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THE NATIONAL SECURITIES EXCHANGE BILL

SENATE 2693

MEMORANDUM SUBMITTED TO THE SENATE COMMITTEE ON BANKING AND CURRENCY

In response to the request of the Chairman made at the conclusion of my testimony before the Committee on March 8, I submit a memorandum regarding the suggestions which I then respectfully offered. These suggestions were briefly as follows:

SECTION 12:

(a) Insert a provision enabling the regulating body to dispense with the filing of quarterly statements in any case or class of cases in which it might deem such statement likely to be misleading or the filing thereof undesirable for any other cause.

(b) Limit the requirement of certified statements to the filing annually of one balance sheet and one statement of income and profit and loss for a full year.

(c) Make the provision regarding certified statements sufficiently flexible to permit of the distribution of the auditing required so far as possible over the year in such way as may be most desirable in the general interest.

SECTION 17:

Limit the liability under this section to cases in which the issue of false or misleading statements is shown to have been wilful.

NOTE: The provisions in this section regarding the measure of damage seem open to criticism, but if the liability is limited to wilful misstatement this point becomes of minor importance.

SECTION 18:

Strike out Section 18 (b), or amend it so as to limit the authority of the Commission to the power to prescribe what information shall be set forth in balance sheets and earnings statements.

Of these suggestions, that looking to the distribution of audit work more evenly over the year is put forward because on the basis of a long and wide experience I am convinced that the adoption of this simple proposal would add very greatly to the efficiency of audits and enable them to be conducted at lower cost and prove generally convenient to all those who are concerned with the study of audited accounts after they have been issued. All the other suggestions are inspired by a profound conviction of the importance of recognizing in any such legislation that accounts are not statements of fact, but necessarily represent the results of the application of accounting principles and judgment to facts.

The misconceptions on this point have been so widespread that it may be worth while to present an illustration which will emphasize the point I have made. I take one from the field of motion pictures, which has now become an important branch of industry. The income of a motion picture producer is, of course, derived mainly from rentals, and is largely dependent on the cost of the picture and the length of its run. In connection with the production of the picture many stage properties are required which may or may not be useful in other productions, so that the cost may or may not be chargeable in total against the picture for use in which they are purchased in

the first instance. The studio will naturally have large overhead expenses which must be apportioned between the pictures which have been or are expected to be produced during the year. Some principles have to be adopted for apportioning this overhead expense, and there is need for the exercise of a considerable amount of judgment in applying the principles and dealing with such expenditures as those for stage properties. Supposing the cost of the picture to be satisfactorily determined—what proportion of this cost is to be charged against each dollar of rental received?

In the early days, the simple rule was adopted that all rentals were applied against the cost until the cost was recovered, and thereafter all rentals were profits. Obviously, such a result was conservative but quite unscientific. If the picture as a whole produced a profit, some part of each dollar of rental received should be deemed to be profit. After careful research it was discovered that the earnings of the ordinary picture followed a more or less well-defined curve, being naturally greatest in the early days of presentation and gradually tapering off to zero at the end of, perhaps, two years. Consequently the practice became general (and has been recognized by the Bureau of Internal Revenue) of computing the income on the basis of writing off the cost of the picture against the rentals on the basis of such curves. Clearly, however, there is even greater need for the exercise of judgment in determining the precise shape of the curves to be used, and naturally when this has been done the experience of every picture will not conform to any such curve, so that constant watchfulness and the

exercise of constant judgment is necessary to insure proper statements of income.

The need for judgment in selecting and applying accounting principles or conventions which I have shown to be necessary in this case is necessary in greater or less degree in almost every business—certainly in every case in which either the exhaustion of fixed property or the carrying of inventories is an incident of the business. It is not true only of complex businesses. I chose for illustration on another occasion the case of one of the unemployed who engaged in the business of selling apples on the street corner and continued in it for only four days, and showed that the same situation (of course, on a small scale) existed in that case.

There is no dispensing with judgment in the preparation of accounts. Obviously, those most intimately associated with the business possess in the highest degree the knowledge which is necessary for the exercise of judgment. But they are not disinterested. The method of audited accounts which involves in the first instance the preparation of accounts by the officers of the company who are most familiar with its operations, and the examination thereof by qualified independent accountants possessing a wide general knowledge of business and able to take a disinterested and objective view of the position is, I believe, now generally recognized as the best combination that has been evolved for producing satisfactory accounts.

In so far as principles of accounting are necessary for the purpose, I think corporations should be allowed to exercise judgment provided that they recognize certain fundamental principles which are so well estab-

lished that they may fairly be given general application, and provided, also, that these principles are definitely laid down and consistently followed. This method of dealing with the problem, I note, has recently been recommended by the Twentieth Century Fund as a result of its survey of the Stock Market ("Stock Market Control" by Evans Clark and others, page 174). Care must, however, be taken to limit the requirements of auditing so as to avoid making them unduly burdensome on the corporations and the investors therein.

