maintained for raw materials, work in process, and finished goods respectively."

Such was acceptable to the Commission.

<u>CASE III</u>[5]

The basis used in determining inventory value must be disclosed. An explanation stating that book value, cost, market, cost or market whichever is lower as a basis, is not acceptable unless accompanied by a clear statement as to the method employed in determining such basis.

The Messenger Corporation in its original balance sheet stated that its Inventories were at "book value" in one lump sum. Since the composition of the inventory account was not disclosed nor an explanation given as to the meaning of "book value", the Commission required addititional disclosure.

In the amended statement the total amount was not changed but the major classes of Inventories were described as: "Inventories—Raw Materials, Work in Process, and Finished Goods at Cost". "Cost" was stated as a basis instead of "book value", and the method followed as

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[5] *Ibid.*, pp. 139-140.

a basis for cost was stated in a footnote as follows:

> "Physical Inventories were computed by the company's cost department by costing all sales since January 31, 1936, as no physical inventories have been taken since that date."

CASE IV[6]

If the general basis used is "cost or market whichever is lower", and part of the inventory valued at cost is in excess of market, the condition should be clearly presented. The Budd Manufacturing Company, previously mentioned, stated that its inventories as being, "certified by responsible officials as to quantities and condition at cost not in excess of market." Concerning the work in process, a footnote was appended to the statement stating that:

> "the company has not deemed it practicable to forecast the net result of completion (certain contracts) and has not provided reserves in the accounts as at April 30 in respect of estimated losses of from $45,000 to $60,000 upon completion. The inventory of such work in process has accordingly been stated at approximate cost in the accompanying balance sheet."

Inventories according to the statement are valued at or below cost; yet the footnote discloses that a loss of $45,000 to $60,000 will probably result and the inventory of these materials are stated at approximate cost. In the amended statement the footnote was unchanged, but the clause following the word "Inventories" was changed to read, "certified by responsible officials as to quantities and condition of a basis of cost not in excess of market except as mentioned in footnote 2." The wording now used puts the reader immediately on notice that some part of the inventory is greater than market value.

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[6] Ibid., pp. 140-141.

CHAPTER VI

INVENTORY VALUATION METHODS

Appropriate at this time would be a discussion of the various bases used in inventory valuation which are generally acceptable to the Commission and practicing auditors and accountants. There are numerous methods used: cost, replacement cost, cost or market whichever is lower, base stock, selling price, retail method, and others. The same corporation may and frequently does employ a different basis for distinct items in the inventory.

Base Stock Method

Within the last several years a marked revival of interest in the base stock method of inventory valuation has developed. It is acknowledged by writers on the subject of valuation that the scheme is by no means new to the accounting profession, since the American Smelting Company and the National Lead Company have used it for over 30 years. In actual practice the method is limited to those types of industries having: (1) a relatively large investment in inventories consisting of a few basic materials, and (2) a relatively constant spread between raw material and finished good prices during the fluctuations of the business cycle. This method is found to be most suitable for manufacturers, fabricators, and converters producing oil, rubber, leather, chemical and various textile goods.

This method is predicated on the assumption that a large or substantial part of the inventory is of similar character to fixed assets.

Of course items of inventory are constantly changing; yet it can be said that a certain amoung of inventory remains in the business regardless of seasonal and cyclical fluctuations. In the past it has been considered permissible to understate assets as a conservative policy; thus having asserted that a portion of inventory is similar to fixed assets, it is easy to adopt a policy of undervaluation for the base quantity inventory.

The adoption of the method requires that the "normal" inventory be reduced to a permanent base quantity and unit price. Nickerson has suggested that "the upper limit of the base quantity should be an average of the low points for inventory quantities (seasonal lows) computed over a period of years."[1] Other writers more general in their method of determination suggest that the base value should be so fixed that future price fluctutations would not affect the book values of the basic quantities. A base-stock procedure follows:

> The XYZ Tin Can Company desires to shift to the base-stock method for its stock of tin. Through investigation of past records it decides that a normal base quantity of tin on hand at all times would be 200,000 pounds at a base unit price of 20 cents per pound. The amount of tin actually on hand represents 250,000 pounds purchased at 25 cents per pound. To carry the method into effect, an adjustment is made valuing 200,000 pounds of metal at the price of 20 cents; the remaining 50,000 pounds excess over the base quantity may be valued by some other costing method--say first-in, first-out which would be 25 cents per pound. Thus the beginning inventory so valued is now worth $52,500 bringing about a $10,000 reduction in book value of the tin. Now let us suppose that during the year 150,000 pounds of tin was purchased at 30 cents per pound. Total monetary value of the tin stock now equals $52,500 plus $45,000 (150,000 @ .30) or $97,500. Assume that the ending inventory consisted of 220,000 pounds; thus the base quantity at 20 cents would be $40,000 plus $6,000 (20,000 @ .30) or $46,000 leaving a cost of sales for the period of $51,500.

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[1] Clarence B. Nickerson, "Inventory Reserves as an Element of Inventory Policy", The Accounting Review, XII (December 1937), p. 346.

The method has appeal in various ways. The application of such a method is simple; as far as the base stock is concerned, the company need not worry any about "cost or market" every time an inventory is taken. The inventories are stated ultra-conservatively on the balance sheet, and through elimination of so-called inventory profits and losses, the method tends to reduce the showing of net income in periods of rising prices and to increase reported income in periods of falling prices; thus giving a greater degree of stability to earnings over cyclical periods.

In respect to the profit and loss statement, income determination is made in consideration of the long-run possibilities of profit. Thus short-run gains and losses are eliminated as far as the base quantity is concerned. Once the base stock method is established and fully understood by investors and management, proponents believe better business expansion and investment decisions will result. Heretofore profit and loss has been considered as a short-term phenomenon. True profit cannot be accurately determined until an enterprise ceases to function and is liquidated.

Perhaps one of the most prevalent criticisms its proponents have to meet is that such inventories so valued are understated considerably on the balance sheet. From the balance sheet viewpoint, substantial understatement of an asset, if adequately disclosed and explained, can not be regarded as being too serious. Another criticism is that investors, comparing income statements of various industries, may erroneously conclude that some business subject to widely fluctuating cycles has the same earning stability as some other industry which by its very nature has relatively stable earnings regardless of the method of inventory valuation.

Regardless of criticism or approval, the base stock method has been approved for certain industries. The Commission has no objection to the method as long as all conditions are explained so that a prospective buyer or seller of the registrant's security is amply informed as to the prevailing conditions.

Last-In, First-Out

The last-in, first-out method is a version of the preceding base-stock method; however, it has a wider range of application. It is based on the theory that it is desirable in certain circumstances to determine cost of sales by matching current or most recent purchases against recent or concurrent sales. In effect it works similar to the base-stock method in that a certain degree of stabilization is given to earnings during the cyclical swings.

Prior to the passage of the 1939 Income Tax Law, certain tax injustices and inequities existed in businesses with unstable profits. This method found favor in that it tended to reduce profits on the upswings and increase profits on the downswings. By reducing the fluctuations of earnings from one year to the next, the taxable income would not be so likely to reach the higher surtax brackets.

While the base stock method as previously noted should be restricted to those situations where the conditions incident to operation make the maintenance of a large stock mandatory and to which fluctuations in value should not affect the income account, the last-in, first-out method is more applicable in varied situations. Since last-in, first-out is primarily a basis of determining costs, it may be used in any circumstance in which first-in, first-out, or average cost methods could be used. For example, the last-in, first-out may be used in costing finished goods inventories; where the base-stock method would meet with many difficulties.

Davis, commented on the application of the method in the following words:

> "In closing your books at any time you simply back up on your purchases, starting with the most recent and cost a quantity equivalent to sales, that is your cost of sales. However, it is not nearly so simple as that if the 'true' results are to be obtained. You either have to take your opening inventory and use it forever after as a reserve from which, at the unit values existing when you started, you borrow and to which you pay back differences in quantities between current sales and purchases; or you have to figure the first period and then the first and second together as a single period, and then the first, second and third together, and so on interminably with the differences between these successive totals giving the results for individual periods."[2]

If at any time the resulting inventory is less than cost according to book figures, it should be so shown on the balance sheet by an enclosure in parenthesis.

Cost or Market Whichever Is Lower

First and foremost in importance among the valuation methods is the one referred to as "cost or market whichever is lower". This rule or method has been so completely accepted in modern accounting practice that the great majority of all published balance sheets display inventories so valued. Nearly all authorities recommend this rule. It has been approved by such groups as the American Institute of Accountants, the Security Exchange Commission, and the U. S. Treasury Department. It is also highly favored and regarded by credit men and investors.

In the National Industrial Conference Board Report entitled, "Prevailing Practice in Inventory Valuation", 63% of 833 companies valued raw materials on this basis, 38% so valued goods in process, and 40% valued

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[2] Albion R. Davis, "Inventory Valuation and Business Profits--The Case for a Stabilized Basis," N.A.C.A. Bulletin (December 1937), p. 386.

finished goods at the lower of cost or market.

Actual application of the cost or market rule is relatively simple in theory although not always so in practice. In taking a periodic inventory the quantities involved are inspected and enumerated on inventory sheets. After the quantities are recorded, inspection of purchase invoices permits valuation of the inventory on a cost basis. The next step is to determine the current or replacement price of each of the individual items in the inventory and extend to a third column the cost or market price whichever is lower. The summation of the last column then gives the ending inventory for the period.

In applying this rule something must be said of the term "market". Market value as defined by the Treasury Department and acceptable to the Security Exchange Commission means "the current bid price prevailing at the date of the inventory for the particular merchandise in volume in which usually purchased by the taxpayer."

In concluding our discussion of this method, we quote H. A. Finney:

> "The cost or market rule conforms with the general accounting principle of providing for all losses and of anticipating no profit. If market values for purchases decline, selling prices will presumably decline with them. Reducing the inventory to market purchase price takes up the loss in the period during which the price declined, and transfers the goods to the next period at a price which they can presumably be sold at a profit."[3]

Retail Inventory Method

The so-called "Retail Inventory Method" is quite limited in application since it can be used only in the retail and wholesale class of concerns where selling prices can be estimated at the time purchases are made. If

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[3] H. A. Finney, Principles of Accounting, Intermediate, p. 182.

properly applied and correctly computed, the inventory is acceptable by the accounting profession since it is computed on the basis of "cost or market whichever is lower." On a rising market the value will be approximate cost; on a falling market, the lower of cost or market will prevail.

In applying this method the individual items of the beginning inventory are valued at cost and also at selling price. Purchases made during the period are entered in the purchase record at cost and at a predetermined selling price. The purchases at both cost and selling prices are added to the corresponding values of cost and selling price totals of the beginning inventory after adjustments for returns, allowances, and interdepartmental transfers have been made. Freight-in is added to the cost price of the goods purchased.

In determining the mark-on or percentage of gross profit which is the difference between the accumulated costs and corresponding selling prices, net mark-ups of original selling prices are added before determining the gross-profit ratio. This procedure tends to value the inventory conservatively, and on a rising market tends to state the inventory at an "average" cost. Net mark-downs of original selling prices are not used in computing the gross profit ratio, but are deducted from the total accumulated selling price along with inventory shortage and net sales of merchandise thus leaving a figure representing the ending inventory priced at retail selling price. The gross profit percentage is applied to this ending amount, thus giving the amoung of profit dollars which when subtracted from the ending retail figure leaves the inventory stated at "the lower of cost or market." Perhaps an example will make the mathematics of the method understandable:

	Cost	Retail	Mark-on
Beginning Inventory	$10,000	$15,000	33 1/3%
Purchases (Less returns and allowances)	5,000	8,000	37 1/2%
Freight In	100		
Net Mark-ups		1,000	
Accumulated values	$15,100	$24,000	
Average Gross-Profit Ratio			37.08%
Net Sales for Period	$10,000		
Net Mark-downs	500		
Inventory Shortage	200		
Total deductions at retail		10,700	
Ending Inventory at Retail		$13,300	
Ending Inventory at Cost:			
$13,300-(.3708 X $13,300) = $8,368.36			

Under this method it is assumed that variations in the original selling price, namely mark-ups and mark-downs, are brought about because of changes in current market or replacement prices. As net mark-ups (mark-ups minus mark-up cancellations) affect the gross profit percentage, they must be carefully distinguished from net mark-downs (mark-downs minus mark-down cancellations). To deduct net mark-downs from the accumulated retail selling price before determining the mark-on would tend to state the inventory at "average" cost; deducting them from the accumulated retail figure after the mark-on percentage has been computed tends to value the inventory more conservatively at "cost or market whichever is lower."

The use of this method facilitates the preparation of the financial statements, since the time-consuming process of inventorying and costing the merchandise is eliminated. Balance sheets may be prepared as often as desired by using the book inventories. It is wise, however, to reconcile the book inventory with a periodic physical count then make adjustment for any loss or shrinkage.

It is well to keep in mind that an average costing ratio is applied to the selling price of the ending inventory. Where the percentage of mark-on varies greatly with different items of merchandise, it is better to departmentalize those items having approximately the same margin of gross profit. Attention must also be paid to special sales of merchandise since low rates of mark-up may distort greatly the mark-on average for the entire business.

In concluding the discussion of this particular method, it must be stated that no cases or formal rulings on this method by the Commission could be found. However, since the Bureau of Internal Revenue and accounting societies recognize this method when and where it is suitable and correctly handled, there is no reason to doubt that it would be acceptable to the Commission if full disclosure is made concerning its application.

<u>Inventory At Net Selling Prices</u>

The valuation of finished goods or merchandise at net selling price as a general rule is considered inconsistent with acceptable accounting procedure. To do so would break the cardinal rule of "no anticipation of profits." It is not considered sound and conservative to take credit for profits which are not fully earned. Orders may be cancelled and goods may be refused for many reasons; therefore, it would indeed be unwise to consider profit made when title to the goods had not passed to a vendee.

Particular industries have deviated from the above rule. This deviation has consisted of valuing inventories or parts of inventories at selling prices less cost of carrying and delivery charges. This procedure takes place in such businesses as those carrying on mining, sugar and oil production. Such companies operate under conditions differing from the general run of enterprises since in these concerns there is generally (1) a continuous demand for their products; (2) contractual agreements between vendors and vendees thus creating a legal obligation, and (3) a relative small percentage of sales cancellation.

Mining and sugar-producing companies often value inventories of "sold metals" and "raw sugar" on the basis of net selling price. In an examination of 23 financial statements presented to the Commission by such companies, principally gold mining companies; fifteen, or more than 50%, showed inventories at market value or net selling price. The remaining companies used a different method or a combination of methods. In general this small sample of mining reports, seems to indicate a preference for the net selling price method. Evidently the procedure is regarded as logical by mine managers and by many who have written on the subject of accounting for "raw metal" inventories.

In speaking particularly of the gold mining industry there is no other business in which the pricing of inventory at net selling price is justifiable to such a degree. Surely, it can be argued, an inventory of gold can be considered the equivalent of cash since the government is bound to purchase all quantities at the established mint price. However, the same line of reasoning, by analogy, may be carried into other lines of business; when this occurs, the method becomes questionable. From a practicable viewpoint it cannot be a matter of extreme importance how a small handfull of gold mining companies value their products, but it is important to determine the limits in which the net selling price basis is or is not proper when extended to other fields.

The position taken by the Commission is that the disclosure in financial statements that they (valuation methods) have been followed according to certain accounting principles for which there is no substantial support is not sufficient. If the conditions are material, the financial statements may, in spite of disclosure be misleading. When the circumstances are such that pricing an inventory at net selling price, or by any other method, is misleading or inappropriate under the circumstances, a statement disclosing such a condition does not of itself convert a misleading balance sheet into a fair presentation of the current position of the company.[4]

Montgomery gives the opinion:

> ".....that accepted accounting practice in certain industries at present permits inventories represented by firm orders from solvent and honorable buyers, verified by actual experience (at least in part) after the date of the balance sheet, to be priced at net sales prices, when no one is deceived and when good business judgment sanctions the practice as fairly reflecting the results of operations for a specified period; always assuming that the accounts are so stated that the facts are clear to all who read the balance sheets, that the practice is optional, and that it is designed only to present fairly the financial condition."[5]

There is little doubt but what the Commission will, in the future, decide the propriety of the method on the relevant circumstances existing at the particular time.

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[4] Securities and Exchange Commission, <u>Accounting Series Release No. 4</u>, p. 1.

[5] Robert H. Montgomery, <u>Auditing Theory and Practice</u>, p. 179.

FIXED ASSETS

CHAPTER VII

DEFINITION AND DESCRIPTION

In connection with the valuation of fixed assets, as in the preceding section on inventories, the Commission, through its formal decisions and stop-order proceedings, has approved some and disapproved other accounting principles and procedures followed by the different registrants. It has cited certain of the principles applied as definitely untrue and misleading and suggested the accounting principles which, in its opinion, should have been applied.

Any discussion of fixed assets necessarily calls for a definition. According to H. A. Finney, "Fixed assets are assets of a relatively permanent nature used in the operation of the business and not intended for sale."[1] The generally accepted rule exists that assets held or used for more than one year are given a fixed or long-term classification on the balance sheet. Thus a heavy machine is a fixed asset because it conforms to the three elements of our definition: (1) it is relatively permanent property which may last an indefinite number of years, (2) it is not intended for sale as is the merchandise which it helps produce, (3) and production of goods would be hindered if it were not used in the operations of the business. When such property no longer is useful but still has junk or scrap value of considerable amount; the acceptable accounting procedure is to write off the book

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[1] H. A. Finney, Principles Of Accounting Intermediate, p. 249.

value of the machine from the fixed asset account to an "other asset" classification pending final disposal of it. Likewise, the value of a building or piece of land no longer used in normal operations of a business should be moved from a fixed asset to an "other asset" account.

Any discussion of fixed assets lends itself to development under two general groupings, tangible and intangible fixed assets. The term tangible means having bodily substance. Tangible fixed assets include land, buildings, machinery, tools, patterns, delivery equipment, furniture and fixtures, and other similar property having physical substance. Intangible assets are reserved for discussion in another chapter since the Commission requires that they must be separated from tangible fixed assets on the balance sheet.

The Commission is highly critical of classifications and methods used in the valuation of tangible fixed assets. This readily understandable since the nature of the problems underlying the valuation of plant, property, and equipment lends itself to gross misrepresentations of fact and dubious values. For the purpose of illustrating in detail the exact information required, the instructions for filling out the general registration form, A-1, regarding fixed assets reads as follows:

<u>Instructions For Property, Plant, and Equipment</u>

A. Submit a schedule indicating the major classification of the plant, property, and equipment account. In case it is not practicable to furnish the detailed information called for in this instruction for the organization of the issuer, furnish the data beginning with January 1, 1942, segregated as follows:

(a) Ledger values
(b) Cost of Issuer
(c) Profits to affiliated interests included therein if any. If profits of this nature are included in fixed assets, give full details thereof including a brief description of the property, the

name of the affiliated interests from whom acquired and the cost of property to such affiliated interests.

