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Editorial

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A. P. RICHARDSON, *Editor*

EDITORIAL

Regulation of Security Issues

The president of the New York Stock Exchange, Mr. Seymour L. Cromwell, in a recent address discussed the subject of publicity in connection with the issuance of securities and the remedies for bucketshops and fraudulent stock promotions. Mr. Cromwell recognized the evils that exist and the responsibility resting upon the stock exchanges in connection therewith, and pledged the important exchange which he represents to full cooperation in carrying forward a sane programme of reform. After discussing the defects of various measures, which have been proposed, Mr. Cromwell, as reported in the daily press, urged the following constructive measures:

"Our position," he said, "is simply this:

"If we are to have new legislation, let us make sure that the new laws really get down to the root of the evil. We already have punitive laws. Let us find additional ways of making such laws applicable to offenders and of making their enforcement more easy.

"A simple way of getting right down to the bottom of our problem would be the passage of a law requiring full publicity in connection with the issuance of securities and the status of the issuing companies. That is in line with the English practice.

"Require that sworn statements be filed prior to the issuance of securities and semi-annually thereafter, and that the statements give adequate information concerning the flotation and the financial position of the issuing companies or parties, and also concerning their operations and earnings. That would strike a vital blow at the fake promotion because you would get the jump on it from the start.

"Officials of companies whose securities are offered for sale would immediately lay themselves open to punishment and could be easily reached by the present laws if they furnished doctored

information to bolster up a swindling promotion. Let us pin the responsibility where it belongs, on the people who furnish the background for the dealer in fake securities, and we will soon make it impossible for such dealers to operate.

"That kind of legislation the stock exchange will support—something that is simple, direct, easily enforceable and that will really give protection to the public."

Most reformers in this field have spoken with more zeal than knowledge and have urged legislation which would be too far-reaching and bound, therefore, to be ineffective. Human nature being as it is, financial speculation can not be abolished; indeed, economic progress would undoubtedly be retarded if it were abolished. The pioneer in every field is in a sense a speculator, although it does not necessarily follow that every speculator is a pioneer. If people wish to invest in speculative securities they are entitled to do so. They may be foolish and perhaps ought to be dissuaded from their course, but such work does not belong to the legislature. What can and should be done by legislation and effective public administration is to throw a light of publicity upon the issuance of securities that will enable investors to judge for themselves whether a given security is sound or whether and to what extent it is speculative. The investor has a right to invest in a speculative security, but he is wronged when a speculative security is represented to him as a sound, conservative investment. Further than this he is entitled to be protected against secret contracts or arrangements among those on the inside.

Mr. Cromwell does not present his programme as something new or novel but states that it is along the lines of the English practice, and he might have added truthfully that this practice has worked well for many years. The provisions of the English companies act relating to this general subject have to do with (a) prospectuses, (b) reports required from companies, and (c) the audit of the accounts submitted to stockholders, and at the risk of repeating what is familiar to many of our readers the more important of these provisions are given as follows:

PROSPECTUSES

Sec. 81—(1) Every prospectus issued by or on behalf of a company, or by or on behalf of any person who is or has been engaged or interested in the formation of the company, must state—

- (a) the contents of the memorandum, with the names, descriptions, and addresses of the signatories, and the number of shares subscribed for by them respectively; and the number of founders or management or deferred shares, if any, the nature and extent

- of the interest of the holders in the property and profits of the company; and
- (b) the number of shares, if any, fixed by the articles as the qualification of a director, and any provision in the articles as to the remuneration of the directors; and
 - (c) the number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued, and
 - (f) the names and addresses of the vendors of any property purchased or acquired by the company, or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus, or the purchase or acquisition of which has not been completed at the date of issue of the prospectus, and the amount payable in cash, shares, or debentures, to the vendor, and where there is more than one separate vendor, or the company is a sub-purchaser, the amount so payable to each vendor: provided that where the vendors or any of them are a firm the members of the firm shall not be treated as separate vendors; and
 - (g) The amount (if any) paid or payable as purchase money in cash, shares, or debentures, for any such property as aforesaid, specifying the amount (if any) payable for *goodwill*; and
 - (h) The amount (if any) paid within the two preceding years, or payable, as commission for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in, or debentures of, the company, or the rate of any such commission: provided that it shall not be necessary to state the commission payable to sub-underwriters; and
 - (i) The amount or estimated amount of preliminary expenses; and
 - (j) The amount paid within the two preceding years or intended to be paid to any *promoter*, and the consideration for any such payment; and
 - (l) The names and addresses of the auditors (*if any*) of the company; and
 - (m) full particulars of the nature and extent of the interest (if any) of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in the firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as a director, or, otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company.

REPORTS AND AUDITS*

106. Once at least in every year the directors shall lay before the company in general meeting a profit-and-loss account for the period since the preceding account or (in the case of the first account) since the incorporation of the company, made up to a date not more than six months before such meeting.