With these general observations, I will proceed to a discussion of the specific suggestions which I have made.

SECTION 12: It follows from what I have said that there is room for error or difference of opinion in regard to the earnings of a business corporation for any period, and, broadly speaking, *the shorter the period the greater relatively becomes the possible margin of error*. The extent thereof will vary with different businesses; it will be wide in any case in which inventories are large in proportion to profits, particularly if the inventory consists mainly of commodities which fluctuate in value. Thus monthly or quarterly statements of earnings of a packing house or a leather company are of little value and probably as likely as not to be misleading unless accompanied by very full explanations.

It is sometimes urged that such statements are at least valuable because comparison with the corresponding period of a preceding year can usefully be made. But unless much more than the bare results

are published, this will not necessarily be true. Innumerable illustrations could be cited to demonstrate this point. I will take only one—a comparison of the earnings of a corporation engaged in the sale at retail of winter clothing for quarters ending in December and March respectively with the corresponding figures for the preceding year may be quite misleading if in one year winter has come early and in the other, late, so that in one case business was delayed until after January 1 which in the other case matured in December.

I have always been opposed to the suggestion that the New York Stock Exchange should make the publication of quarterly statements a uniform requirement for listing, and therefore I urge that power at least should be given to the regulating body to waive such a requirement in any case in which it believes that to do so would best serve the public interest.

If quarterly statements are to be published, I feel strongly that it is the duty of those who are seeking to help the public to emphasize the fact that while such statements may have value, that value is distinctly limited. This, for two reasons—first, that as I have already pointed out, allocations of profits to short periods of time can only be approximate and arbitrary; and, secondly, that the value of securities depends on the future, and that statements of past results are valuable mainly as they afford an indication of the reasonable expectations for the future, and profits for a quarter or other short period are an entirely unsafe basis on which to rest an estimate for the future.

The Committee is naturally anxious to do what it can to put those possessing inside information and the members of the general public as nearly as possible

on an equality in dealing in securities, but it is faced with the insuperable obstacle that the advantage of the insider rests upon the fact that he has knowledge and qualifications for estimating the future which are not possessed by and cannot possibly be extended to the general public. His advantage is not that he knows what the past earnings have been, but that he can judge what future earnings are likely to be—and no one would suggest that corporation executives should be compelled by statute to prophesy.

To require that quarterly statements should be certified by accountants would be to ascribe to them an importance which they cannot possibly merit. This is the principal reason which leads me to suggest the elimination of this requirement from Section 12. Other reasons are, that to require that quarterly statements should be audited before being published would involve a substantial delay in the presentation of figures which owe a large part of any value they possess to their timeliness, and that it would involve a very heavy burden of expense. I have no means of estimating how great this burden of expense would be, but it would certainly run to very large figures. I should not regard this as a fatal objection, but I should regard the expenditure as not merely wasted, but as actually being devoted to an undesirable end.

I believe, however, that in this matter Congress has an opportunity to take a very simple but very effective step to improve present audit practice. The most serious problem which the auditors of the accounts of listed corporations have to face is that audits are required at the close of the fiscal year, and that the great majority of corporations end their fiscal year with the calendar

year, with the result that there is an enormous congestion of work in a few months. The existence of this condition adds to the cost and detracts from the efficiency of audits, and it could easily be avoided by a simple provision such as I have proposed.

In many industries, December 31 is a most unnatural time for closing the accounts. In a few instances, this fact has been recognized and another closing date has been selected—thus the packing houses generally close their accounts at the end of October. But assumed convenience in income tax affairs and similar considerations have led many corporations to adopt the calendar year as their fiscal year, although accounts for a period ending at some other date would be more informative. The natural closing date for automobile and tire companies would be September 30 or October 31. Formerly all the railroads closed their accounts at June 30. A discretionary provision such as I have suggested would admit of the work of auditing being distributed more equally over the entire year, thus not only reducing the cost and increasing the efficiency of audits, but contributing to the convenience of the exchanges and regulating bodies, and others who are called upon to scrutinize audited accounts when issued. I recognize that in the past audits of corporations other than financial institutions have usually been made at the close of the calendar year, but any inconvenience that might result from a change in this respect would be trivial in comparison with the advantages to be derived from a better distribution of the work of auditing over the entire year. Of course, the requirement of quarterly audits as proposed in the bill would

itself result in the equal distribution of work over the year which I regard as so desirable, but only at an undue expense to the corporation and the investors therein.