(d) Unrealized appreciation or write-down resulting from revaluations, reorganizations, mergers, or otherwise. If any such appreciation or write-down is included or excluded in fixed assets, a statement should be submitted showing the nature of the transaction giving rise to them, including, (1) in case of appraisals; dates of appraisals, the basis thereof, the name of the appraiser and a comparison of the previous ledger value and the appraised value of the property; and, (2) in case of mergers, consolidations, reorganizations, etc., a comparison of the recorded values on the books of the respective vendors and vendees.

(e) Bond Discount, commissions, and expense (if any) included therein, other than previously allocable thereto for the construction period.

(f) Stock discount, commissions and expense if included.

B. This schedule should not include intangible items such as franchises, patents and trademarks, goodwill, organization expense, etc., included separately in the balance sheet.

C. If any important item of the issuer has been definitely abandoned and not written off, state the amount thereof; estimated if not known.

D. Issuers owning, mining, oil and similar businesses which incurred expenditures in development, stripping, drilling, and costs of a similar nature, and included same in cost of property plant and equipment, should set forth in a separate schedule and nature and amounts thereof and the basis of the extinguishment of such costs.[2]

A discussion of some of the problems arising from the Commissions accounting requirements for proper valuation and full disclosure in related schedules will ensue in the succeeding chapters.

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[2] Form A-1, Instructions Pertaining to Balance Sheet of Issuer, p. 29.

CHAPTER VIII

REVALUATION OF PROPERTY

One of the most perplexing problems that the accountant has to face deals with the revaluation (appraisal) of fixed assets. This controversial question of appraisal has been argued and debated by experts for years without reaching conclusions which are acceptable in entirity under varied circumstances. It may never-the-less be stated that a majority of accountants favor the valuation of fixed assets at original or actual cost; however, in many instances to truly show the facts as they exist a revaluation would not only be acceptable but a necessity.

According to Fedde, plant, property, and equipment valuations may be made for the following purposes:

(1) Ascertaining insurable values and proving losses.
(2) Restatement of asset accounts where they have been improperly kept.
(3) Determining a basis for sale of property.
(4) Determining values in connection with borrowing and other financing.
(5) Establishing a capital surplus credit (write-up).
(6) Decreasing subsequent depreciation charges (write-down).
(7) Revision of operating costs in connection with pricing of products.[1]

Corporations may have an appraisal made of their property for the purpose of determining the adequacy of the insurance carried. Because losses, due to efficient fire protection and fireproof construction, are

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[1] A. S. Fedde, Proceedings of Fourth International Congress on Accounting, p. 21.

often only partial, there is a tendency to insure for only a small part of the value or worth of the property. To combat this tendency of the insured to cover his estimated possible loss, the insurance company may place a co-insurance clause in their policy. In this clause the insured consents to carry insurance in an amount equal to a percentage of the sound value of the property. If the insured refuses to carry the required amount, any payment of loss by the insurer will be scaled down in propro-tion that the insurance carried bears to the percentage of sound value of the property. In case of an increasing price level many structures may be under-valued; thus for adequate protection more insurance would be required. Such an appraisal does not necessarily find its way into the accounts.

Many items of property have been handed down from one corporation to another over a period of years. Records of original and actual costs of betterments and retirements may have been lost in the maze of transactions; so that any value assigned to such property would tend to be a hodgepodge of doubtful amounts. In cases like this an appraisal would almost be a necessity in order to arrive at a proper valuation. Particularly in the field of public utilities have appraisals been required.

In the determination of a basis of purchase and sale, appraisals are often required. Book valuations in many instances are not acceptable between buyer and seller due to differences in opinion as to the adequacy or inadequacy of depreciation reserves and to the methods of handling betterments and retirements in the accounts. Probably the most important reason for a valuation would be a desire by the interested parties to check the current reproductive prices of assets with their book values; thus giving due regard to changing price levels.

Companies undergoing refinancing or reorganizing often have their property appraised before the issuance of new stocks or bonds. Often the methods used in such upward revaluation has been criticized severly by the Commission on the grounds that they were unscientific and based on no real appreciation in value. However, if a proper appraisal is made, there is little question that write-ups of assets would be a valuable aid in the securing of future security flotations.

Fedde's last two reasons for revaluation of assets pertain to the write-down of such items to lessen subsequent depreciation charges, thus bringing about a revision of operating costs in relation to proper managerial and pricing policies. Many revaluations downward took place in the thirties. The main purpose of such reductions was to get rid of all fixed charges possible during the worst years of the depression thereby showing more favorable income statements. This close relationship of write-ups and write-downs to movement of the business cycle can easily be seen in Tables 1 and 2.

TABLE I[2]
WRITE UPS AND WRITE DOWNS OF PROPERTY
PLANT AND EQUIPMENT (1925-34)
(Unit: $1000)

Year	write-ups	write-downs	net write-ups
1925	28,309	12,813	15,496
1926	65,944	24,356	41,588
1927	23,248	16,432	6,816
1928	26,255	68,429	- 42,174
1929	14,359	128,578	-114,219
1930	24,392	16,723	7,669
1931	5,924	194,686	-188,762
1932	23	251,468	-251,445
1933	123	117,315	-117,192
1934	77	117,426	-117,349

272 large industrial corporations[2]

TABLE II
NUMBER OF
CORPORATIONS REPORTING REVALUATIONS OF PROPERTY PLANT
AND EQUIPMENT

Year	write-ups	write-downs
1925	12	10
1926	13	13
1927	14	11
1928	16	16
1929	12	15
1930	8	23
1931	4	48
1932	1	55
1933	2	44
1934	1	27

Out of 272 corporations examined.[3]

Writing down assets because of a declining price level is, to be sure, highly questionable. Where corporations have fairly accurate records based on cost, the act of substituting figures based on estimates of replacement when there is no intention of replacing the asset with one exactly like it, smacks of imprudent judgment. The reduction of a depreciation charges throught valuation downward of assets will improve the income statement appearance admittedly, and at the same time please yet deceive the unthinking investor, since such a procedure has no direct effect on the ability of an organization to stand the stress of the times. Probably many of the valuations downward during the depression were made with the thought that the price level would never reach the heighth that it did in the twenties. Perchance there would be grounds for revaluation if the

[2] Issued by the Committee on Accounting Procedure, American Institute of Accountants, Accounting Research Bulletin No. 5, p. 45.

[3] *Ibid.*, p. 45.

price level changed and henceforth was stable, but who is there to hazzard a guess as to the permanency of any price.

Regardless of whether one is a cost or present value advocate as to the proper basis of fixed asset valuation; the practicing accountant and the Commission must decide to their own satisfaction the following questions:

(1) What is the proper basis of asset valuation for accounting purposes--to what extent should appraisal data be recorded in the accounts?

(2) If appraisal values are recognized should the depreciation that is subsequently deducted from revenues be based on original costs or on appraised values?

(3) How should the items "unrealized" and "realized" appreciation (or declination) be interpreted?

(4) If appraisal values are recognized, how should the necessary changes be recorded in the accounts and exhibited in the financial statements?

In seeking an answer to the first of these queries, one is forced to admit that no definite answer can be found. The arguments put forth by the actual cost advocates run as follows: (1) accounting as such is designed to record only the actual or real transaction which is subject to verification, and (2) revaluations after all are based on individual judgments and continuous recognition of such values would lead to the necessity of repeated adjustments in the accounts, and (3) replacement value is a questionable concept since obsolescense caused by technological improvements will prevent the replacement of worn-out assets by new, identical ones. Canning in his "Economics of Accountancy" states:

> "Accountants are properly skeptical of valuations bases on other than original cost. So, too, will replacement cost become a real thing when it is incurred. But because prices of equipment fluctuate, because there are always many alternative ways of getting service and because the amount and kind of service needed in an enterprise change with its selling opportunities--because of all these extremely elusive matters it requires a

> good deal of positive evidence to show on which side of experienced cost per unit of service a future unit cost is likely to lie. Adequately to consider possible future substitutions is as difficult and expensive a task as a redesigning of all plant and fixed equipment."[4]

Just as ardent in their belief are the replacement-cost theorists whose arguments are premised on: (1) the need for showing present economic position and progress of an enterprise, and (2) propriety of maintaining capital investment. Their reasoning states that fixed assets acquired during a period of low prices and contributing to costs throught depreciation charges in the ensuing years while the sales price of the product rises with increasing general price levels, tends to be misleading to both management and investors. Thus if the higher costs of replacement are not recognized in the calculation of cost, one may come to the unwarranted conclusion that good will or superior management exists because of abnormally large profits. In supporting point two of their argument, they say that the maintenance of capital in not necessarily the preservation of its dollar value, but the replacement of the physical asset regardless of whether the value of the dollar has increased or decreased. Thus when replacement cost of assets increase, the cost of the product manufactured should be increased by additional depreciation charges in order to recover present value increment along with actual cost.

The Commission has gone on record as favoring actual cost where ascertainable. However, it sets forth the facts to be disclosed in its Form A-1 when a proper appraisal has been made. This rule reads as follows

> Unrealized appreciation or write-down resulting from revaluations, reorganizations, mergers, or otherwise. If any such appreciation or write-down is included or excluded in fixed assets, a statement should be submitted showing the nature of the transactions giving rise to them, including (1) in case of appraisals: date of appraisals, the basis thereof, the name of the appraiser and a comparison of previous ledger value and appraised value of the property, and (2) in case of mergers, consolidations, re-

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[4] Canning, Economics of Accountancy, p. 48.

organizations, etc., a comparison of the recorded values on the books of respective vendors and vendees.[5]

Especially has the Commission been critical of appraisals or revaluations when an industrial company in its promotional stage with no record of possible earning capacity attempts to use replacement value on its books. In one of the releases on accounting procedure, the following is stated:

"In connection with a registration statement, an industrial company in its promotional stages with no record of business or earning capacity, filed a balance sheet in which property, plant, and equipment acquired in arms-length transactions at a cost of $200,000 was carried at $720,042.81 which represented its 'sound value' derived from independent appraisal of the estimated 'replacement value new less (observed) depreciation.' The balance sheet figure exceeded cost by $520,042.81 which excess was carried as 'surplus arising from revaluation of property.'

In the appraisal report filed the term 'sound Value' was qualified by the appraiser as being 'the value for use by a going concern having prospects for profitable use, at normal plant capacity of the property appraised.'

The registrant was required to amend its balance sheet and show its fixed assets at cost."[6]

The Commission has not given a direct answer to the second of the above queries concerning depreciation charges on appreciated values which have been written into the accounts. Several methods are used by accountants, in preparation of financial statements. The question of whether to charge depreciation on appraised value or only on cost to operations is still far from a decided solution. Some accountants prefer to dispose of appreciation by the so-called balance sheet method. By this method only accounts appearing on the balance sheet are affected by the recognition of

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[5] Instruction Book for Form A-1, p. 29.

[6] Securities and Exchange Commission, Accounting Series, Release No. 8, p. 1.

increased asset values. In this manner depreciation on original cost is still charged against operations while the depreciation charge against the excess appraisal increase is debited against the revaluation surplus which had arisen from the appraisal. Thus there will be a periodic credit charge over the remaining life of the asset to the appraisal increase account offset by a debit to the surplus which arose by the revaluation. This method in effect is little better than the method of some accountants who desire to confine accounting recognition of appraisals to footnotes only.

Since the American Institute of Accountants and the Security Exchange Commission have worked hand in hand in recognizing and presenting generally accepted accounting principles, it may be proper to present the attitude of the Committee on Accounting Procedure of the A.I.A. In the Committee's Accounting Research Bulletin No. 5 the general statement is made that accounting for fixed assets should normally be based on cost and any attempt to make property accounts in general reflect current values is impractical and inexpedient. However the problem of depreciation charges must be faced when appreciation has already been recorded on the books.

To answer this question the following statement was formulated:

> "The Committee is of the opinion that when such appreciation has been entered in the books, income should be charged with depreciation computed on the newer and higher values. A corporation should not at the same time claim larger property values in its statement of assets, and provide for the amortization of only smaller property sums in its statement of income.
>
> This conclusion does not rest upon any basis of narrow logic or precise classification: it is derived from consideration of equity and public policy of the broadest character. These include an application of something analgous to the legal doctrine of estoppel, which asserts that one who has made certain representations is thereby precluded from afterward

avering anything inconsistent with them....In the present case this would mean that a company which has made representations as to an increase of value of plant cannot afterward account for depreciation and income as if it had never made such representations in its balance sheet as to an increased value of its properties and others have bought its securities upon those representations; it is not unreasonable to interpret the formal adoption of the large amount for plant as implying an intention on the part of the company to maintain that larger amount of invested capital intact by proper charges against income. To implement such intention it is necessary that the company charge income with depreciation on the larger values represented."[7]

In effect the Committee is saying if securities are issued on the basis of a registration statement or prospectus in which higher values are claimed by the registrant, there would be logic and consistency in charging depreciation on the enhanced value in arriving at the profits available for distribution to stockholders. It may reasonably be argued that new investors in securities purchase them on the ground that higher values already exist and have been given recognition in the accounts, and when they buy a share of stock they feel that they are buying a part of this enhanced value. Therefore to charge depreciation only on cost would be misleading if dividends are paid out of future earnings. Such dividends in effect would be a return of part of their original investment.

Mr. Carmen G. Blough, former Chief Accountant of the Securities Exchange Commission and active member of the Committee, vigorously upheld this statement of principle. He believed that, <u>in all cases</u>, depreciation on appreciation should be charged to operations. Regardless of whether or not there has been such a case on the point in question before the Com-

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[7] Committee on Accounting Procedure, American Institute of Accountants, <u>Accounting Research Bulletin, No. 5</u>, p. 38.

mission, the probability is that the Committee's opinion would be upheld in full.

Some accountants still prefer a third method of showing depreciation on appreciation. In this method appreciation is absorbed in operational charges for the purpose of showing the effect of higher replacement costs in departmental expenses; then this additional charge on appreciation is offset in earned surplus by a charge to the surplus which arose by revaluation and a credit to earned surplus. In effect the final net addition to surplus is based on original or actual cost. Thus the effect of the appraisal is shown in the operational statement while the earned surplus change (net) is the same as if depreciation were on original cost only. Such a method necessitates two property accounts: one for the actual or original cost and the other for the appraisal increase. The handling of such accounts will be demonstrated later.

The third query deals with the interpretation and classification of the surplus arising from appreciation. This 'unrealized surplus' arising because of increased price levels differs from 'realized surplus' in that the property value increase has not been validated by a sale of the property at a figure in excess of original cost less depreciation, nor has the amount of the write-up been included in operational charges thus being recovered through the sale of the product. The general rule handed down by the Commission is that surplus should be classified into three groups when determinable: (1) paid-in surplus, (2) surplus arising from revaluations and, (3) earned surplus. In case a registrant does not segregate surplus, he must defend his position for not doing so. Not only must surplus arising from revaluations be so designated but it must be amply supported by statements of proof issued by competent appraisers who have carried out all investigations which will enable them to support the enhanced valuation. Several cases have come before the Commission which shows their attitude on the revaluation question:

CASE I:[8]

The original registration statement of the World Digest Association showed all surplus as being included under one heading. A large portion of such surplus had arisen from revaluation of assets. The amount of surplus was given as $23,438.72 with a note appended stating that such surplus was not available for dividends because it represented a donation of a copyright to the association by a Mr. Brecht, who had stated that the value of the copyright was $25,000.00 which represented expenditures and services contributed by himself. In the amended statement the surplus and intangible was presented as follows:

Intangibles--Copyright	$25,000.00
Surplus Section:	
Unrealized appreciation arising from revaluation of capital assets	$24,580.18
Earned surplus	$ 961.52
Total	$25,541.70

In explanation of the Unrealized Appreciation it was stated:

Assets:		
At the inception of the corporation (Dec. 7, 1935) the excess of liabilities assumed over assets transferred from the predecessor partnership was charged to good will at		$ 2,619.82
By agreement with former stockholders and officers from whom their interests were purchased in April, 1936 loans payable due them were cancelled amounting to	$2,000.00	

[8] B. B. Greidinger, Accounting Requirements of the S.E.C., pp. 290-291.

Additional adjustments with respect to this transfer amounted to .... $ 200.00 This total was used to reduce the value of good will previously established..............	$ 2,200.00
The remaining balance was transferred to surplus..	$ 419.82
Credit to surplus from donation of Copywright.....	$25,000.00
Net balance to credit of Surplus arising from appreciation and revaluation of Capital Assets....	$24,580.18
EARNED SURPLUS:	
Balance beginning	0
Net income as above	961.52
Total	961.52
Dividends paid on common stock	0
Balance in earned surplus at end of period	$ 961.52

Thus the Commission considered the surplus section of the balance sheet adequately explained.

CASE II:[9]

In the case of Breeze Corporations, Inc., the point in question was not the propriety of including unrealized appreciation on the balance sheet, but the evidence on which the amount used in the surplus account was based. According to the Commission any surplus arising from revaluation must meet two general tests: first, it must be based on scientific method; second, there must be a fair and accurate application of the methods purported to be followed in ascertaining values.

The registrant's balance sheet of September 30, 1936 showed intangible assets as follows:

PATENTS, PATENT APPLICATIONS AND TRADEMARKS:		
Acquired for stock..............	$1,213,295.41	
Cash expenditures...............	41,761.78	
	$1,255,057.19	
Less: Amortization thereon......	820,810.90	
Net..		$434,246.29
Appreciation resulting from appraisal (see note 1 below).....	$1,708,620.68	
Less: amortization thereon......	277,700.86	

[9] Securities and Exchange Commission, Decisions and Reports, 3, 709-736.

Net	$ 1,430,919.82
	$ 1,865,166.11
Good will	1.00
	$ 1,865,167.11

The Surplus section was as follows:

Surplus from appreciation of patents..........	$ 1,430,919.82
Surplus arising from reduction of stated value of no-par stock	753,839.43
Total	$ 2,184,759.25

Note No. 1 referred to in the balance sheet stated that the appreciation of book value of these intangibles resulted from an appraisal by a Mr. Cousins on June 30, 1933, and that the figures were based on past and estimated prospective sales and estimated prospective earnings of Breeze Company, Inc. Cousins as patent attorney for the company appeared to have, by his testimony, a general acquaintance with the affairs of the company and with the trend of business in which the company was engaged. This information seemingly was based upon his visits to the plant and his conversations with its officers and engineers. He testified that he discussed each individual patent with officers of the company inquiring as to the volume of goods made and sold under each. In addition he had formally requested the company to furnish him its gross annual sales of products sold under its patents; its estimated future gross sales annually on these products, based upon contracts and probable markets; the average net profit based upon such sales expressed in gross and in percentages; copies of instruments showing titles or licenses to patents or patent applications; and such other information which would be useful in formulating a proper appraisal.