107. A balance-sheet shall be made out in every year and laid before the company in general meeting made up to a date not more than six months before such meeting. The balance-sheet shall be accompanied

*NOTE: Similar provisions appear under section 94-A of the Dominion companies act (1908) as amended in 1917 in Canada.

by a report of the directors as to the state of the company's affairs, and the amount which they recommend to be paid by way of dividend, and the amount, if any, which they propose to carry to reserve fund.

108. A copy of the balance-sheet and report shall, seven days previously to the meeting, be sent to the persons entitled to receive notices of general meetings in the manner in which notices are to be given hereunder.

109. Auditors shall be appointed and their duties regulated in accordance with sections one hundred and twelve and one hundred and thirteen of the companies (consolidation) act, 1908, or any statutory modification thereof for the time being in force.

Under the foregoing provisions the most speculative enterprise can be floated and anyone familiar with the prospectuses appearing from time to time in England is struck by the number of highly speculative issues; but the investor in such securities knows that he is taking a risk and he also knows that the company officials, promoters and bankers are responsible for the representations made to him. In like manner an investor seeking a safe investment can identify that article, and all investors know that a high standard of good faith is required of everyone who offers securities to the public. This is the end to which we should aim, and the recommendations made by Mr. Cromwell are timely and wise.

Federal Tax Problems

Federal taxation was the subject of two of the papers presented at the September meeting of the American Institute of Accountants and both of them appear in this number of THE JOURNAL. Mr. Montgomery does not, indeed, discuss taxes so much as the attitude of members of congress and American business men toward the subject. Business men could influence congress if they would think through financial and economic problems. They ought to be able to advise upon these matters, but when business men appear before congress or its committees they too often come seeking a benefit for themselves or their trade-group or else they want to show how to place a burden on some other group. It is not strange, therefore, that business men fail to influence legislators more than they do.

The fact is that our tax problems are so complicated that there are few men in or out of congress who have gone far below the surface. This is excellently illustrated by the fact that upon so fundamental a question as that of the taxation of capital gains there is still room for difference of opinion. Mr.

May's paper upon this subject certainly shows that our attempts to tax such gains as income have produced highly imperfect results. When a few years ago, we adopted the income tax we decided, with substantial unanimity, to tax capital gains and now we are not happy over it. England, with a much longer experience in income taxation, has not taxed capital gains, but of late she has shown signs of uneasiness over her methods.

During the war it was often said that the world was going to be different, and, while we now have less optimism about the kind of new world, we realize that the world is different, and in nothing is it more different than in its tax problems. To compare pre-war tax laws with the provisions of the revenue act of 1921 is like comparing the "one hoss shay" with a high-powered motor car. At first we thought the problem was one of rates, and in a sense it is, but we now find that high rates bring a whole train of circumstances in their wake—things which nobody thought of before and not the least disconcerting of the lot is the fact now amply proven that very high rates tend to defeat their purpose and soon lose productivity. Perhaps it is something like the old law of nature which provides in the animal world that as the scale of intelligence increases the rate of productivity decreases.

It will probably take years of practical experimentation to determine the best tax policy. Little light is thrown upon the subject by past experience; and we have been and still are facing what is in fact an entirely new problem, although it came to us clothed in the garb of an old problem. The amount of revenue that must be raised by taxation is so staggering that all our tax machinery was inadequate and it is not to be marvelled at that our first and somewhat hastily devised plans have not worked entirely well. In perhaps no other field of human effort is there a wider difference between theory and practice. In theory the excess-profits tax can be defended. It is logical and appears to be sound. In practice it has proved to be impossible, except during war time and as a war measure. As a permanent institution its machinery is too complicated to work. The real argument against an excess-profits tax is found, therefore, not in theory but in its impracticability. Much the same considerations apply to the allowance of a deduction for depletion in computing taxable net income. In theory such a deduction seems imperative but in practice it involves questions

of valuation, of engineering and of accounting which may well lead one to ask whether the matter could not better be dealt with by some special allowance or by a change in the rates applicable to income from natural resources.

The taxation of capital gains is probably more sound in theory than the other rule which has been followed so long by England. If the plan is unsound, it must, we think, be unsound because in practice it does not yield satisfactory results, and before accepting this point of view the students of the subject will want to study the defects and if possible cure them by less drastic action than would be involved in a reversal of policy. One other form of tax seems to merit more discussion than has yet been given to it. Last year Representative Mills of New York introduced in congress a bill providing for a tax on spendings. Probably the need for revenue could not be met entirely by a spendings tax alone, and it would have to be coupled for the time being at least with an income tax. Having regard to the vast and growing bulk of tax-free income and the delay that must be encountered in securing a constitutional amendment permitting the taxation of income from future issues of state and municipal securities, the situation is most unsatisfactory and a spendings tax offers a means of at once imposing a tax which will to some extent be levied upon the persons who now enjoy tax-exempt income.

Accountants ought to lead in the discussion of these tax problems and THE JOURNAL will welcome thoughtful contributions upon the subject.