SECTION 17:

I urge that the liabilities imposed by Section 17 should be limited to cases in which the issue of false or misleading statements is shown to be wilful, because I am convinced that it is contrary to the public interest to impose such liabilities for honest error, either of fact or of judgment. Particularly is this true in respect of statements which are so largely matters of judgment as quarterly statements of profits. It is notorious that sometimes the most truthful statement may be the most misleading because of the unwarranted inferences to which it gives rise.

In the long run, the main part of the financial burden imposed by this section will fall upon the corporation—that is upon the investors, whereas the benefits thereof would accrue mainly to speculators, and I do not believe it is wise to place burdens on investors for the benefit of speculators.

The provisions of the section relating to the measure of damages seem to me to be open to serious objection because, as has already been pointed out to your Committee, they would enable damages to be recovered which would bear no relation to the damage actually suffered, and this seems to me to be a vicious principle, particularly if it is to be applied to cases of honest error, either of fact or of judgment. If the section is limited to cases of wilful misrepresentation, I do not suppose anyone would be concerned over a possible undue liberality in the measure of damages.

SECTION 18:

I now turn to Section 18 (b), which confers on the regulating body not only the power to prescribe the form in which accounts shall be presented, but how profits shall be computed.

I have said, and it cannot be too often repeated, that accounts necessarily represent the result of the application of appropriate accounting principles and judgment to facts. Upon the soundness of the judgment employed first in choosing and then in applying the guiding principles depends the value of the resulting accounts. Sound judgment can be based only on intimate knowledge and ample experience, and its exercise should be attended with responsibility. I believe the provision is unwise in so far as the sub-section would vest the right to exercise this judgment in a commission which would have no responsibility, legal or moral, for the consequences that might ensue, and would necessarily lay down general rules which might or might not fit the specific cases to which they would have to be applied. I recognize that similar powers have been vested in the Interstate Commerce Commission and other bodies; but while our theories of rate regulation probably necessitated some such procedure in the case of railroads and other public utilities, the results are to my mind none the less unfortunate because they may have been inevitable.

In the first place, the idea that uniformity can be attained and the exercise of discretion rendered unnecessary by rules, however detailed, is entirely illusory. Today, after more than a quarter of a century of intensive development of the accounting classifications of the Interstate Commerce Commission, it is still pos-

sible to produce widely different accounting results from a slight difference in the form of treatment of substantially identical transactions. Moreover, under those classifications, while manuals running to hundreds of pages exist in which the treatment of innumerable items large and small is prescribed in meticulous detail, it is still necessary to allow the railroads to determine the monthly charges to many important operating accounts on the basis of budget estimates of future expenditures. In respect of other important elements, such as depreciation, the practice of regulated companies still varies widely. Meantime, the uninformed public assumes a uniformity and a comparability between accounts of different railroads and utilities which does not exist and can never be attained.

In the second place, uniformity necessarily means a uniformly low standard—indeed, laws can do no more than lay down minimum standards; higher standards can come only as the result of the recognition of ethical and moral obligations. The accounting standards of the majority of industrial corporations with which I am acquainted are distinctly more conservative than those of regulated corporations.

In 1932, a committee of the American Institute of Accountants, as a result of a study of the general question, rendered a report, a copy of which was put in evidence before the Senate Committee by the chairman of the Committee on Stock List of The New York Stock Exchange on January 12, 1933. In that report, the Committee recommended to the Exchange, *inter alia*, to use its influence—

“To make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general accept-

ance, and within the limits of such broad principles to make no attempt to restrict the right of corporations to select detailed methods of accounting deemed by them to be best adapted to the requirements of their business; but—

(a) To ask each listed corporation to cause a statement of the methods of accounting and reporting employed by it to be formulated in sufficient detail to be a guide to its accounting department; to have such statement adopted by its board so as to be binding on its accounting officers; and to furnish such statement to the Exchange and make it available to any stockholder on request and upon payment, if desired, of a reasonable fee.

(b) To secure assurances that the methods so formulated will be followed consistently from year to year and that if any change is made in the principles or any material change in the manner of application, the stockholders and the Exchange shall be advised when the first accounts are presented in which effect is given to such change.

(c) To endeavor to bring about a change in the form of audit certificate so that the auditors would specifically report to the shareholders whether the accounts as presented were properly prepared in accordance with the methods of accounting regularly employed by the company, defined as already indicated.”

I believe that this method of approach to the problem would prove more practically effective than an attempt to institute uniform accounting. I understand, however, that the Department of Commerce is at the present time conducting a study into the whole question of uniform accounting and uniform

statistics. Legislation on the subject does not seem to me to form an essential part of a law the primary purpose of which is the regulation of stock exchanges and stock exchange practices, and I would urge that Sub-section 18 (b) should be eliminated and the whole question dealt with on its merits in the light of full information such as I trust will be developed through the inquiry to which I have referred.

Respectfully submitted,

GEORGE O. MAY,

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March 10, 1934.