Cousin determined the appraisal value of the patents in 1933 by estimating the company's net profits for their remaining life, at $3,700,000.00. Figuring, that a large part of this was prospective value, he arbitrarily deducted $1,500,000.00 and added to the difference $200,00.00 at which he valued the trademarks; thereby reaching an appraised valuation of $2,400,000.00. The examiner for the Commission contended that the statement: "Tt is our opinion that we will average for the next ten years $240,000.00 net profit per year when we have completed our developments," by the president of Breeze, Inc., had an undue influence on Cousin's appraisal. Ten years times $240,000.00 amounts to $2,400,000. which is the value determined by Cousin.

In the concluding words of the examiner one sees that no appraisal values and surplus arising therefrom can be shown or presented in a registration statement when haphazzard and arbitrary methods of appraisal are used. In his summary of the case the examiner stated:

> "Cousins was not a qualified appraiser. His valuation was not based on independent investigation. His only information as to future prospects and as to costs was the estimates given him by the company and its executives. His valuation was not based on a consideration of all relevant data which could, or should, have been available. In making the appraisal he examined none of the companies records. He testified not only that he had no knowledge as to the profits and losses that the enterprise had incurred in the years preceding his report, but that he was never interested in their financial condition. By his own admission therefore, he did not know that, according to information contained in the company's federal income-tax returns, it has had an operating loss, before amortization of patents for every year since 1926 except 1931, when it showed a small profit of $3962.29 and for every year since 1926 after amortization of patents. In sum, the valuation, based upon methods which without question were incompetent and arbitrary, was not an appraisal. Clearly misleading therefore, was a representation in the registrant's financial statements, based on this appraisal, that in 1933 there had been an appreciation of $1,708,620.28 in the value of the registrant's intangibles.
>
> If an appraisal, or a representation of value purportedly based thereon is not to be misleading the appraisal must meet two tests. In the first place, as we have observed in a previous opinion, "an appraisal purports to be more than an arbitrary determination of value. It seeks to attach value to its objects as a consequence of method." In other words,

> it is misleading to represent as an appraisal a valuation which is not based solely on scientific method, but which rests in whole, or even in part, upon foundations which are arbitrary and capricious. In the second place, there must be a fair and accurate application of the methods perported to be followed. Thus valuations contained in an appraisal purporting to follow certain norms, even though in the final analysis they represent merely informed judgment, nevertheless are representations that these norms have been accurately and fairly followed. If the norms purported to be followed are not fairly observed, the valuations finally arrived at are in essence misrepresentations of fact because they untruthfully describe the basis upon which judgment has been exercised. The fact that valuations are in the final analysis expressions of judgment does not warrant a departure from these standards.
>
> It is clear upon consideration of the record that, measured by the foregoing tests, the Cousin's valuation in 1933 cannot appropriately be designated as an appraisal."[10]

As stated previously, neither the accountants of the Security Exchange Commission nor the Committee on Accounting Procedure of the American Institute of Accountants have been willing to uphold any one method as to the disposition of unrealized appreciation. The Committee states in Research Bulletin No. 5 that several methods are followed by practicing accountants: (1) transfer to capital stock by means of a stock dividend, (2) regular periodic charges from the appraisal credit account to earned surplus, of amounts equal to depreciation on the appreciation recorded, and (3) transfer to earned surplus, only when appraised units are retired, of the amount of appraisal credit which has been realized with respect to such retired units.

Certain other difficulties present themselves. It is not possible to make a general statement as to the legal status of appraisal figures. This varies in different jurisdictions, and for different purposes. Usually appreciation increments have no recognition for income tax purposes; however,

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[10] Ibid., p. 719.

an appraisal may be accepted as of March 1, 1913 as a basic value of property. Some state statutes recognize unrealized appreciation as a basis of asset values and for certain types of dividends. There is little doubt but what cost is the basis of valuation favored by the Commission, but appraisals are and have been recognized and judged as to their fairness and reasonableness; this depending on the circumstances of the case in question.

In answering the last of our basic queries, "If appraisals are recognized, how should the necessary changes be recorded in the accounts and exhibited in the financial statements?", one can find only the general statement concerning facts to be disclosed in the instruction book for filling out form A-1 of the registration statement. The registrant must state the date of the appraisal, the basis thereof, the name of the appraiser and a comparison of previous ledger value and appraised value of the property.

In making a comparison of previous ledger value and appraised value, H. A. Finney[11] suggests a maintenance of a clear distinction between actual costs and appraisal write-ups by: (1) the opening of a separate property account which will be charged with the excess of reproduction cost new over original or actual cost; and (2) the opening of another depreciation reserve account in which the excess of depreciation on reproduction cost over the depreciation on actual cost is credited to this account. A problem is now presented to illustrate Finney's method:

> On January 1, 1935 the XY Company constructed a building for $100,000.00 with the expected life of 25 years. On January 1, 1940 the Blank Appraisal Company valued the building at reproduction cost new at $150,000.00 less $37,500,00 accrued

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11 H. A. Finney, Op. Cit., pp. 287-297.

depreciation. The XY Company desires to record the appraisal on the books in preparation to new security flotations. Present the entries necessary to disclose all pertinent facts.

The facts as given disclose the following values:

	Per Appraisal	Per Books	Excess per appraisal
COST:			
Reporduction cost new	$150,000		
Original cost per books		$100,000	
Excess			$50,000
DEPRECIATION:			
Reproduction cost	37,500	*(25,000)	
Original cost per books		20,000	12,500
DEPRECIATED VALUES:			
Sound value per appraisal	112,500		
Net book value		75,000	
Excess			37,500

Entries to give effect to the appraisal (cost and related reserve are already shown in the accounts):

Building Appraisal Increase..........	$50,000	
Reserve for Depr. Appraisal Increase		$12,500
Reserve for Unrealized Increment		$37,500

Now the accounts contain:

Building (original cost)	$100,000	
Building Appraisal Increase	50,000	
Reserve for Depr. on Cost		20,000
Reserve of Depr. (Appraisal Increase).		12,500
Reserve for Unrealized Increment......		37,500

It is noted in the illustration following that accrued depreciation based on cost is not the same as that estimated by the appraisal company:

	Per Books	Per Appraisal
Gross value	$100,000	$150,000
Depreciation	20,000	37,500
Net	80,000	112,500
Percentage of accrued depreciation	20%	25%

Because the appraisal shows 25% accrued depreciation, it is seen that an adjustment should be made to the Reserve for

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*Correct depreciation on original cost on the basis of appraisal percentage.

Depreciation on Cost Account so that the same percentage of depreciation will be reflected on the original amount. This correction may be made by the following entry:

Earned Surplus	$5,000	
Reserve for Depr.--Building		$5,000

In this manner depreciation provided in past years is corrected. However, not always should surplus and the depreciation reserve based on cost be adjusted. Depreciation is determined on a theoretical basis which does not, in most instances, parallel actual physical deterioration year after year. If depreciation per appraisal is meant to reflect this actual physical deterioration; then there is little point in adjusting the depreciation reserve on cost.

Since the Committee on Accounting Procedure has gone on record for charging depreciation on appreciation to operation, the annual entires to carry out such procedures follow(assuming that twenty years of life is all that remains in the structure):

Depreciation (to operations)...........	$5,625	
Reserve for Depr.--Building Cost.......		$3,750
Reserve for Depr.--Appraisal Increase..		$1,875
Reserve for Unrealized Increment-Appraisal	$1,875	
Earned Surplus		$1,875.

Depreciation on appraisal increase is charged to cost of goods manufactured by the above method and is presumably 'realized' through sale of the products. Therefore a portion of the Unrealized Increment may be credited to Earned Surplus since realization has taken place.

This method of handling depreciation on appreciation was presented, not as the only way, but as the procedure condoned by the American Institute of Accountants. The Commission has not approved any one method. The other facts concerning full disclosure of the appraisal may be presented in a footnote to the balance sheet or referred to in the auditor's certificate.

CHAPTER IX

VALUATION OF WASTING ASSETS

According to Paton there are three principal types of wasting assets: (1) mineral deposits, (2) oil and gas resources, (3) timber tracts. One outstanding feature of such assets which distinguishes them from other types of fixed tangible assets is that they cannot or will not be replaced for practical reasons quite obvious. Coal when once mined from a particular deposit is incapable of replacement. Oil and gas when brought to the earth's surface can no longer be replaced when it is used and it therefore represents a wasting asset. The valuation of such assets represents one of the hardest problems that the accountant has to face. In many instances stock is offered as a purchase price for a mine. In all probability this same stock has never been sold for cash so that a fair market value for the stock could be determined. The question then arises as to the valuation to be placed on the asset since the par value of the stock exchanged may have little relation to the value of the asset acquired. Transactions like this, the Commission thoroughly analyzes to see if material misrepresentations have been made or significant facts omitted.

The Commission must decide whether the value as given in the registration statement is a fair and reasonable amount to be presented to prospective investors. Theirs is a great responsibility since cash, itself, is not always paid for a wasting asset, and the laws of many mining states are lax and permit almost any valuation to be placed on a property. The Commission must trace through several sales of the property in question to see if arms-length bargaining has been carried on between vendor and vendee; thus attempting to ferret out actual costs or a basis to judge the value claimed by the registrant. Several pertinent and informative decisions have been handed down as to the proper procedure for wasting asset valuations. The Commission's attitude is shown in the following cases which were tried before it:

CASE I [1]

In the matter of Comstock-Dexter, Mines, Inc., the accounting principle in question was the basis on which the value of the ore body was carried. In respect to the registration statement, the facts as stated were misleading in regard to the engineer's report and related balance sheet amounts. The report prepared by E. L. Huff, mining engineer, contained an estimate of 4000 tons of probable ore averaging $10 per ton in gold and silver, and 6000 to 8000 tons of probable ore averaging about $15 per ton in gold and silver. Without Huff's participation or knowledge, these estimates of probable ore were transmitted into an item on the asset side of the registrant's balance sheet as follows:

Prospective value (unrealized appreciation of exposed ore body based on price for gold of $20.67 and silver at $6.26 per ounce................. $159,072

All prospectuses filed and issued in connection with the registration statement include reference to this item. The Registrant's counsel and accountant based their computation on the maximum tonnages of probable ore in Huff's estimates:

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[1] Securities and Exchange Commission, Decisions and Reports, 10, 358-370.

4000 tons at $10	....	$ 40,000
8000 tons at $15	....	$120,000
	Total	160,000

No explanation is offered as to why the round figure so obtained was reduced to $159,072. A permissible inference is that the odd figure was made up and used merely because it would look like a precise valuation rather than a rough estimate. It is of course an inflationary item against which most of the registrant's stock was issued.

In any event the value assigned to the probable ore represented a gross value. No allowance was made in the balance sheet for the cost of extracting or milling the ore, nor was the dollar amount discounted to allow for the time that would necessarily elapse before any return could be realized by operations. The promoter testified that the cost of milling and extracting ore might be as high as 50 percent. Huff estimated that, "mining and milling costs, on a scale of operations from 50 to 100 tons per day should approximate $5 to $6 per ton". This of course leaves out numerous other factors such as cost of transporting ore to the smelter smelter charges, and general overhead up to the time of ultimate sale.

There is little doubt that accepted accounting procedures had not been followed. The probable ore had been valued at gross value. A mining authority states:

> Probable ore as distinguished from proved ore is a technical term connoting a degree of speculation or risk as to the continuity of an ore body. It differs from proved ore in that there is virtually no risk of failure in continuity between the faces sampled, or if a block is so extensively surrounded by sampled faces that risk is reduced to a minimum, the ore may be designated as proved.[2]

The valuation of such ore as proved ore without deducting the

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[2] T. J. Hoover, The Economics of Mining, 1933, pp. 109-110.

cost factors of extracting and milling could not be accepted by the Commission, and since this 'prospective value' item represented 63% of the registrant's total assets, there is little wonder that a stop-order was issued pending amendment.

CASE II [3]

In the case of La Luz Mining Corporation, the Commission took two exceptions to the registrant's statement regarding the valuation of its property. The Commission asserted that, (1) the valuation of property had been based on false appraisal, and (2) that present worth over the estimated life of the mine had not been considered in determining the balance sheet figure.

The appraisal amount had been based on a figure of 700,000 tons of potential ore available. This estimate of the ore available had been made from only three samplings; whereas according to good engineering practice, there should have been at least a thousand samplings of ore taken to justify such an estimation. From the gross value of 700,000 tons of ore having a gold content of $12.50 per ton, an amount of $2.50 per ton was subtracted as a close estimation of mining cost. On the basis of $10 net per ton times the tonnage of ore available, a figure of $7,000,000 was presented in the statement as the valuation of the mine. Concurrent to this transaction, stock of a par value of $1,428,000 was issued to the promoters by the registrant. The difference between the asset value and the capital stock was credited to capital surplus.

The attitude of the Commission examiner is summed up in the following statement:

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[3] Securities and Exchange Commission, Op. Cit., 1, 217-225.

Because of the manner in which the appraisal report and estimate were prepared, as already pointed out, they are unreliable and do not afford a valid basis for the figures at which property, plant, and equipment, and capital surplus appear in the balance sheet. It follows that these figures are misleading. Furthermore, assuming the engineer's estimate of tonnage and value are reliable, the $7,000,000 figure represents not the present value which would be recovered not immediately but over the entire life of the property which, upon the registrant's plan for production would be about 17 years. Its present worth would be much less than $7,000,000. Had the registrant honored this elementary principle of valuation and accounting, the property account and capital surplus would have been greatly diminished.[4]

CASE III [5]

In the case of Monitor Gold mining Company a gross value of ore reserves had been placed on the registration statement at $1,687,000. As heretofore stated, the Commission holds that valuations of mining properties based on future returns over a period of years must be reduced to their present value. The Monitor Company had attempted to carry this rule into effect; however, the question arose as to the percent to use in finding present worth which would be adequately expressive and informative as to the risk involved.

A present value formula advocated in "Cost of Mining," by J. R. Finlay was used. This formula deducted from the average yearly return over costs of production the amount which, when deposited each year at a compound interest rate, would return the present value to the investor on the final exhaustion of the ore body. The interest rate considered by the company to be an estimation of the risk involved was 7 percent.

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[4] Ibid., p. 223.

[5] Securities and Exchange Commission, Op. Cit., 4, 347-355.

Commission investigation found that the risk as expressed by 7 percent was very low thereby making the present worth of the mine over-valued. The commission based their decision on the disclosure that the ore body under consideration was "possible" ore which connotes a very high degree of risk. In addition the engineer's reports on the estimated ore body were more than 20 years old. In concluding the hearing, the Commission examiner stated:

> "We find the risk rate of 7% far too low as a basis for determining the present value of the registrant's property. The figure $1,687,000 representing the present value of the registrant's properties is thus excessive. In this respect, therefore, the engineer's report, the schedule to the balance sheet, and the prospectuses are materially misleading. On the basis of these findings a stop-order will issue."[6]

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6 Ibid., p. 350.

CHAPTER X

COST OF PROPERTY--DISCOUNTS, COMMISSIONS AND MISCEL-LANEOUS EXPENSE

The Commission has upheld the generally accepted accounting principle of excluding all stock or debt discount from any fixed asset classifications on the balance sheet and showing the said items separately. Especially in the case of mining properties have blocks of stock been issued at par for a mine or group of mines when, by a concurrent sale, the fair market value of such stock was far below par. From such an example only one conclusion can be drawn--in effect the stock was issued at a discount and therefore the value of the property is not that of par. Property or fixed assets so acquired should be valued at the fair market value of the stock so exchanged.

A pertinent question often arises when an entire block of stock is issued in exchange for property. In all probability there has been little or no opportunity for a fair market value to be established; so the asset will in all probability be valued at the par of the stock. In such instances creditors have a very difficult time in proving that the stock was actually issued at a discount. Courts, as a rule, have been reticent to question a board of directors' estimation of an asset value when there is no evidence of fraud.

The Commission holds that the inclusion in cost of property of par value of shares issued therefore and concurrently "donated back" to the issuer is misleading to prospective investors as to the true value. Such a method is often called the Treasury Stock Subterfuge which is an ill-concealed attempt to raise working capital by a cash sale of the stock donated back to the corporation. By such a method, promoters hope to relieve the stock of its discount liability; thus making the donated shares easier to sell. The cases following have come before the Commission in which accepted accounting procedure has been upheld.

CASE I [1]

In the case of Bering Straits Tin Mines, Inc., Peterson, president of the registrant company, conveyed six mining claims which he owned to the corporation in exchange for its entire capital stock, which at the time represented 750,000 shares of 10¢ par value stock. Immediately after the receipt of this stock, Peterson gave back to the concern more than half of the shares which he received. Right after this transaction he (Peterson) gave to the corporation without consideration 28 of the other mining claims which he owned at the time. This incorporation took place in May 1935; since that time and up to the time of the hearing before the Commission in 1937 the capitalization of the firm had been changed twice.

When the registrant company submitted a balance sheet and registration statement in preparation for new and additional financing, Donated Surplus of $16,826 was included which represented the stock donated back by Peterson in 1935. The cost to the registrant corporation of six mining claims was shown at the par value of the 750,000 shares originally issued and the proceeds from the sale of the shares concurrently donated back was credited to donated surplus. In criticizing this point the trial examiner stated:

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[1] Security and Exchange Commission, Decisions and Reports, 3, 486-500

> "We (Commission) have had several occasions to condemn this practice as misleading and untrue. The cost of such claims to the registrant clearly cannot include the par value of shares returned to the treasury as a part of the same transaction whereby the claims were acquired. This being the case, it necessarily follows that there is no basis whatsoever for setting up a capital surplus account in connection with the transaction. On the basis of the above finding a stop-order will issue suspending the effectiveness of the registration statement."[2]

CASE II [3]

The case of Virginnia City Gold Mining Company is an interesting example of improper valuation condemned by the Commission. The registrant, a Washington Corporation, was organized in 1932 with a capitalization of 2,000,000 shares of common stock with a 10¢ par value. At this time in 1937 the capital stock authorized has been increased to 3,500,000 shares with the same par value. The registran made application with the Commission to sell the new shares authorized.

During the period up to the time registration was made with the Commission, many erroneous accounting procedures were followed, but we are concerned only with the valuation of the Plant, Property, and Equipment Account. This account had been charged with $200,000 which was the par value of all the stock authorized at the inception of the company. Investigation showed, however, that the vendor "donated back" 30% of those shares. Disregarding for the moment the actual value of the stock, it follows that the figure for Plant, Property, and Equipment should be reducted to 70% of par value or $140,000. Additional investigation showed that at and during the incorporation period some of this stock sold at 5¢ per share. It was indeed bad accounting methodology to

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[2] Ibid., p. 497.

[3] Securities and Exchange Commission, Op. Cit., 2, 855-870.

carry an asset at par value when current market price of the stock was 50% of par.

The Commission suspended registration until the asset account had been corrected and all pertinent facts disclosed.

CASE III [4]

In the case of the American Terminals and Transit Company, the Commission took exception to the registrant's procedure of including the cost of debt discount in the property account.

The registrant, its two subsidiaries, a coal and terminal company, and an affiliate of the registrant operated an integrated enterprise. The terminal company, acting as "financial agent" for the enterprise, floated a public issue of notes at a discount and loaned a good part of the sum to the other companies. With these proceeds each of the companies acquired the property which appeared in the balance sheet and which the Commission cites as deficient.

The financing or terminal company exchanged its own notes, par for par, with holders of certain building and loan stocks. These stocks were sold at a discount approximating half of their par value. The terminal company used a part of the proceeds to purchase additional equipment and loaned the rest to the affiliated companies. The loan to the subsidiaries was charged with the debt discount by the terminal company thereby eradicating the debt discount off the books completely. The subsidiaries in setting up the cost of the property they purchased included the debt discount as a cost.

The Commission in its investigation found the cost of the fixed

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[4] Securities and Exchange Commission, Op. Cit., 1, 786-809.

assets of the subsidiaries to be stated at approximately $75,000 of which approximately $30,000 was the debt discount. The Commission concluded as follows:

> "We hold that the figure of $75,000 given as the cost of the terminal plant is false, and would be false even had the presence of debt discount therein been fully disclosed rather than hidden at every step of the way. The investor is entitled to a fair opportunity to learn cost, in the sense of the monies immediately expended in the acquisition of assets, in order that he may check appraisals of the value of those assets..."[5]

The Commission then laid down this principle:

> "The inclusion of debt discount in cost of assets purchased with proceeds of notes sold at discount held untrue statement of cost of assets."

Quoting Paton, the Commission stated:

> "Debt discount is part of the interest cost of the capital obtained from the issue and should therefore be spread over the life of the bonded debt. Discount on securities can have nothing to do with asset values. Hence the amount of discount is a phase of interest to be paid in the future and has nothing to do with the value of the property acquired with the proceeds of the issue."[6]

In Regulation S-X--"Uniform Accounting Requirements for Financial Statements" a rule provides that, "Discount on capital shares, if significant in amount, shall be shown separately as a deduction from capital shares or from surplus, as circumstances require, with an indication of what provisions have been made for writing them off." There is little doubt but what this rule has the sanction of the accounting profession and accounting text authors. To fully protect investors, the Commission realized the importance of not allowing Discount on Stock to be hid under a title by any other name. At least the Com-

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5 _Ibid._, p. 715.

6 _Ibid._, p. 715.

mission feels responsible for the disclosure of the danger since the discount later may be subject to collection by call from the corporation, or by a lawsuit instituted by creditors. This contingent liability of the owner of the stock rests on the theory that it is the par value rather than the amount paid in which represents the capital fund available for the operation of the business and the protection of the creditors.

Certain miscellaneous expenses such as commissions, advertisement, revenue stamps, printing costs, and etc. are connected with the flotation of any security issues. The Commission has always condemned the practice of concealing any of the items in a fixed asset account; it supports the position that debt and stock selling expenses should be segregated from other items in the statement and classified as a deferred charge.

Where the amount of such miscellaneous expense cannot be determined, the reasons why should be disclosed. Such a situation may arise when the accounting system used makes no provision for the segregation of such expenses from other expenditures; nevertheless, an attempt should be made to determine what portion of the total of such expenditures are properly chargeable to stock or bond selling expense. The Commission has ruled:

> Where the books and records of the company do not disclose an adequate basis for such allocation of expense to the costs of security flotations, this fact should be stated or else an inquiry to determine the allocation should be made. Failure to inquire or to qualify the certificate casts some doubt upon the adequacy of the investigation made by the accountant.[7]

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[7] *Ibid.*, p. 341.

CHAPTER XI

INTANGIBLE FIXED ASSETS

Intangibles differ from tangible assets largely in that they do not possess materiality. These assets have no physical body substance but possess value because of the rights which their ownership confer, such as the possession of a patent, copyright, or franchise. Other intangibles, such as goodwill and going concern value, possess no distinctiveness apart from the enterprise as a going concern. Intangibles as a class make no physical contribution to production, as do materials and supplies; however in cases of secret formula and processes there is a connection between the intangible value of such and the operations of the plant.

The value of intangible assets, being closely connected with the result of the operation of the enterprise as a whole, is usually difficult to determine. There is a great deal of dependency upon the amount of earnings as to the value of such intangibles. This relationship between intangibles and superior earning power must be emphasized. Unless earning power above normal can be demonstrated as a result of the ownership of certain intangibles, there may be no ground for having a value on such assets. A concern may possess secret formulas, franchises, and patent rights; yet be without intangible worth due to the fact that the presence of such rights does not give the concern any special advantage over other competitive enterprises.

Intangibles may be classified in several ways: those subject to amortization such as patents, copyrights, franchises, and leaseholds, and those not subject to amortization such as trade marks and goodwill. The American Institute classifies intangibles into three broad groups as follows:

1. Those having a term of existence limited by law, regulation, or agreement, or by their nature. Examples: patents, copyrights, leases, licenses, and franchises.

2. Those having no limited term of existence and as to which there is at the time of acquisition, no indication of limited life. Examples: goodwill, going value, trademarks, secret processes and organization costs.

3. The excess of a parent company's investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter's books at the date of acquisition, in so far as that excess would be treated as an intangible in the consolidated financial statements of the parent and subsidiary.[1]

The Security Exchange Commission is particularly critical of the intangible classifications and values presented to them in registration statements. Under this general grouping, registrants are most likely to be optimistic as to the various values which they place on specific intangible items. True enough the valuation of such items by accountants and auditors is one of the most difficult problems to be faced, but there are certain generally accepted 'yardstick' rules which are used by the Commission to test the reasonableness of the registrants valuation.

Costs of various intangibles are often established on some other basis than cash. A payment for goodwill may be made by a transfer of

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[1] Committee on Accounting Procedure, American Institute of Accountants, "Accounting for Intangible Assets," Accounting Research Bulletin No. 24, p. 1.

stock at a nominal or par value; yet the true price may be much lower or incapable of determination. In other cases the price paid for intangibles may not be the result of an independent bargain between independent parties thus leaving a possibility of gross inflation of assets resulting from the transfer. Under such circumstances the Commission requires full and absolute disclosure of the transactions between vendor and vendee.

The Commission requires that tangible and intangible assets must be separated on the financial statements and adequately described in supporting schedules. Total intangible value may be given on the balance sheet with reference to a schedule which must contain the following information:

RULE 12-08 INTANGIBLE ASSETS (1)

COLUMN A -- Description (2)
COLUMN B -- Balance at Beginning of Period. (3)
COLUMN C -- Additions at Cost-describe. (4)
COLUMN D -- Deductions (5)
(1) Charged to Profit and Loss or Income
(2) Charged to other accounts-describe
COLUMN E -- Other changes--debit and/or credit--describe.
COLUMN F -- Balance at close of period.

(1) If in the accounts it is not practicable to separate intangible assets from property, plant, and equipment, the information here required may be included in the schedule for property, plant, and equipment. In such event state in the balance sheet any known amount of intangibles so included with an indication that a further unknown amount of intangibles is also included.

(2) Show by major classifications, such as patents, or goodwill. If such classification is not present or practicable, this may be stated in one amount. The additions included in column C shall, however, be segregated in accordance with an appropriate classification. Items of minor importance may be included under a miscellaneous caption.

(3) The balance at the beginning of the period of report may be as per the accounts. If neither the total additions

nor the total reductions during the period amount to more than 10% of the closing balance and a statement to that effect is made, columns B,C,D, and E may be omitted by any company other than a public utility company. Any information required by note 4 or 5 shall however, be given and may be in a summarized form.

(4) If the changes in accounts in column C represent anything other than additions from acquisitions, state clearly the nature of the changes and the accounts affected. If cost of additions represents other than cash expenditures, explain. If acquired from an affiliate at other than cost to the affiliate, show such cost, provided the acquisition by the affiliate was within two years prior to the acquisition by the person for which the statement is filed.

(5) If provisions for depreciation and amortization of intangible assets is credited in the books directly to the intangible assets accounts, the amounts shall be stated in column D with explanations, including the accounts to which charged.[2]

A discussion of the accepted methods of valuation of intangibles correlated with cases which have come up before the Commission should give a suggestion as to the attitude and influence of this federal body over valuation procedure.

Goodwill

In the beginning goodwill was defined in terms of the favorable attitudes of the customers and general public towards a concern. Someone has said that "The Goodwill which has been the subject of sale was nothing more than the probability that the old customer will resort to the same old place." Goodwill may be taken as the typical form of intangible asset which represents the advantages of location, reputation, personality of management, name, and etc. A company may be fair and honest in its dealings; it may attract new customers continually, and

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[2] Security and Exchange Commission, Regulation S-X--Forms and Content of Financial Statements, as amended 1942, p. 37

yet possess no goodwill in an economic sense. Goodwill, and other intangibles to a certain degree, depends for its value on the earning of excess profits. Thus according to Finney, "Goodwill may be defined as the capitalized value of the profits of a business which are in excess of a normal or basic return on the capital invested exclusive of goodwill."[3]

As a generally accepted rule, Goodwill may appear on the statements of a registrant only if it has been paid for and at the actual amount paid for it. When a purchaser buys a going concern and pays a price for goodwill, he no doubt feels that he is paying an amount for the excess profits of the future indicated by the highly profitable operations of the past. Since the profits of the past are an indication of the probable earning capacity in the future, it is customary to estimate goodwill on the basis of past excessive earning capacity. There are several methods, more or less arbitrary, for computing the value of goodwill at the time of purchase, but these will not be discussed here.

In the past the Goodwill Account has been used for many ulterior purposes. If the account had always represented the amount actually paid for it at the time of purchase; it would not be in its present state of disrepute. The Commission has found that in many instances stock discount, organization expense, early operating deficits, and bonuses of shares of stock have been charged to it. Under such circumstances the Commission requires that the account be eliminated and the various charges to it be properly classified in the amended statements.

Some rulings by the Commission on goodwill valuation follow:

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[3] H. A. Finney, Principles of Accounting Intermediate, p. 308.

CASE I [4]

In the matter of American Gyro Company an account appeared on the financial statements titled, "Goodwill Gyroplane" represented by a book figure of $260,000. According to the company this account was justified:

> "......since the most satisfactory results have been had from our wind tunnel tests of our gyroplane....we have seen fit by resolution of the Board of Directors to give an appreciation or goodwill value to our gyroplane on the books of the company in the sum of $260,000."[5]

Evidence showed that there was little or no basis for an intelligent opinion as to the value of the gyroplane, and the conclusion is that the $260,000 is a mere guess. Since the company was new and was producing a revolutionary new contrivance which was in the experimental stage and not proven to be a success, goodwill based on actual or past profits could not exist. Neither, according to the Commission, had any demonstration of future possible or prospective excess profits been shown, and "mere speculation as to the existence of intangible value is insufficient grounds for an account representing that value."

CASE II

The Commission has had occasion to deal with the question of valuation of business enterprises on the basis of earnings in its consideration of reorganization plans of various companies under the Bankruptcy Act. In one case its report contained the following:

> "In order to translate earnings into a valuation, it is customary to use the device of capitalizing earnings which may be reasonably anticipated. The rate of capitalization is determined in the light of the risks inherent in the venture, and will reflect the rate of return which the

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[4] Security and Exchange Commission, Decisions and Reports, Vol. 1, pp. 83-97.

[5] Ibid., p. 88.

investor might fairly require as compensation for an investment subject to such risks."[6]

In the report from which the following is extracted, the Commission indicated the factors which it thought should be considered in fixing a proper rate appropriate for the capitalization of earnings in the case under review:

> "To ascertain goodwill value it is necessary to capitalize reasonably foreseeable earnings at a rate which reflects a fair investment return, in view of the risks of the industry and the relative stability of the company's earning's. From our investigation of factors pertinent to a determination of a proper rate, including consideration of the debtors earnings record in relation to estimated earnings, the general outlook for and the highly competitive nature of the cigar industry, and similar related elements we are of the opinion that a rate lower than 10% would not be appropriate for the capitalization of the debtor's anticipated earnings after federal income taxes."[7]

In reorganization, consideration should be given to any abnormal conditions that may have affected adversely the earnings of the predecessor such as change in product, need for reducing fixed charges, or expansion of facilities. All these may have prevented the former organization from showing large profits, even though it possessed a valuable goodwill on which the successor corporation may be able to realize excellent profits in subsequent years. The Commission, in reporting upon a proposed reorganization plan, took the position that the circumstances enumerated may have substantially affected the usefulness of past earnings as a guide to future results:

> "In examining the past earnings of a corporation for purposes of guidance in estimating reasonably anticipated

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[6] In the matter of La France Industries et al., Corporate Reorganization Release No. 16, 1939.

[7] In the matter of Porto Rican American Tobacco Company, Corporate Reorganization Release No. 27, 1940.

> future earnings, consideration must be given to the possibility that changes in the volume and nature of its business, and the sources of its revenues, may have substantially affected the usefulness of past earnings as a guide. In this case an analysis of the factors which affected the debtor's operations in its profitable period, 1927-1935, indicates that the earnings for those years are not indicative of the prospective earning power of the enterprise."[8]

Patents

When patents are purchased for cash or other consideration, the amount of such consideration generally constitutes their cost. If a patent is obtained by an inventor, its cost is the total of experimental expenses, cost of working models and drawings, and attorney and filing fees. A patent is said to have no proven worth until it has stood the test of an infringement suit; the cost of such suit, if successful, represents an additional cost in establishing the patent.

Patents on inventions and processes are granted for a period of 17 years after issuance of the patent letters. However in many cases the real value of the patent exists for a much shorter period of time. Since it is generally accepted accounting practice to amortize periodically a portion of the cost of the patent over the life of the patent, the Commission requires that full disclosure be made concerning the amount and regularity of the write-offs of value as the patent expires in usefulness, and that costs of patents ascertained to be of no commercial value must be written off immediately.

In many cases a residual value remains which merges into the goodwill created by the use of a patent; but this is a different kind of

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[8] In the Matter of Thos. Mills of America, Inc., Corporate Reorganization Release, No. 22, 1940.

asset, and one is not justified in anticipating such an outcome which may or may not occur and therefore ignoring the diminishing period of protection of the patent. Patents depreciate also because of unfavorable decisions in lawsuits, obsolescence, or the impossibility of making the article a commercial success. Thus a patent may not remain valuable during its whole life, and, if it does not, the Commission encourages proper revaluation.

In some instances it has been the duty of the Commission to require registrants to determine the actual cash value of patents which have been acquired in exchange for capital stock. If at the time there was a free and active market for the shares, it would seem evident that willing buyers and sellers would fix a fair price for the patents. When the market for such shares is not active other evidence must be sought to support such valuation. The following analysis of a case before the Commission indicates several methods of fixing patent values and its support of such methods.

CASE I [9]

In the case of Peterson Engine Co., Inc., the registrant presented the item, "Patent Rights, Plans and other Intangible Assets" at $254,801 on the balance sheet in the registration statement. The derivation of the sum at which this item was carried was stated in a footnote as follows: "The above valuation represents the excess of par value of 290,001 shares of capital stock of the registrant of $1 each over the cost to the predecessor companies of the net assets of $35,200 acquired at organization

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[9] Securities and Exchange Commission, Op. Cit., 2, 893-910.

of the company." Thus unrealized appreciation over cost to the predecessor companies had been reflected in the capitalization of the registrant.

The Commission's investigation disclosed that the cost of the patent rights to the predecessor company was $11,577 and that such rights were in effect only patent applications--no formal letters of patent being granted by the government at the time. The Commission's patent attorney testified that there were only four acceptable bases for appraising a patent, namely: (1) the amount of an actual cash sale between parties dealing at arms length with each other; (2) the amount of a bona-fide cash offer to purchase made by a financially responsible person; (3) a capitalization of royalties obtained from a patent; and (4) a capitalization of those earnings of a company strictly attributable to a patent. In the absence of information upon which one of the foregoing criteria of value could be applied, any value given to a patent would not be an acceptable appraisal but a mere guess, and that under such circumstances, it was improper to assign more than a nominal value to any patent.

In concluding the Commission stated:

> "It is apparent that the valuation of "Patent Rights" at $254,801 reflected on the balance sheet of the registrant represents at most the guess of the officers of the company as to the value of the company's patent applications. If there is any basis for such guess it lies in the estimate of the potentiality for future profits which may be inherent in the patent applications. Courts have viewed with disfavor the issuance of par value stock based not upon any conservative evaluation of the property acquired, but on an unsubstantiated estimate of large future profits to be derived from the property acquired, particularly where the cost to the seller of the property acquired for the stock is small as compared to the par value of the stock issued for the property by the purchasing corporation. Thus this account has no proper basis and is additionally misleading to prospective investors because of the non-revelation in the balance sheet or in explanatory notes of circumstances

which may have influenced the calculation of the value placed upon such Patent Rights."[10]

Trademarks

Whatever value may be regarded as attaching to a trademark is closely analogous to goodwill or going concern value. They all represent the value of an established business and become valueless if the business is discontinued. Generally no direct cost is incurred in creating value for a trademark or trade name, although both may have been acquired at great cost for advertising and other sales-promotion expense.

It is seldom that a separate valuation is placed upon trade-marks acquired; whatever consideration is paid for them is almost always included in the amount paid for goodwill. Whatever value a trademark may have lies in the protection by the courts of the right of the originator to use it. Such a right to the use of the trademark is perpetual, and possesses more intangibility of value than either a patent or a copyright. The valuation of trademarks is not subject to amortization and is often combined with goodwill in one account as a single asset.

If, however, a trade-mark account appears in a registration statement, it is considered permissible by accountants to capitalize as the cost of the trade-mark all attorney's fees, registration fees with the U. S. Patent Office, and other expenditures definitely identifiable with its acquisition. Any attempt to determine the portion of a concern's advertising that may properly be treated as a cost of developing a trade-mark or trade name usually involves such difficulties that it is probably wiser to treat such expenditures as current expense items.

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[10] Ibid., pp. 908-909.

Copyrights

The term of a copyright is twenty-eight years, with the privilege of renewal for another period of the same duration. The cost of a copyright is generally nominal in amount unless it has been revalued when purchased from another. As most copyrights diminish in value rapidly, amortization should not be based on their entire life, but usually on a policy of writing off cost against the first edition or printing of a publication.

Formula and Processes

The remarks made previously on the subjects of goodwill and trademarks are applicable also to the valuation of secret processes and formula. There is a particularly close analogy between such assets and trademarks, and it seems unnecessary to repeat what has been said on the subject.

In the rare event of payment having been made specifically for formula and processes, it may be possible to revalue the asset to give effect to changing conditions; but it will be found that such assets are most always created on the books in combination with goodwill, and that any particularity in the designation of the account is only for the purpose of expressing the thought that the intangible assets acquired were more than the general goodwill of the business.

It is the Commission's preference that the various classes of intangible assets be stated separately. Where, however, the system of accounting followed by the registrant has made no provision in the accounts for a segregation of these items, and where the registrant finds it exceedingly difficult or well-nigh impossible, except for a great deal of time and expense, to separate these classes, the total may be stated. The reason for its inability to state these classes separately should be disclosed, preferably in a footnote to the balance sheet or to the schedule in which the intangibles are presented.

The following case before the Commission is one in which two intangible assets were intermingled from the time of purchase to the partial sale of such assets.

CASE I [11]

In the matter of A. Hollander & Son, Inc., a fur dealer and registrant, who in 1925, through Bertram J. Goodman, Inc., a subsidiary specifically formed for the purpose, paid $460,000 for the goodwill, processes and formula of Bertram J. Goodman of New York. An agreement entered into by the registrant on April 21, 1931 permitted B. J. Goodman and certain associated to re-enter the dressing and dyeing business under the name Goodman & George, Inc., upon payment of $75,000 in five equal installments to the registrant. The 1931 agreement also bound registrant's subsidiary, Bertram J. Goodman, Inc., to refrain after 1936 from engaging in the fur dressing and dyeing business under that name.

Counsel for the Commission contended that of 1931 the entire original cost of acquiring the Goodman business should have been written off on the ground that Bertram J. Goodman's re-entry into the dressing and dyeing business and the agreement of registrant's subsidiary to cease using the name of Bertram J. Goodman rendered valueless for the registrant the assets purchased under the 1925 agreement.

There is little doubt that the $75,000 which the registrant received under the 1931 agreement with Goodman and associates was in effect consideration for the reconveyance of at least some of the rights which the

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[11] Securities and Exchange Commission, *Op. Cit.*, 8, 586-619.

registrant had acquired under the 1925 contract. In reaching a decision as to the procedure in handling the resale of such rights, the Chief Accountant concluded:

> ".... we therefore find that it ($75,000) should have been credited to the original $460,000 cost of acquiring the Goodman business. While we find that the registrant erred in not handling the transaction in this manner, the evidence is insufficient to convince us that the $75,000 was consideration for the conveyance of all the assets acquired in 1925, and we find no basis in the record before us for holding that the registrant erred in failing to write off the entire $460,000 at that time."[12]

Royalty and License Contracts

When royalty and license contracts relative to patents and copyrights have been made directly with the owners of such intangibles, there is usually no occasion to give them financial recognition in the accounts. However when agreements of this character have been assigned to the registrant for a consideration, the cost of obtaining the assignment may be capitalized and amortized over the life of the agreement or the expected period of its utility if shorter.

For such assets the Commission favors actual cost as a proper basis, and where the basis is not disclosed or is arbitrarily set up, it is necessary to amend the statements as indicated in the following two cases.

CASE I [13]

Certain licenses, permitting manufacture of certain airplane parts by the Crouch Bolas Aircraft Corporation, were acquired from two of the

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[12] Ibid., pp. 611-612.

[13] Crouch-Bolas Aircraft Corporation, Registration Statement A-1, File No. 2-1649, on file with the S.E.C.

men who, on the organization of the corporation, became members of its board of directors. The valuation placed on such licenses on the books of the corporation was determined by the board and not by independent appraisers.

The original balance sheet filed with the Commission failed to disclose: (1) the basis used in determining the amount at which the licenses were carried in the balance sheet, (2) by whom the valuation was made, and (3) the relationship existing between the vendor and the officers of the registrant. In the original balance sheet, the licenses were shown at a value of $163,600. No other information was contained either in the face of the balance sheet or in any of its supporting footnotes to explain these assets further.

In the amended balance sheet, two material changes were made. The amount for licenses was reduced to $117,250, and the following footnote was added:

> "The licenses are exclusive licenses covering the U. S., its territories and possessions. Their valuations is arbitrary and was made by the Board of Directors and not by independent appraisers. Messrs. Crouch and Bolas, who are directors and officers, were indirectly the vendors of the licenses. The actual value of these licenses has not been proven and value is only prospective. The patents on which these licenses are based represent over two years continuous work by Messrs. Crouch and Bolas, plus an expenditure estimated by them as being in excess of $29,000."[14]

<u>CASE II</u> [15]

The Manasco Manufacturing Company case is slightly different from the one above. This company, besides manufacturing, repairing, and

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[14] Ibid., footnote to amended balance sheet.

[15] Filed on form A-1, File No. 2-2510, filed with the S.E.C.

selling aircraft engine parts and other machine work, also sells its license rights for the manufacture and sale of such engines and parts.

The deficient balance sheet contained the following item:

Approved License Certificates. (See Footnote No. 2) ... $35,000

Footnote 2 stated that the above value was established by appraisal by officers of the applicant. In the amended filing, the balance sheet item remained the same but the footnote was changed to read:

> "This figure represents Approved type Certificates at $5,000 each and is an arbitrary valuation and does not represent actual value which is unknown but only prospective and was fixed by the Board of Directors of which the Vendor was a member and not by independent appraisers."[16]

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16 *Ibid.*, footnote to balance sheet.

CHAPTER XII

RESERVES FOR FIXED ASSET VALUATION

Until fairly recently, many corporations did not make any provision for depreciation, depletion, and amortization in the computation of net income and proper asset values for statement purposes. An investigation conducted in 1916 by the Federal Trade Commission, predecessor to the Securities and Exchange Commission, discovered that out of 60,000 apparently successful corporations doing at least $100,000 a year of business, fully 50% did not take depreciation and other periodic charges into consideration at all. In the years before the federal income tax laws made depreciation, depletion, and amortization charges profitable, it was not very difficult to disregard the fact of daily wear and tear on physical equipment and the maintenance of intangibles at fixed values in order to show a favorable income statement and be able to pay dividends.

It is becoming more and more recognized that depreciation, depletion and amortization charges are as much a cost of doing business as is the cost of coal consumed in running the plant; such charges differ from other costs only in that it does not represent and immediate outlay of cash. The provision for such charges affects both the income statement and the balance sheet. The debit entry represents an expense charge to income; the reciprocal credit entry or entries is made to a real account thus becoming a valuation amount used to reduce the book value of the fixed asset on the balance sheet. Such valuation amounts are known as valuation reserves, and according to the Commission,

"-shall be shown separately in the statements as deductions from the specific assets to which they apply."

Since, for commercial and industrial concerns, fixed assets are required to be separated into tangible and intangible classes where possible, two reserve schedules are necessary to support the total reserves shown on the financial statement. Rules 12-07 and 12-09 of Regulation S-X call for the following information:

RULE 12-07 RESERVES FOR DEPRECIATION, DEPLETION, AND AMORTIZATION OF PLANT, PROPERTY, AND EQUIPMENT. (1)

COLUMN A....Description (2)
COLUMN B....Balance at beginning of period. (3)
COLUMN C....Additions
(1) Charged to profit and loss or income.
(2) Charged to other accounts..describe.
COLUMN D....Deductions from reserves
(1) Retirements, renewals, and replacements.
(2) Other..describe.
COLUMN E....Balance at close of period.

(1) (a) If other reserves are created in lieu of depreciation reserves, the same information shall be given with respect to them.

(b) Insofar as amounts for depreciation, depletion, and amortization are credited to the property accounts, such amounts shall be shown in the schedule of property, plant, and equipment, as there required.

(2) If practicable, reserves shall be shown to correspond with the classifications of property set forth in the related schedule of property, plant, and equipment, separating especially depreciation, depletion, amortization, and provisions for retirement.

(3) The balance at the beginning of the period of report may be as per the accounts.[1]

RULE 12-09 RESERVES FOR DEPRECIATION AND AMORTIZATION OF INTANGIBLE ASSETS

The rule provides for the same columns as in the Reserve Schedule for Plant, Property, and Equipment with the following explanations:

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[1] Commission, Regulation S-X, Form and Content of Financial Statements, as amended in 1944, p. 50.

(1) Insofar as amounts for depreciation and amortization are credited to the intangible asset accounts, such amounts shall be shown in the schedule of intangible assets, as there required.

(2) If practicable, reserves shall be shown to correspond with the classification in the related schedule of intangible assets.

(3) The balance at the beginning of the period of report may be as per the accounts.[2]

There is little doubt but what the Commission compels full disclosure as to depreciation, depletion, and amortization policies. The explanation of the Registrant's policies should be in such detail as to permit a clear understanding of the methods followed and the adequacy of the periodic charges. Where the company follows the policy of crediting the fixed asset account instead of a reserve valuation account with the periodic credits, full disclosure should be made in the schedule pertaining to the tangible or intangible asset section.

Often times a registrant may fail to maintain consistency in the treatment of its periodic debits and credits to the income and to the valuation reserve account. Where there are such inconsistencies, the Commission requires that a full explanation be made in the reserve schedules or in the accountant's certificate. The Commission has held various financial statements to be deficient because of lack of disclosure on the general points following:

(1) No clear statement as to policy, both present and future, for the accounting of depreciation, depletion, and amortization.

(2) No explanation in changes of method of accounting from the preceding period or periods regarding valuation accounts.

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[2] Ibid., p. 52.

(3) No reason given for failure to provide for periodic charges to income and valuation reserve.

(4) No statement as to policy in regard to the treatment of repairs and replacements.

(5) No explanation why periodic charges to income and valuation reserves are different than those charges claimed for income tax purposes.

The Commission examiners have repeatedly criticized accountants and auditors for not observing more closely the rules and requirements set forth in the various registration forms and the accounting releases. Such responsibilities of accountants for proper fixed asset valuations will be discussed in a following section.

S.E.C. INFLUENCE ON AUDITING PROCEDURE AND PRACTICE

CHAPTER XIII

THE COMMISSION'S INVESTIGATION OF McKESSON AND ROBBINS, INC. AND ITS INFLUENCE ON THE EXTENSION OF AUDITING PROCEDURES

One of the most important cases ever to come before the Commission was the case of McKesson and Robbins, Inc.,[1] drug wholesalers operating in the United States and Canada. The fraud committed by certain officers of the corporation was on such an immense scale that international attention and comment was given to the case. In this thesis particular attention is given to the part that the Securities and Exchange Commission played in lending its authoritative support to the extension of auditing procedures in the verification and valuation of inventories.

The first public intimation of the inflation in assets on the books and statements of McKesson & Robbins was contained in a complaint which sought a receivership for the corporation. The complaint filed in U. S. District Court, Hartford, Connecticut, by V. W. Dennis, corporation counsel, alleged that:

> "...through its officers and directors, for a long time prior to the date hereof, had fraudulently represented its assets to be of substantial character and in its statements to stockholders, security holders, and to the general public has included in its inventory and accounts receivable, inventories which do not and have not existed and accounts receivable which do not and have not existed..."[2]

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[1] Securities and Exchange Commission, Report on Investigation--McKesson & Robbins, Inc., pp. 1-500.

[2] Ibid., p. 13.

The suit for receivership further stated that fictitious inventories and accounts receivable aggregated in excess of $10,000,000.

On December 6, 1938 several important things happened. All transactions in McKesson & Robbins' stocks and bonds were prohibited on the New York Stock Exchange, and several directors of McKesson invited in the Security Exchange Commission for a thorough investigation by a special examining board. It was at this point, and with little factual knowledge of the case that the Commission instituted proceedings. Finding reasonable grounds to believe that the financial statements, contained in the most recent annual report filed by McKesson Co. with the Commission and the New York Stock Exchange as required by the Security Laws, did not fairly present the financial position of the company and its subsidiaries as of the date of such statements and were false and misleading as to various assets shown, the Commission began a full inquiry.

On the basis of this investigation into certain auditing phases and in view of the substantiated false and misleading statements prepared and certified by Price, Waterhouse & Company which were contained in the annual reports filed with the Commission, the Commission on December 29, 1938 entered an order directing public hearings to be held for the purpose of determining and investigating the following:

(1) the character, detail and scope of the audit procedure followed by Price, Waterhouse & Co. in the preparation of the financial statements included in the said registration statement and reports;

(2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by Price, Waterhouse & Co. in the preparation of said financial statements; and

(3) the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure

to assure reliability and accuracy of financial statements.[3]

The facts disclosed by the investigation were indeed startling. Financial statements of the corporation and its subsidiaries for the year ending December 31, 1937 certified to, by Price, Waterhouse & Co. reported total consolidated assets in excess of $87,000,000. Approximately $19,000,000 of these assets proved to be fictitious. The fictitious items consisted of inventories of $10,000,000; accounts receivable, $9,000,000; and cash in bank, $75,000. These false assets arose out of the operations at the Bridgeport office of a wholly fictitious foreign crude drug business shown on the books of the Connecticut Division of McKesson & Robbins, Limited (Canada), one of its subsidiaries. For the year 1937 approximately 18 billion dollars of fictitious sales were made through this office with an estimated two million dollar profit. At the time of exposure of the fraud on December 5, 1938, the fictitious assets had increased to approximately $21,000,000.

The fraud was engineered by Frank Donald Coster, president of McKesson & Robbins since its merger with Girard & Co., Inc. in November 1926. In reality Coster was Philip M. Musica who, under the latter name, had been convicted of commercial frauds. In carrying out the fraud Coster, in the later years, was assisted principally by his three brothers: George Dietrich, assistant treasurer of the corporation, who was in reality George Musica; R. J. Dietrich, head of the shipping, receiving, and warehousing department of the firm at Bridgeport and who was in reality Robert Musica; and George Vernard, who was in reality Arthur Musica, manager of the offices, mailing addresses, bank accounts

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[3] Securities and Exchange Commission, Accounting Series Release No. 19, pp. 1-2.

and other activities of the dummy concerns with whom the McKesson company supposedly conducted the fictitious business.

To accomplish the deception, purchases were pretended to have been made by the McKesson Companies from five Canadian vendors, who thereafter purportedly retained the merchandise at their warehouses. Sales were pretended to have been made for McKesson's account by W. W. Smith & Company and the goods shipped directly by this company from the Canadian warehouses to the costomers. Payments for goods purchased and collections from customers for goods sold were pretended to have been made by a Montreal banking firm of Manning & Company for the account of McKesson. Smith Company, Manning & Company, and the five Canadian vendors were blinds used by Coster for the purpose of supporting the fictitious transactions.

Invoices, advises, and other documents prepared on printed forms in the names of these firms were used to give an appearance of reality to these transactions. In addition to this manufacture of documents, a series of contracts and guaranties with Smith and Manning and forged credit reports on Smith were also utilized. The foreign firms to whom the goods were supposed to have been sold were real but had done no business of the type indicated with McKesson.

The fictitious transactions originated early in the life of Girard & Co., Inc., Coster's predecessor concern, incorporated on January 31, 1923 and increased until they reached the proportions mentioned above. The manner of handling the transactions described above was instituted in 1935. Prior to that time, the fictitious goods were supposed to have been received and shipped from the Bridgeport offices of McKesson instead of from the Canadian vendors. The investigation of this system disclosed that of the twenty-four million dollars of cash outgo for false purchases all but approximately three million dollars came back to the McKesson Company as collections on fictitious receivables or as cash transfers from the fictitious bank of Manning & Company.

The investigation by the Commission clearly disclosed that the audit of inventories by Price, Waterhouse & Co. was essentially that which was prescribed by generally accepted auditing procedure at the particular time. Any examination of inventories falls into three large categories: (1) tests of the accuracy of computations and footings, (2) investigation of the basis of valuation, (3) a check on the quantity, quality, and condition of the inventory. In the first two categories mentioned above, the accountant must check the inventories sufficiently to satisfy himself as to the substantial accuracy of the clerical work performed and to see that the goods are valued in accord with accepted valuation methods in that particular type of business. This, Price Waterhouse & Co. had performed to a certain degree. Members of the accounting firm had meticulously checked the footings and computations of McKesson's book records. The inventory was stated as being valued at "cost or market whichever is lower", which is an acceptable basis in a crude drug business. In making their tests the auditing firm compared inventory prices with the previous year's inventory prices, with current year's purchase prices, with the client's sales prices for a period subsequent to the inventory date, and with quoted market prices. Testing in this manner disclosed that book values of foreign crude drugs were at variance with quoted prices in various trade journals. Wide discrepancies appeared between quoted prices and selling prices; the quoted purchase price of some drugs in some instances was above the

McKesson sales price to customers. The auditors accepted the explanation offered by the company that this was due to the superior buying power of McKesson because such large quantities were handled. The auditors made no attempt to verify the quantities to which the quoted and book prices applied.

In regard to the condition, quality and quantity of inventory, the auditor must rely, in some instances, upon officers and employees of the company for this information. The accountant is not an appraiser and does not possess the technical knowledge to properly value some inventories such as ore piles and chemical mixtures in process. In the case of a business which does not call for technical knowledge, the accountant may be justified in assuming a larger responsibility for inventory values than in cases where expert knowledge is essential. There is little doubt that if physical verification or spot checking of the inventory held in the various warehouses had been carried into effect, the fraud would have been discovered years previously. Professional curiosity as to the business being audited might well have prompted a request to see the huge stocks and piles of crude drugs carried at the Bridgeport and later at the Canadian warehouses. A wide-awake tour of such establishments would have been entirely sufficient to reveal the shortages.

The Commission stated during its public hearing that:

> "In our opinion the complete omission of any attempt at physical contact with the inventory when it was supposed to have been at Bridgport cannot be justified even on the theory of non-assumption of responsibility by the auditors for inventory quantities. While in view of the size of this fraud such inquiry, if boldly attempted, might well have disclosed the inflation, a mere cursory inspection cannot of course be relied upon in place of a regular test of and assumption of reasonable responsibility for inventory quantities.

> There are two generally recognized methods for making such tests. The auditor may arrange with the client to be present as an observer while the inventory is being taken and make or supervise such test counts as he deems necessary during the course of the work. Or the auditor may go in at some other date and make sample counts of stock for comparison with permanent inventory records or for reconciliation with the physical inventory by taking purchases and sales in the interim into account."[4]

Experts, members of other accounting firms, testified at the public hearing that sample counts or test checks were feasible in many lines of business and that such checking procedure was by no means new and revolutionary to the accounting profession. Many of the experts disclosed that their firms required such methods be used in certain circumstances, but "test checking" was not an invariable rule of auditing to be followed in every case. Testimony from the various witnesses disclosed many points of substantial agreement:

> (1) Accountants in taking inventory tests should have a general knowledge of the client's products, but should not profess to have a technical knowledge of all technical items.
>
> (2) Physical tests made should be based on ordinary business judgment and are support for accounting tests based upon the book records.
>
> (3) Due consideration should be given in all cases to the internal check and control over inventories and to the manner in which the business is conducted in judging whether packaged goods really contain material described on the labels.
>
> (4) Certain industries and lines of business in which the nature of the product or character of the merchandise makes physical testing impossible in which case test checking would not be a reasonable and practicable requirement.

In their concluding remarks on the case on which 500 pages of written testimony was taken, the Commission summarized and concluded:

> "Our conclusion based upon the facts revealed by the record, the testimony of the expert witnesses, and the writings

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4 Securities and Exchange Commission, _op. cit._, p. 407.

of recognized authorities is that the audits performed by Price, Waterhouse & Co. substantially conformed, in form, as to scope and procedures employed, to what generally was considered mandatory during the period of the Girard-McKesson engagements. Their failure to discover the gross overstatement of assets and of earnings is attributable to the manner in which the audit work was done. In carrying out the work they failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing. In addition, the overstatement should have been disclosed if the auditors had corroborated the Company's records by actual observation and independent confirmation through procedures involving regular inspection of inventories and confirmation of accounts receivable, audit steps which, although considered better practice and used by many accountants, were not considered mandatory by the profession prior to our hearings.

In our opinion, the time has come when auditors must, as a part of their examination when ever reasonable and practicable make physical contact with the inventory and assume reasonable responsibility therefor as had already become the practice in many cases before the present hearings. By this we do not mean that auditors should be, or by making such test become the guarantors of inventories any more than any of the other items in the statements, but we do mean that they should all make reasonable tests and inquiries and not merely those limited to the books in order to state their professional opinion, as auditors, as to the truthfulness of that item in the same way as they do for other items in the statements.

We do feel, however, that there should be a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined are to a greater extent checked by auditors through physical inspection or independent confirmation. The time has long passed, if it ever existed when the basis of an audit was restricted to the material appearing in the books and records.

We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action is being taken by the various accounting societies adopting certain auditing procedures considered in this case. Particularly, it is our opinion that auditing procedures relating to the inspection of inventories and confirmation of receivables should be accepted as normal auditing procedures in connection with the presentation of comprehensive and dependable financial statements to investors."[5]

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5 Ibid., pp. 10-11.

Because of the great deficiencies in generally recognized auditing standards brought to light by the McKesson Case, professional societies immediately formulated additional steps to be followed in an audit program for inventories. Under the date of May 9, 1939 the council of the American Institute of Accountants adopted a report entitled "Extensions of Auditing Procedure". This report placed the responsibility upon the accountant to adopt such procedures as his judgment deemed appropriate and recommended that certain additional auditing practices be considered as generally accepted procedure. The action of the council received widespread support of state organizations of accountants, and the proposed recommendations received the hearty approval of investors, credit men, the public, and the Security Exchange Commission whose comments previously mentioned at the public hearing of the McKesson Case greatly encouraged the adoption of additional procedures as being normal and necessary.

The auditing procedures for inventories considered sufficient before the time of the McKesson Case were set forth in a bulletin prepared by the American Institute, "Examination of Financial Statements by Independent Public Accountants". The routine for such procedure is outlined briefly:

(1) Obtain copies of inventory instructions and determine how complete the physical stocktaking has been or whether there has been substantial reliance on book inventories. In the latter case inquire as to how frequently they have been tested by physical inventories throughout the period. Discussion of situation with client before actual stocktaking is desirable.

(2) Obtain original stock sheets if they are in existence. Test final inventory sheets by comparison with originals, and with tickets or other means used in making original count.

(3) See that inventory sheets are signed or initialed

by persons responsible for taking stock, determining prices and making calculations and footings. Obtain from a responsible official a clear and detailed statement in writing as to methods followed, and as to accuracy of the inventory as a whole.

(4) Test the accuracy of the footings and extensions, especially the larger ones.

(5) Make a test of comparison of the inventories with the stock records, if any, as to quantities and prices. Any material discrepancy should be satisfactorily explained.

(6) See that goods which are not owned but are on consignment from others have not been included in the inventory.

(7) See that goods set aside for shipment, the title to which has passed to customers, have not been included in the inventory.

(8) When a cost system is not adequately controlled by the financial accounting, special attention should be given to work in process records.

(9) See that no machinery or other material which has been charged to plant or property account is included in inventory.

(10) Make inquiries and tests to ascertain that purchase invoices for stock included in the inventory have been entered on the books. Look for post-dated invoices and give special attention to goods in transit.

(11) If it is customary to receive deliveries under purchase contracts not promptly billed, confirm the quantities delivered by communication with contractor.

(12) See that acceptable pricing bases have been used. Market prices may be determined by obtaining current quotations, consulting trade journals and by comparison with recent purchases. Replacement costs should be considered also selling prices, less shipping and selling expense.

(13) For materials and merchandise purchased make test comparisons of cost prices with purchases invoices. For work in process and finished goods, examine the cost system as to overhead items included, intercompany profits, and etc.

(14) Duties, freight, insurance and other charges added to the inventories should be tested to ascertain that they are proper.

(15) Give considerations to possibility that obsolete, excessive, or damaged stocks are included in the inventories

at greater than realizable values. Make tests of detailed stock records to determine if the quantities are reasonable in relation to average consumption and purchases.

(16) If firm has discontinued the manufacture of any of its products during the period, the inventory of these goods should be scrutinized and provision made for anticipated losses.

(17) In the case of part shipments or uncompleted contracts partial profits should be recognized only where this is clearly justified. If a loss on uncompleted work is anticipated provision should be made therefor.

(18) Check the inventory total by the "gross profit" method.

(19) Ascertain that the inventories at the beginning and at the end of the period are stated on the same basis, or if not, the approximate effect on the operating results.

(20) Advance payments on account of purchases contracts for future delivery should preferably be shown in the balance sheet under separate heading.

(21) If stocks have been hypothecated, that fact and the book value of the stocks hypothecated should be stated on the balance sheet.[6]

To this pre-McKesson standard for inventory audit procedures must be added the new rules or extensions advocated by the Security Commission and recommended by the Institute in their bulletin, "Extensions of Auditing Procedure":

(a) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, where ever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified

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[6] American Institute of Accountants, <u>Examination of Financial Statements by Independent Public Accountants</u>, pp. 17-20.

public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim charges), it will ordinarily be necessary for the foregoing procedures to be followed at the time.

In cases where the concern maintains well kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon to support the inventory totals as shown on the balance sheet.

(b) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved represents a significant proportion of the current assets or of the total assets of a concern, the independent public accountant shall make supplementary inquiries.[7]

Several questions have come up as to the meaning and implication of several passages in the above procedures. The term "physical tests" needed explanation, and the Institute declared that it meant for the auditor to attend the inventory taking and observe the method of taking the inventory, making in conjunction such inquiries or test checks as deemed advisable. Such additional procedures are generally accepted practice only when they are practicable and reasonable, such being determined by the facts of the particular case.

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[7] Committee on Auditing Procedure, American Institute of Accountants, "Extensions of Auditing Procedure, Statements on Auditing Procedure No. 1., pp. 6-7.

In regard to the increased responsibility of the auditor, it must be stated that the certified accountant holds himself out to the public as being professionally qualified. His function is to examine a concern's accounting records and supporting data, to obtain outside confirmations, and to require supplementary information from the management and employees, to the degree and effort necessary which will enable him to form an intelligent opinion as to the material accuracy and truthfulness of the financial statements, but in no case is he to be considered a guarantor, insurer, appraiser, or expert in materials. The public must understand that he (auditor) can take the additional steps in verification of inventories; yet such procedure according to professional dictum does not invest his opinion with a degree of authority which he does not claim for it or impose upon him a measure of responsibility which the nature of his work does not justify.

A novel question raised by the McKesson Case and referred to in Part B above of the "Extensions of Auditing Procedure" is whether an auditor should investigate custodians of the client's merchandise. In many instances the storing of goods in public warehouses is a common practice and the holding of customers' merchandise by vendors was not uncommon before this case. Price, Waterhouse & Co. confirmed merchandise held off the client's premises by direct confirmation; however the results was to receive confirmation documents which had been forged from the dummy concerns set up by the Coster brothers.

Authorities are in substantial agreement that goods stored off the client's premises should be confirmed if material in amount. In this case or in any case confirmation alone would not disclose a misappropriation of goods by the holder, but this leads to the point of requiring evidence of the financial responsibility of the holder of the goods. In this case, Ritts, employee of Price, Waterhouse & Co., had suggested securing financial statements of the five Canadian vendors who supposedly held inventories of McKesson of around seven million dollars; Ritts, however, allowed himself to be overruled by Coster who convinced him that such procedure was unnecessary.

If Ritts had insisted upon financial reports of the vendors, it is very likely that falsified reports of some type would have been produced. However, if the auditors had conducted an independent investigation of the legitimacy of these concerns by requesting the Canadian firm of Price, Waterhouse & Co. to make an inquiry, no doubt exposure of the fraud would have resulted. The Commission at the public hearing voiced the opinion that Price, Waterhouse & Co. should have made supplemental, independent inquiries since the inventory represented to be outside the client's premise was definitely substantial in amount; thus the responsibilities of auditors and accountants were materially enlarged in scope.

CHAPTER XIV

INVENTORY VERIFICATION UNDER WARTIME CONDITIONS

In order to avoid any possible interruption in the production of war materials, the Commission has established a liberalized policy with respect to its requirements regarding the verification of physical inventories by certifying accountants. Where the customary taking of inventory (including observance or test-checking by auditors) would hinder production of such materials, such procedures may be omitted so long "as all reasonable and practical alternative measures are taken by the company and its independent public accountants to assure the substantial fairness of inventory amounts stated in the financial statements and proper disclosure is made."

The Commission has encouraged correspondence between itself and registrants concerning the extent to which normal procedures may be followed without curtailment of production, and the extent to which it is reasonable and practicable to employ alternative procedures with a view of determining in the most satisfactory manner available the correct inventory valuations. On the basis of such conferences and correspondence where full disclosure of the circumstances has been made in the financial statements and certificates, no objections have been raised to the omission of normal procedures under the prevailing conditions.

A statement of procedure, prepared by William Werntz, Chief Accountant, addressed to registrants with the Commission reads as follows:

"The taking of an inventory has always been considered an important part of the accounting of a corporation in reporting its position and the results of its operations. Observation of the taking of inventory or the test-checking of the inventory has for some time been recognized as a normal procedure to be followed by independent public accountants in audits made for the purpose of expressing their professional opinion as to whether the statements fairly reflect the financial position of a company and the results of its operations in accordance with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year.

Under present circumstances, however, it may in particular cases be impossible to take a satisfactory physical inventory without interruption of the production and delivery of war materials. It may also be impossible for the independent accountants to have such physical contact with the inventory as normal auditing procedure calls for. Where the book inventory records provide sufficient control over inventories, a temporary cessation of the periodic comparison with the physical stocktakings would ordinarily be less serious than where book records are inadequate or lacking. However, it is clearly in the public interest that as positive and effective substantiation of the inventory amounts be made as circumstances permit. The auditor by devising supplemental procedures based on the circumstances of the particular case and by extending the scope of normal procedures which do not require the cessation of production should endeavor wherever possible so to satisfy himself as to the substantial fairness of the inventory amounts that his certificate, while indicating the omission of the normal procedure of observation or test-checking, need not contain an exception to the substantial fairness of the presentation of inventories.

It is the administrative policy of this Commission not to object to the omission of normal procedures, provided all reasonable and practical alternative and additional measures are taken by the company and its accountants to support the substantial fairness of the amounts at which inventories are included in the financial statements and provided further that by means of a letter the company indicates the necessity for omitting such procedures and gives the following information:

(1) Its priority ratings and the extent to which the company is engaged in production of war materials, in terms for example of the proportion of inventories, production or other appropriate basis.

(2) A statement as to whether normal procedures in the taking of inventories are to be followed except where interruption to the production of war materials would result.

(3) The delay that would be caused by shutting down to take inventory.

(4) A statement as to whether it is reasonable and practicable for the particular company to take reasonably accurate physical inventories while the plants are in operation or at times when the plants are shut down for other purposes.

(5) If at the time of the last physical inventory it was necessary to make significant adjustments in order to reconcile book and physical inventories, a summarized statement of the general nature and amounts of such adjustments is proper.[1]

The "reasonable and practicable alternative and additional measures," referred to in the above statement, must necessarily be based on some type of book records of the registrant's costing system. Particularly will this be true for work-in-process inventories since it would be the most difficult to physically test-check without holding up the manufacturing process of essential materials. If such an inventory account can be broken down and a section or sections of it can be checked at different times by the independent accountant by physical inspection without interrupting production, it is doubtful that any alternate procedure would be acceptable. Thus, if no opportunity exists for physical testing, the auditor must place his reliance on the book records based on sufficient tests of such records and supporting data and a careful review of the system of internal control.

In addition to the usual accounting records, production and engineering data will often furnish further evidence as a basis for over-all and specific tests to support the reasonableness of book inventories. Such data may include production schedules, records of units in process and completed thereafter, reports of engineers as to percent-

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[1] Securities and Exchange Commission, Accounting Series Release No. 30, pp. 1-3.

age completion of contracts, and etc. Any information as to units and costs completed shortly after the inventory date may be helpful to the auditor in substantiating the work-in-process inventory.

In the case of all companies using strategic materials subject to priority ratings, the War Production Board requires the maintenance of inventory production schedules and planning records in order to obtain allotments of scarce materials. These records governing the flow of materials can be of value in determining the credibility of the various inventory amounts.

The Commission emphasizes that in many cases the difficulties caused the independent accountant may be nearly eliminated by consultations of the accountant and his client previous to the year end. In many cases a physical inventory of raw materials, supplies, and finished goods can be taken, possibly on a staggered basis, without interrupting production, then an alternate procedure would not be acceptable to the Commission.

CHAPTER XV

AUDITORS RESPONSIBILITIES FOR FIXED ASSET VALUATIONS

The Commission does not prescribe any specific or uniform auditing procedure to be used in the valuation and determination of fixed assets nor any other balance sheet item for that matter. Such procedure is left for the accounting profession to determine. In order to leave no doubt as to the complete liberty allowed to, and the corresponding responsibility of, the members of the accounting profession in respect of the audit procedures to be followed in any given case, Rule 2-02 of Regulation S-X concerning certification by accountants is quoted:

> "Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule."[1]

In explanation of this rule, Mr. Blough, former Chief Accountant of the Commission, said:

> "According to my understanding, it means that the independent accountant shall not omit any audit procedure necessary to present a comprehensive and dependable financial statement.
>
> The accounting profession has certain well-established requirements for a general periodic audit. The Institute, in its bulletin entitled Examination of Financial Statements, has laid down a program which, where applicable, must surely be recognized by the profession as a guide in determining the extent to which an audit of this kind must go. Recognized authorities have written extensively on the

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[1] Security and Exchange Commission, Regulation S-X - Form and Content of Financial Statements, as amended 1944, p. 5.

subject; it is part of an accountant's training and education."[2]

Through this acknowledgment, the Commission recognizes the general audit principles laid down by the accounting profession as being acceptable to them, but the Commission does, however, reserve the right to determine for itself whether the scope of the audit as well as the procedures followed by the independent accountant in making the audit are adequate under the particular circumstances. The certain "well-established requirements...by the accounting profession" to which Mr. Blough refers, must be couched in general terms since the auditors investigation method and procedure of fixed assets must necessarily vary from case to case; it follows, however, that the auditor in his investigation must weigh and give consideration to the following points recognized as "reasonable and practicable" by the profession:

1. Verify the ownership of the fixed asset.
2. Ascertain the cost of the fixed asset, if purchased.
3. See that cost is properly computed, if constructed.
4. Obtain and examine all vouchers connected with major fixed asset purchases.
5. See that all cost additions are at the proper figures.
6. See that capital and revenue expenditures are properly distinguished.
7. Examine the minute book and other records for authority to purchase or build assets.
8. Be sure that fixed assets are carried in separate accounts, if possible.
9. See that insurance on fixed assets is adequate.

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[2] C. G. Blough, "Accountant's Certificates", Journal of Accountancy, Vol. 65, (February 1938), p. 116.

10. See that taxes on fixed assets are recorded or paid.

11. Check profit and loss computations on the sale of fixed assets.

12. See that all accounts are correctly treated upon disposal by sale, abandonment, and trade.

13. See that leasehold improvements are written off over the life of the lease.

14. Examine and trace all fixed asset account additions and deductions, inspecting invoices for purchases and tracing receipts for all major disposals to the cash book.

15. Ascertain fixed assets owned but not used.

16. Determine the extent of fixed asset revaluations during the year and ascertain the disposition of the revaluation surplus or deficit.

The Commission has criticized certifying accountants for failure to make full investigations as outlined in the above points and/or failure to express an opinion as to some of the accounting principles followed by the registrant. Without bringing into consideration the independence of the certifying accountant which is discussed in another chapter, certificate deficiencies as cited by the Commission are discussed in the following paragraphs:

(1) Failure to verify ownership of fixed assets.

Any certificate shall be held deficient in which the auditor disclaims any or all responsibility as to the validity of the registrants title to the property which appears on the balance sheet. The verification as to title deemed necessary is set forth by Mr. Blough. In part, he said:

> "...We do not believe the accountant should be permitted to avoid the ordinary responsibilities of an auditor by disclaiming them in his certificate. Our rules provide that there shall be no omission from the audit "of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

Generally an auditor is not required to make a specific study of the public records to verify the company's ownership of its property or to obtain legal opinion as to such owner ship, provided the usual indicia of ownership appear in the accounts and nothing is revealed by the audit to indicate otherwise.

If the auditor finds and examines deeds showing evidence of having been recorded; if tax payments, special assessments, maintenance and repair charges, etc., properly supported, relating to such property are found to be reflected in the accounts; if rentals received from the property are found recorded; if no rental payments are shown that might indicate lack of ownership; if no cash receipts from unentered mortgages are revealed and no payments of principal or interest or unentered mortgages are found; and if similar lines of examination customarily followed in the normal audit reveal nothing to create suspicion as to the ownership of the property--the accountant ordinarily is not expected to make a search of public records as to title or liens.

If, on the other hand, the audit reveals something that leads the accountant to suspect that the property is not owned in fee or that existing liens or mortgages against the property have not been recorded on the books, I think he is bound to make such investigation of the public records or get such opinion from attorneys as will convince him that the facts are properly recorded."[3]

(2) <u>Failure to fully investigate and comment on appraisals of fixed assets in the certificate</u>.

Where appraisals have been made, the auditor is required to disclose all pertinent facts either in schedules to the balance sheet or in his certificate. Any appraisal amounts resulting from revaluations, reorganizations, mergers, and etc., affecting fixed assets in some manner must be explained fully--dates of appraisals, the basis thereof, the name of the appraiser, and a comparison of the previous ledger value and appraisal value of the property must be shown.

The Commission has pointed out that accountants whose training does not qualify them to serve in the capacity of appraiser should

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[3] <u>Ibid</u>., pp. 113-114.

neither assign values to property nor certify to the accuracy of the values placed on such properties. In many cases before the Commission dealing with mining property revaluation, the following principle has been enunciated:

> "Estimate of value of mining property by an accountant without experience as an appraiser of mining property or knowledge of methods of valuation, held to render the balance sheet false and misleading."[4]

The accountant may certify to a report although he disagrees with certain of the facts presented on the balance sheet. He should, however, in his certificate point out those items which in his opinion do not follow accepted accounting practice. Commenting on this, Mr. Blough said:

> "It is not uncommon for an accountant to present financial statements and, in his certificate, point out certain facts of inclusion and exclusion without expressing any opinion as to whether the statements properly reflect the facts or not. Thus the accountant who would certify to a financial statement in which plant and equipment is carried at twice its cost and three times its present sales value on the basis of a 1928 appraisal at which time the appreciation was carried to, and is now included in the earned surplus accounts, might very well attempt to protect himself by including in his certification a statement of such facts without expressing his opinion as to the propriety of such treatment. In our opinion, the protection requires that the accountant who, by a narration of facts in his certificate, attempts to protect himself, should be required to express his opinion with regard to the propriety of showing the facts in the manner in which they have been shown. If all of the facts have been treated in the statement in a manner he considers to be in accordance with accepted accounting practice, he should so state. If he is prevented from properly presenting the facts, he should qualify his statement with respect to such items and should express his disapproval of handling them in the manner in which they have been handled."[5]

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[4] Security and Exchange Commission, <u>Decision and Reports</u>, Vol. 1, p. 621.

[5] C. G. Blough, "Relationship of the S.E.C. to the Accountant," <u>Journal of Accountancy</u>, <u>Vol. 63</u>, (Jan. 1937), pp. 28-29.

(3) Failure of auditor to investigate costs of fixed assets transferred from predecessor company.

In one case before the Commission, the certification was held deficient because the auditor had failed to verify the accuracy of the capitalized developmental expenses carried forward as an asset from the books of the predecessor company. The Commission held that if the accountant was unable to examine the crudely kept records of the predecessor company which render such items incapable of verification except in the memories of the officers of the company, the accountant's certificate should have so indicated.

(4) Failure to comment on or to properly distinguish various charges included as costs of fixed assets.

The auditor is responsible for disclosing and commenting on any items carried as a cost of fixed assets which correct accounting procedure and practice would exclude from such classifications. The auditor must investigate the validity of all debits and credits to fixed asset accounts—stock and bond discounts, payments for leases and options, commissions and promotional expenses are not to be considered a cost of such assets according to the Commission and should be separately shown in the financial statements.

Accounting texts written by recognized professional men are in accord or in substantial agreement as to what items are properly includable as a cost in the various fixed asset classifications. However, it is wishful thinking to presume that all public accounting practioners, or those who claim to be, follow recognized procedures and practices consistently. When an auditor follows such practices or allows accounting principles to be used in valuation for which there exists no substantial authoritative support, with or without comment in his certificate, the Commission will hold such statements deficient until amended to conform with recognized practices.

Where the auditor finds that shares of stock have been issued for fixed assets and then in part donated back to the corporation, it is his responsibility to disclose such transactions either in a footnote or by comment in his certificate. The auditor is likewise responsible to disclose all information regarding the valuation of property at par of stock issued when the cash value of such stock sold to the public is much less. Where all the stock issued is for property without a concurrent sale to the public, the auditor should make an investigation as to the costs of such property carried on the books of the vendor company.

(5) Failure to express any opinion as to total fixed asset values constitutes a deficiency in certification.

In the case of Resources Corporation International, the auditors certificate stated,

> "...it is not possible for us to make any determination of the value of such assets (timber tracts); consequently we are not in a position to express an opinion with respect to the accompanying balance sheet that embraces the matter of value assigned to the timber tracts."[6]

Such an accountant's report is clearly insufficient to satisfy the requirement that the registrant file a certified balance sheet. The requirements for certified statements are not met when the accountant's report expresses no opinion or only an opinion concerning part of the total assets. Thus, according to the Commission, a report by the auditor is not a certificate unless a clear unequivocal opinion is expressed on the accounting practices followed by the registrant.

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[6] Commission, *Op. Cit.*, Vol. 7, p. 737.

CHAPTER XVI

ACCOUNTANTS' CERTIFICATE REQUIREMENTS

The Commission has done much to improve the standards of auditing procedure and practice. To this end the Commission has provided flexible as well as rigid rules for accountants' certificates, has fully upheld the principle of full independence by certifying accountants, and has worked hand in hand with professional accounting societies for the adoption of better auditing practices. No one can deny that financial statements to be of real worth must be certified by responsible, independent accountants who have followed generally recognized and accepted principles in the determination of financial statement values. The 1933 Security Act makes certification of financial reports by independent public accountants mandatory, and gives the Commission the power to prescribe the form, method, and content of such certificates presented to it for registration purposes. Under this Act the rules governing the content of the report reads as follows:

> "The certificate of the accountant or accountants shall dated, shall be reasonably comprehensive as to the scope of the audit made, and shall state clearly the opinion of the accountant or accountants in respect of the financial statements of, and the accounting principles and procedures followed by, the person or persons whose statements are furnished. In certifying to the financial statements, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such case the independent accountants shall review the accounting procedures followed by the registrant and its subsidiaries and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed. Nothing in this rule shall be construed to imply authority for the omis-

> sion of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit. The certificate of the accountant or accountants shall be applicable to the matter in the registration statement proper to which a reference is required in the financial statements."[1]

In analyzing the above general rules which were applicable to all certificates filed with the Commission prior to the McKesson Robbins Case of 1939, one notes both rigid and flexible requirements. Thus there is a degree of rigidity in that a certificate must be prepared, dated, and presented to the Commission by independent public accountants, along with a reasonably comprehensive statement as to scope of the audit made, the opinion of the accountant must be given in respect to the financial statements of, and the accounting principles and procedures followed by the person or persons whose statements are furnished.

It may be noted that in the way of flexibility there is no specific wording required; the accountant may use his own language to describe his procedures carried into effect. Though the opinion of the accountant as to the financial statements and accounting practices of the client is a rigid requirement, he may express himself in such language that would most aptly fit the facts of the case.

As a survey and aid to the accountant who practices before the Commission, the Commission prepared Accounting Release No. 7 which gives an analysis of the deficiencies commonly cited by the Commission in connection with the financial statements and auditor's certificates filed under the Securities Act of 1933 and Securities Exchange Act of 1934. This analysis, prepared by Carman G. Blough, Chief Accountant at

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[1] Securities and Exchange Commission, <u>Accounting Series Release No. 22</u>, p. 1

the time, covers accountants certificates, consolidated financial statements, balance sheets, profit and loss statements and the various related schedules. Mr. Blough's analysis of commonly found deficiencies was preceded by a letter addressed to accountants practicing before the Commission:

May 6, 1938

To Accountants Practicing Before the
Securities and Exchange Commission

Gentlemen:

As an aid to registrants and their accountants in the preparation of financial statements to be filed with this Commission pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934 there is submitted herewith a list of the more common deficiencies which it has been found necessary to cite in connection with financial date included in registration statements filed with this Commission.

It will be noted that many of the deficiencies cited do not involve any important problem in accounting and that some involve simply the failure to follow the express regulations and instructions of the Commission.

It is thought that if particular attention is given to the items comprising this list and to the instructions pertaining thereto, contained in the Commissions forms and regulations, considerable inconvenience and expense to registrants will be avoided and the work of the Commission's staff in reviewing the statements filed will be greatly facilitated.

Very truly yours,

Carman G. Blough
Chief Accountant

Of particular interests and with which we are wholly concerned at this time, are the Commission's comments on the deficiencies of accountant's certificates. Some of the criticisms and comments read as follows:

(1) Accountant's opinion in respect of (1) the financial statements of, and (2) the accounting principles and procedures followed by the registrant, not clearly stated.

(2) Use of equivocal phrases such as "subject to the foregoing", "subject to the above comments", "subject to comments and explanations in exhibits", "subject to the accompanying comments", etc.

(3) A reasonably comprehensive statement as to scope of the audit made not included in the certificate.

(4) Adequate audit not made by certifying accountant. In this connection attention is directed to the regulation that accountants shall not omit "any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit".

(5) Failure to certify all financial statements required to be submitted, e.g., failure to certify profit and loss statement as well as balance sheet, and failure to certify statements of registrant as well as statements of registrant and subsidiaries consolidated.

(6) Financial statements and supporting schedules covered by the certificate not clearly indentified.

(7) Certifying that the accounting principles followed by the registrant are in accordance with the system of accounts prescribed by a state regulatory body, or in a particular industry, but without indicating whether the practice of the registrant is in accordance with generally accepted accounting principles and procedures.

(8) Effect upon the financial statements of the registrant's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.

(9) Effect upon the financial statements of substantial changes in accounting policies of the registrant not commented upon and explained by the certifying accountants.

(10) Disclaimer of responsibility on the part of the certifying accountants with respect to matters clearly within their province.

(11) Reservations on the part of the certifying accountants with respect to matters not within their province which might indicate that apparently the accountants were not satisfied that such matters as legal titles, outstanding liabilities, etc. were properly reflected in the financial statements.

(12) Certificate undated, or not manually signed.[2]

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[2] Securities and Exchange Commission, Accounting Series Release No. 7, pp. 2-3.

In view of the numerous deficiencies cited above, the attempt of some accountants to limit their responsibility in their certification, and the startling facts disclosed in the McKesson Robbins Case, the Commission revised its rules to correct deficiencies found in its analysis of accountant's certificates and to raise the standards for certification thus requiring the extensions of auditing procedure for inventories advocated by it (Commission) as a result of the public hearing of the McKesson Case. At the time of the revision of Rule 2-02 and 3-07 of Regulation S-X, dealing with the form and content of financial statements, it was stated:

> "In view of the case of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 and the several major forms under the 1933 and 1934 acts. Upon completion of these proceedings, however, such rules are to be considered with a view to revisions deemed necessary as a result of these cases."[3]

Thus on February 5, 1941 the Commission, acting within its lawful authority, amended its previous rules on accountant's certificates of Regulations S-X to read as follows:

RULE 2-02 ACCOUNTANT'S CERTIFICATES

(a) Technical requirements:

> "The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) Representations as to the audit:

> "accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made in-

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[3] Securities and Exchange Commission, <u>Accounting Series Release No. 21</u>, p. 1.

cluding if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weigh may be given to an internal system of audit regularly maintained by means of auditors employed on the registrants own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) Opinions to be expressed:

The accountant's certificate shall state clearly:

(i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accepted principles and practices reflected therein:

(ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and

(iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) Exceptions:

Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

RULE 3-07 Changes in accounting principles and practices:

> "If any significant change in accounting principle or practice or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."[4]

Amendments of the rules as to accountants' certificates had for some time been the subject of correspondence and discussion between committees representing the American Institute of Accountants, the Controllers Institute of America, the American Accounting Association, and various members of the Securities Exchange Commission. After much discussion with these professional bodies, the Commission revised its Rule 2-02 and added Rule 3-07 which are stated above.

Rule 2-02, now in effect, sets forth the requirements as to the contents of the accountant's certificate in four distinct sections.

Section (a) of the rule states the various technical requirements and is no different from pre-existing rules.

Section (b) contains the requirements for the accountant's representations as to the nature of the audit which he has made. More disclosure must be made than previously to meet the requirement subsection (b) (i). Previously it had been stated that if in the judgment of the auditor it was not practicable and reasonable to undertake the full normal auditing procedures for inventory or any asset verification, and he had satisfied himself by other methods regarding those assets, it would serve no useful purpose to give an explanation in his report. However, under this new ruling by the Commission, a specific

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[4] _Ibid._, pp. 3-4.

designation of all normal auditing procedures omitted is required along with the reasons for such omissions. By the term, "designations of procedures omitted," the Commission meant for such designations to extend only to those auditing requirements which have been recognized as standard or normal procedures, such as the physical-testing or observation of inventory taking by an auditor--not the detailed or mechanical steps of such procedures.

Sub-section (b) (ii) of the rule further calls for a representation as to whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. The Commission, in referring to generally accepted auditing standards, means "in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons." The Commission defines "generally recognized normal auditing procedures" as those ordinarily employed by skilled accountants and those prescribed by various governmental bodies and recognized accounting societies. Thus auditing standards are regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of the various auditing procedures. Thus auditing standards would require in inventory verification that the accountant must satisfy himself by evidence and approved methods that values had been determined on a basis recognized as being acceptable under the circumstances and that physical test-checks or observation of inventory counts by the client support the inventory quantities involved. The means used and the detail work to fulfill such standards are designated as procedures.

Sub-section (b) (iii) requires that any procedure omitted yet deemed necessary by the accountant under the particular circumstances, be stated in the certificate. This is included as a requirement because the Commission felt that circumstances, in some instances, may call for extensions and additions to normal procedures perhaps due to the lack of sufficient internal control or other causes.

Section (c) concerning the opinion of the accountant as to the statements covered by the certificate and the accounting principles followed is to a great extent a clarification of previous existing rules. Sub-section (c) (ii) requires the opinion of the accountant along with proper explanation of any significant changes in accounting principle or practice of the client and of any current retroactive adjustments of significance dealing with prior years. The term, "significant retroactive adjustments" is taken to mean the extra-ordinary types of surplus adjustments such as major depreciation adjustments when the basis for fixed assets is changed from cost to appraised values or vice versa.

Sub-section (c) (iii) presents a new requirement. It concerns the difference between the amounts shown on the registrant's books when finally closed and the amounts shown on the financial statements. If the difference is significant the accountant must explain the differences.

Section (d) provides for a clear statement of exceptions to the normal standards, and to the extent practicable, the effect of each exception on the financial statements. If an exception is taken to the use of certain accounting principles by the registrant, a clear statement of the effect is deemed necessary if investors are not to be mislead.

In commenting at the time on the revised rule of the Commission, particularly Sub-section (b) (i), (c) (ii), and (c) (iii), the Committee on Extensions of Auditing Procedure of the American Institute of Accountants stated:

> "The revised rule is, of course, applicable only to reports filed with the Commission. As a practical matter, however, practising accountants may in course of time consider it advisable to apply the same standards of disclosure in reports for other purposes also, though the old form will doubtless continue to be used for an intermediate period."[5]

It is evident at this time that the Committee did not give full support to all the requirements set forth by the Commission, particularly to Sub-section (b) (i) in which the Commission required that any normal and generally recognized auditing procedures omitted in the course of an audit must be specifically stated along with reasons for such omissions. The Committee's attitude has been stated as follows:

> "It is the responsibility of the accountant--and one which he cannot escape--to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to under take the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he is satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practical and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear cut exception in his report."[6]

The Committee in 1942, realized that the difference in certificate

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[5] Committee on Auditing Procedure, American Institute of Accountants, "The Revised S.E.C. Rule on Accountants' Certificates", Statements on Auditing Procedure, No. 6, (March 1941), p. 48.

[6] Committee on Auditing Procedure, American Institute of Accountants, "Extensions of Auditing Procedure", Statements on Auditing Procedure, No. 1, (October 1941), p. 2.

requirements between the Commission and the American Institute was causing widespread misunderstanding and that many of the accounting profession had already adopted the new standards of disclosure advocated by the Commission, amended its Bulletin, "Extensions of Auditing Procedure" to read:

> "Accordingly, the committee on auditing procedure hereby recommends that hereafter disclosure be required in the short form of independent accountant's report or opinion in all cases in which the extended procedures regarding inventories and receivables set forth in "Extensions of Auditing Procedure" are not carried out, regardless of whether they are practicable and reasonable, <u>and even thought the independent accountant may have satisfied himself by other methods</u>."[7]

After waiving the objections which it saw to the aforementioned requirements of the Commission's revised rule, the Committee proposed the addition of the underscored sentence to the first paragraph of the 1939 short form of Institute certificate which reads as follows:

> We have examined the balance-sheet of the XYZ Company as of (Month) (Day) (Year), and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. <u>In our opinion, our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and it includes all procedures which we considered necessary</u>.
>
> In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at (Month) (Day) (Year), and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[8]

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[7] Committee on Auditing Procedure, American Institute of Accountants, "Amendments to Extensions of Auditing Procedure", *op. cit.*, No. 12, p. 89.

[8] Committee on Auditing Procedure, American Institute of Accountants, "The Revised S.E.C. Rule on Accountants' Certificates", *op. cit.*, No. 5, (February 1941), pp. 38-39.

The Commission held that the proposed use of the words, "in our opinion" of the aforementioned new sentence in the certificate was inconsistent with Section (b) (ii) of the revised rule because the phrase fails to connote "a positive representation consistent with the implied representation he (the auditor) makes by holding himself out as a professional and expert accountant or auditor."[9]

In order to avoid an impasse with the Commission and upon being advised by counsel that, regardless of whether the statement was made without the use of the words, "in our opinion", or specifically as a matter of opinion, it could be in fact only a statement of the opinion of the auditor, the Committee decided not to pursue the matter further. Consequently, accountants and auditors omit the words, "in our opinion" from the new sentence in respect of financial statements filed with the Commission.

It is very likely, as previously mentioned, that this amplified form of certificate will come into general use. Clients whose securities are listed on a stock exchange, and who must therefore file reports annually with the Commission, will probably wish to have the identical form of certificate used in such reports and in their published reports to stockholders. This in turn will probably lead to the adoption of the amplified form for use in reports to stockholders, and other interested parties, of companies whose securities are not listed. Thus, as in respect of other matters of particular interest to the auditor and accountant, provisions of the securities acts and the authoratative regulatory requirements of the Security and Exchange Commission will

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[9] <u>Ibid.</u>, p. 40.

tend to influence the standards of accounting practice, not only in the case of companies coming under the jurisdiction of the Commission but in the business anf financial world in general.

CHAPTER XVII

INDEPENDENCE OF CERTIFYING ACCOUNTANTS

Along with the importance of maintaining sound auditing standards is the necessity of maintaining high standards of independence and professional conduct among certifying accountants. The Securities Act of 1933 and 1934 have always upheld the concept of independence as a basis or prerequisite to any certification made by an auditor. The rules of the Commission have always required that the independence of the auditor be in fact and have refused to consider an accountant independent in respect to his client when he has a substantial interest, direct or indirect, in the client's business, or with whom he is, or was, during the period of the report, connected with the firm as director, officer, p romoter, underwriter, voting trustee, or employee.

Rule 650 of the Securities Act, or Rule 2-01 of supplemental Regulations S-X concerning qualifications as to independence of accountants reads as follows:

Rule 2-01 Qualification of Accountants

> (a) "The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as a certified public accountant under the accounting laws of the State, Territory, or country of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the State, Territory, or country of the residence or principal office."
>
> (b) "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he

has a substantial interest, direct or indirect, or with whom he is connected as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions."

(c) "In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships, between the accountants and that registrant, and will not confine itself to the relations existing in connection with the filing of reports with the Commission."[1]

Through the decisions and accounting releases of the Commission, informal rulings have been handed down which give a suggestion of the attitude of the Commission towards the independent relationship between auditors and their clients. This requirement of the Securities Exchange Commission that an accountant be in fact independent with respect to a company whose financial statements he certifies is grounded on the conviction that the existence of certain types of relationships between a company and its certifying accountant may bias the accountant's judgment on accounting and auditing matters. Certain relationships between an accountant and his client appear so apt to influence the accountant away from complete objectivity in his analysis that he would not in fact be independent. Since the Commission does not recognize statements and certificates by accountants who are independent according to their standards, it is appropriate to analyze some of the cases dealing with this particular point.

<u>CASE I</u> Determination of Independence Measured by Auditor's Investment in Registrant's Stock.

In Accounting Release No. 2[2] the Commission presented a case in

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[1] Security and Exchange Commission, <u>Regulation S-X--Form and Content of Financial Statements</u>, as amended, (May 1943), p. 3.

[2] Securities and Exchange Commission, <u>Accounting Series Release No. 2</u>, p. 1.

which one member of a firm of public accountants, doing work for the registrant, owned stock in the client's corporation. The Commission refused to hold that the firm was independent for the purpose of certifying the financial statements of such corporation and based said refusal upon the fact that the value of such holdings was substantial and constituted more than 1% of the partner's personal furtune.

In this case the Commission seems to have gone to the ultimate extreme in its definition of independence. It is extremely difficult to see how ownership of the registrant's stock constituting 1% of the personal assets of a member of a large firm of public accountants could be considered a "substantial interest" by the Commission. In comment the Journal of Accountancy said, in referring to the 1% ownership of the registrant's stock by the accountant, "the idea.........is so novel that it is hoped the Commission will make clear its interpretation of this ruling, if it is intended to be a ruling."

Another important case, A. Hollander & Son, Inc.,[3] is pertinent to the question of the "substantial interest ruling" issued by the Commission. In this case the accounting work was done by Puder and Puder Accountants for the registrant. Investigation by the Commission showed that there were substantial stockholdings held by this firm in its client. The two Puders and their wives had from 1935 to 1940 owned stock of the registrant ranging from ½ to 9 percent of their personal fortune. Such a condition was held to void the certification of the registrant's statements by <u>independent</u> accountants. In addition to this stockowner relationship, the Commission further pointed out that loans had been

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[3] Securities and Exchange Commission, "In the Matter of A. Hollander & Son, Inc., "<u>Decisions and Reports</u>, 8, pp. 586-620.

made by the Hollanders to the accountants and vice versa. On such a point the Commission examiner held that:

> "In certain circumstances it may be as detrimental to the independence of an accountant for him to be on the lending as on the borrowing side of a loan transaction; the accountant's interest as a lender in seeing to it that the borrower is able to repay the loan may be a potent factor in depriving the accountant of his independence."[4]

In summing up their findings as to the independence of Puder & Puder, it was stated:

> "Under the circumstances of the case, we have no hesitation in finding that neither the firm of Puder & Puder nor A. H. Puder individually are independent public accountants within the meaning of our statute and regulations with respect to the financial statements filed by the registrant. Accordingly, we find that the reports filed by the registrant are further deficient in that the financial statements included therein have not been certified as required by the appropriate regulations, by an independent public accountant."[5]

<u>CASE II</u> (a) Employee of accounting firm preparing statements as officer in registrant's corporation.
(b) Accounting firm receiving annual percentage of gross proceeds of registrant.

The Cornucopia Gold Mines Case[6] heard before the Commission on February 7, 1936 proved interesting and unique. The examiner for the Commission questioned the statement in the accountant's certificate that "the relationship between accountant and registrant was the usual relationship of independent accountant to their client." In this particular instance, the actual accounting and audit was prepared chiefly by one, David Hill, as employee of White and Currie, certifying public

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[4] <u>Ibid</u>., p. 612.

[5] <u>Ibid</u>., p. 617.

[6] Securities and Exchange Commission, "In the Matter of Cornupia Gold Mines", <u>Decisions and Reports</u>, 1, pp. 364-370.

accountants. In the examination of the relationship between the registrant and White and Currie, who signed the certificate, the examiner found that White and Currie had entered into a contract with the registrant by the terms of which they (accountants) were to receive $5000 per annum plus one percent of the gross proceeds of the metal sales for one year. Their contract with said registrant called for a system installation, audits, and the furnishing of office space for use by the registrant. Evidence was further shown that this was the only contract of such nature which White and Currie had with their clients; all others were on a fixed fee basis.

Investigation concurrently disclosed that David Hill, employee of White and Currie was comptroller of the registrant's corporation with powers over accounting matters, check issuance, and etc., of the registrant's firm. Hill, also, was a stockholder, having purchased 1760 shares of stock previous to the filing of the registration statement.

From these facts as presented, Mr. Hill as employee of White and Currie and comptroller of the registrant corporation with substantial stockholdings could or would not: (1) approach the accounting problems of the firm as an independent accountant, and (2) view the accounting problems with the objectivity of an independent accountant, criticising and correcting accounting practices of the corporation's staff, since, in part, he would be reviewing his own work.

Concerning the contractual arrangement of 1% of the annual proceeds from metal sales, the Commission stated:

> "A continuing pecuniary interest which an accountant has in a registrant may be so small or so indirect as to give rise to no inference that the accountant has lost or is likely to lose that objectivity which is implied in the concept of an

"independent" accountant. This case is not such an instance, for a claim of 1% to the gross proceedsof the metal sales of a mining company is a substantial and pecuniary continuing interest. The holder of such a claim has too close an identity with the financial destinies and too intimate personal concern with the managerial policies of the enterprise to bring to bear in his accounting and auditing work the objectivity which is the "essence" of an "independent" accountant.

We therefore find that the statement of relationship contained in the certificate made by White and Currie was an untrue and misleading statement."[7]

CASE III Conscious falsification of facts by certifying accountants held to refute presumptions of independence arising from absence of direct interest or employment.

In the matter of American Terminals and Transit Company,[8] the financial data furnished in the registration statement was collected and certified by a F. J. Kopecky, whose certificate read:

"I hereby certify that the above (financial statements) have been prepared by me for the books and records of the corporation and are true and correct copies to the best of my knowledge and belief." Signed: F. J. Kopecky, Independent Accountant.[9]

The truth of such a statement was questioned in the investigation that followed. Cash was stated at $1482.82 on the balance sheet; yet there was no cash. Kopecky admitted that the figure shown as cash was the amount of an overdraft and that he made an adjustment of the figure for accounts receivable in order to compensate for the overdraft and the cash amount shown on the statement. In order to force this balance the accounts receivable showed a fictitious reduction in comparison with the actual amount shown on the books of original entry.

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7 Ibid., pp. 366-367.

8 Securities and Exchange Commission, "In the Matter of American Terminals and Transit Company", Decisions and Reports, 1, pp. 701-742.

9 Ibid., p. 706.

In concluding on this point the trial examiner stated:

> "Accordingly we find the certificate an untrue statement of material fact. The facts just recited concerning the manner in which this balance sheet was drawn, however, suggest that there is a further deficiency in this and all other certificates signed by Kopecky for the registrant, by raising the question whether in view of Kopecky's approach to registrant's accounting problems he can be considered "independent", in accordance with the requirement of the statute.
>
> "The methods and results of his auditing work cause us to doubt whether any presumption of independence which the absence of relations or contractual connections with registrant would normally justify, can be indulged here. To be sure not every error in a financial statement can be construed as reflecting a lack of independence on the part of the accountant who set it up. But where the accountant has consciously falsified the facts, as here, an inference of actual absence of independence would seem to be justified. He who, as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts cannot be said to qualify as an "independent" expert."[10]

<u>CASE IV</u> Accountants subordinating their judgment to the desires of their client deemed not independent.

In the case of Metropolitan Personal Loan Company[11] the accuracy and sufficiency of the certificate of Campbell and Carr, certifying accountants, was challenged. Said registrant was a small, incorporated company in Nevada and was qualified to do business in Pennsylvania and Maryland. The sale of securities covered by the registration statement began July 6, 1936 and was continuing until the Commission called a hearing to determine whether a stop-order should be placed suspending the disposal of the securities.

Investigation of the financial data and certificate of the ac-

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[10] <u>Op. cit.</u>, p. 707.

[11] Securities and Exchange Commission, "In the Matter of Metropolitan Personal Loan Company", <u>Decisions and Reports</u>, 2, pp. 798-817.

countants showed numerous violations of accounting principles and lack of competence or independence on the part of the auditors. The annual reports of the accountants for the years 1933 and 1934 disclosed that the offices of the registrant outside of the home office had not been visited in order to examine the receivables and collateral held for such loans. During 1935 two audits were made in which examination of collateral was not made. The report for the year (1935) stated: "our work for this quarter consisted mainly of adjusting the books to recommendations contained in the minutes." Testimony was also taken as of March 31, 1936 (date of balance sheet) that no verification had been made of cash on hand, cash in banks or loans payable for the reason that as of that date, "the report was primarily for examining the collateral at the home office."

The accountant's failure to make such investigations as would substantiate the correctness of various balance sheet items is a violation of one of the Commission's cardinal rules which prohibits, "the omission of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit." Such certification without investigation of assets which by their very nature, are readily convertible into cash or are pledgable, is of little or no value without the actual examination or verification of such assets.

In questioning the independence of Campbell and Carr, the facts that they (accountants) had completely subordinated their judgment to the desires of their client in setting up items on the statements completely nullified their status as being independent. The Commission declared that independence was lacking because: (1) the accountants had accepted registrant's statements as to various material values with little or no independent investigation, (2) no independent judgment had been used with respect to the adequacy of the reserves, (3) various credits in reduction of liabilities were improperly made to income at the order of their client.

The concluding statement of the examiner:

> "He who as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts cannot be said to qualify as an independent expert. Protection of investors in these situations requires not only that these fiduciaries be free of entangling alliances which relational and contractual connections with registrants frequently engender, but also that they approach their task with complete objectivity--critical of the practice and procedures of registrants, and unwilling to aid and abet in making statements which the facts do not warrant."[12]

<u>CASE V</u> Accountant not independent when employee or partner relationship exists with other accountant owning large block of registrant's stock.

In the case of Richard Ramore Gold Mines Ltd.,[13] the original registration statement was certified by a V. D. Harbinson & Company. V. D. Harbinson was owner of 11,000 shares of the registrant's stock of which 10,000 represented the number given him for various accounting services performed at the time of incorporation of the registrant. In an apparent effort to circumvent the Commission's rule concerning the independence of certifying accountants, an amended balance sheet and certificate was filed with the Commission certified by a R. L. Johnston employee or associate of V. D. Harbinson & Company. For such certification Johnston was paid in cash for his service by the registrant; thus attempting to satisfy the Commission regulation since Johnston

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[12] <u>Ibid</u>., pp. 813-814.

[13] Securities and Exchange Commission, "In the Matter of Richard Ramore Gold Mines, Ltd., <u>Decisions and Reports</u>, 2, pp. 377-391.

owned no stock in the firm.

This case presents conflicts of interests comparable to a preceding case. Harbinson as a substantial stockholder would not be likely to approach the accounts of the registrant as an independent accountant in view of the fact that the value of the registrant's stock could be enhanced by window dressing the statements. Since Johnston was either an employee or partner of Harbinson, the Commission's rule on independence would be invalidated or evaded if by its provisions Harbinson was disqualified, and Johnston was not likewise disqualified. Thus certification was required by another firm of accountants.

In review of the preceding cases, one readily sees that the Commission has been a powerful influence in maintaining and abetting proper accounting ethics. Heretofore state laws governing the issuance and revocation of licenses to practice as a certified or independent public accountant have recognized the necessity of maintaining high standards of professional conduct. Through various state and national organizations, the accounting profession has voluntarily established codes of ethics which, if violated, may be grounds for public admonition, suspension, or expulsion from the society, or in the case of state and federal regulatory bodies--the revocation of the legal right to practice. Because of the close relationship to the accounting work of the Commission, the "Rules of Professional Conduct" of the American Institute of Accountants may be quoted. Rule 5 reads as follows:

> "In expressing an opinion or representation in financial statements which he has examined, a member or associate (of the Institute) shall be held guilty of an act discreditable to the profession if:
>
> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial state-

ments not misleading; or

(b) He fails to report any material misstatement known to him to appear in the financial statements; or

(c) He is grossly negligent in the conduct of his examination or in making his report thereon; or

(d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable to the circumstances."[14]

Because of the existence of various methods of disciplinary action it has been the practice of the Commission to bring to the attention of the appropriate societies and government agencies each case in which the Commission has publicly criticized the work or professional conduct of accountants practicing before it. The Council of the American Institute has, as a trial board on cases called to its attention by the Commission, found some of its members guilty of violating the Codes of the Institute and were therefore suspended from membership in the organization. Voluntary disciplinary action of this kind, if diligently and wisely applied, can be of great importance in the maintenance of proper standards of professional conduct. Such voluntary disciplinary action, however, cannot supplant the Commission's direct authority under its Rules of Practice. This power of the Commission is stated in Rule 2 which reads:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter:

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[14] American Institute of Accountants, Rules of Professional Conduct, p. 7.

(1) Not to possess the requisite qualifications to represent others, or

(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."[15]

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[15] Stated in footnote; Securities and Exchange Commission, _Accounting Series Release No. 28_, p. 3.

SUMMARY AND CONCLUSIONS

SUMMARY AND CONCLUSIONS

All of the acts of Congress enforced under the jurisdiction of the Securities and Exchange Commission affect the work of accountants and bring them into close contact with that body. These acts are the Securities Act of 1933, Act of 1934, Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940.

The passage of the Security Act of 1933 caused somewhat of a panic in the accounting profession for two principal reasons: (1) Because of the unreasonable degree of liability imposed on accountants, and (2) because it was feared that the enormous powers conferred originally on the Federal Trade Commission and later transferred to the Securities and Exchange Commission, which included the power to prescribe forms of financial statements, might not be wisely administered. When the Act of 1934 was passed, the accounting profession breathed more easily because the basis of recovery against accountants who were responsible for material misrepresentations was made more reasonable and the period within which action could be taken against said accountants was reduced from ten to three years.

The powers of the Commission to prescribe rules and regulations, including forms of financial statements, was formerly the cause of great fears on the part of accountants that either unsound or unworkable principles of accounting would be enunciated. The first registration form, Form A-1, administered by the Federal Trade Commission under the

Act of 1933, was criticized as being inelastic and obviously designed primarily for public utility companies, and therefore was not suitable for other types of concerns. When the Act of 1934 was passed which provided for the appointment of the present Commission, an investigation of the charges was immediately started.

In its investigation, the Commission approached its problems by calling a group of prominent accountants into consultation and asking them to appoint a committee to cooperate. The Commission readily agreed that a more elastic form of registration statement, one which called for less historical information, would be more appropriate. Finally, after many months of cooperation between the Commission and various committees of accountants, form A-2 was promulgated. It received the full endorsement of the accountancy profession as represented by the committees both of the American Institute of Accountants and of the New York State Society of Certified Public Accountants. As was to be expected, it was not found to be perfect in all respects, but suggestions for amendment initiated by the committees were welcomed and many were approved, and in cases where proposed amendments were initiated by the Commission, the committees of accountants were given ample opportunity to express their views. This happy relationship has continued down to the present date and will probably continue.

It is obvious that with the close harmony which has existed between the Commission and profession, the influence of the Commission, backed by the effective powers bestowed upon it by law, has been applied in the direction of insisting on the presentation of financial statements prepared in accordance with sound accounting principles. No doubt exists that corporate reports and the underlying principles on which these reports and the underlying principles on which these reports are based have shown vast improvement this past decade. It may be said that:

> (1) Recognized principles, in many instances, of accounting have replaced questionable accounting practices heretofore followed by certain corporations in the preparation of the required financial reports. The profession's success in the last few years in convincing management of the wisdom of making various changes, in many cases is directly attributable to the Commission's present policy.
>
> (2) Financial statements have become more informative and the items contained therein more reliable.
>
> (3) As a result of the conditions mentioned above, accountant's reports are free of many of the exceptions and qualifications which formerly could not be omitted.

More progress in this direction may be expected in the years that lie ahead. In answer to the Commission's dictum contained in the previously mentioned Accounting Release No. 4 which states that financial statements prepared in accordance with accounting principles for which there is no substantial authoritative support will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements, prevailing accounting conventions are being reexamined and revalued more critically and analytically than ever before. From the cooperation between the various accounting societies, teachers, professional schools of accountancy, and the S.E.C. there is developing a body of authoritative accounting doctrine which it is hoped will come closer to universal acceptance as "recognized and accepted accounting practice" than has been the case in the past. The pronouncements of the American Institute in its accounting research bulletins and its statements on auditing procedure represents a major step in this direction.

But there are inherent dangers which must not be overlooked. The greatest of these would be the failure of the profession to continue to cooperate and assist the Commission, and the unlikely possibility that control of the Commission might fall into hands which would disregard the experience and advice of those who have spent a lifetime in the profession and that it might not continue to recognize its tremendous responsibility in establishing accounting principles and practices, but would make invariable rules without due consideration of the peculiar circumstances which call for exceptional treatment. It is true that all legislation which aims at controlling or regulating business transactions must, necessarily, start from the premise that there are certain definable standards which should control all business transaction. Within certain limits, this in no doubt true. However, disagreement develops when an agency of the government proceeds on the assumption that all business transactions and their reflection in a set of financial statements can be reduced to a definite set of rules. Of course general principles can be developed, however, rules intended to cover every type of transaction are not only impractical but, if attempted, can result in a lower standard so far as accountancy is concerned and, for that reason, they are deplored by the profession as a detriment to sound social and economic development. The bridge should not be crossed before it is reached, however. All the dire possibilities of inflexibility and rigidity in accounting practice promulgated by government control seem to disappear when one looks in retrospect at the fair, open-minded attitude of the Securities and Exchange Commission.

In closing this thesis and basing an opinion on an intensive survey of S.E.C. Accounting Releases, Decisions and Reports, books, articles, and pamphlets on the subject, the writer feels qualified to say that the influence of the authority of the Securities and Exchange Commission constitutes one of the greatest, if not the greatest, single aid to the development of sound accounting principles and forms of presentation of financial statements in the history of the accounting profession.

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